Sharī'ah Evaluation of Financial Derivatives and Developing *Sharī'ah* Compliant Hedging Instruments

Thesis submitted in partial fulfillment of the requirements
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PhD in Islamic Banking and Finance

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***Sharī'ah* Evaluation of Financial Derivatives and**

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STATEMENT OF DECLARATION

I, Muhammad Daraz Khan, do hereby declare and affirm that the thesis titled "*Sharīʿah* Evaluation of Financial Derivatives and Developing *Sharīʿah* Compliant Hedging Instruments" is the presentation of my original research work and based on genuine and authentic sources on the relevant subject. Any part or portion that appears in this study has not been used in support of an application for another degree in qualification to this or any other University or institution of higher learning. Wherever contributions of others are involved, efforts have been made to indicate that clearly in that relevant portion, with due reference to the sources, literature. This thesis has been undertaken by me under the supervision of Professor Dr. Mohammad Tahir Mansoori, Ex-Vice President Higher Studies and Research & Professor Department of *Sharīʿah*, Faculty of *Sharīʿah* and Law and Dr. Abdul Rashid, Associate Professor, International Institute of Islamic Economic (IIIE) as Co-Supervisor of the International Islamic University, Islamabad. I also declare that this thesis is for seeking the Doctoral degree in Islamic Banking and Finance.

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STATEMENT OF COPYRIGHT

DEDICATION

I dedicate with gratitude and affection this piece of work after the grate educator Holy Prophet Muhammad (S.W.A) to my Sweet Father Mian Muhammad (late) may Allah shower His countless blessings on his soul.

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First of all, I am extremely thankful to Almighty Allah, the most beneficial and the most merciful, whose blessings are showering on me throughout my life and who gave me the strength and wisdom to conduct and complete this Study. I admit my heartfelt gratitude to the Holy Prophet (PBUH) who had spread the light of knowledge and learning in this world and for whom the world has been created. I acknowledge the care and support of my family that enabled me to undertake my studies with diligence and determination.

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ABSTRACT

Sharī'ah Evaluation of Financial Derivatives and Developing *Sharī'ah* Compliant Hedging Instruments

The usage of conventional derivative instruments i.e. Forwards, Futures, Options and Swaps, from *Sharī'ah* perspective, have been controversial. Opinions of the *Sharī'ah* Scholars on the permissibility or impermissibility of these instruments is divided. Modernists (which are in minority, including Mohammad Hashim Kamali, 'Alī El-Gārī, Obiyatullah Ismath Bacha, Sāmi Hamoud and Al-Misri, Muhammad Al-Bashir and Muhammad Al-Amin etc.) appear relatively more liberal, they are of the view, that these instruments can be made acceptable and compatible in Islamic Finance subject to certain adjustments and by updating and removing the un-Islamic element from their methods and usage. They have based their reasoning on various grounds such as public interest, objectives of *Sharī'ah*, analogy on *Salam* and *Istisnā,* needs of the modern business requirements and on the provisions of *Malikīs* and *Hanbalīs* schools which appears relatively more liberal as compare to *Hanafī* and *Shaf 'ī.* However, their reasoning and justifications are not acceptable to many other jurists.

On the other hand Traditionalist (they are in majority) are of the opinion that the already existing conventional instruments such as forward, futures, options and swaps are un-acceptable in *Sharī'ah* due to their involvement of various *Sharī'ah* prohibitions such as *riba, gharar,jahal or* ignorance and excessive speculation etc. However, much of their work is of a juridical nature, even the basis or stated reason of their objections and non-acceptance has been found based on very different grounds. Further, they examine the same

within the narrow boundaries of contractual arrangements and thereby miss the broader picture i.e the public needs and *Maqāsid al-Sharī ah* of why instruments like futures and options are needed in modern business environments. So this commonly held opinion that Derivatives are totally un-Islamic and there is no need for such type of instrument may not be entirely accurate.

This study attempts to understand the exact nature and need of these instruments and to clarify the actual *Sharī'ah* position on the legitimacy or otherwise of these contracts and to give a clearer picture of these instruments widely used for hedging and speculation in conventional finance. On the basis of inductive method and descriptive research by displaying texts, previous literature, opinions of the jurists from Islamic law perspective and current industry practices, the study concludes that, in principle, the current application of these instruments in the financial markets are impermissible and not *Sharī'ah* compliant due to existence of a number of forbidden elements from *Sharī'ah* perspective such as gambling, *gharar* (ambiguity), *riba* (usury), harm speculation and other illegal activities that are still in the circle of debate among Muslim scholars.

However, the overall prevalence of this negative approach and the The use of Islamic derivatives in some jurisdiction and not in others on the one hand and the lesser clarity regarding their *Sharī'ah* compliance on the other hand have created uncertainty and thus hindrance for the Islamic financial institutions in properly managing the associated risks. Hence, it was significant to address and analyze the existing instruments and to hunt *Sharī'ah* compliant alternative avenues of investment so that Islamic financial institutions do not find themselves in an unfavorable position. Therefore, we suggest that *Sharī'ah* has some risk management strategies that may be compatible with *Sharī'ah* principles and at the same time can achieve the same objectives as conventional derivatives. Thus, the closest alternative contracts having derivative like features are available in Islamic finance that could be considered and used as the basis or building block for Islamic Derivatives as proposed by *Sharī'ah* scholars and practitioners such as the *Ba'y Salam*, *W'ad* and *Murābahah* based arrangement, *Istijrar, Khiyār al-Shart and Arbūn* contracts have been examined. Theoretical i.e jurisprudential concept and requirements of these instruments and practical procedure (modus operandi) along with process flow, industry usage of these Islamic concept/products have been structured out which can simultaneously be used for the same purpose of hedging the risk and achieve almost the same goals as those provided by conventional derivative instruments. The market participants who are concerned with *Sharī'ah* principles will be able to identify and propose the similar instruments without violating the Islamic principles.

Keywords: Derivatives, Forwards, Futures, Options, Swaps, *Sharī'ah* compliant hedging, *Salam, Wa'ad, Murābahah, Istijrār, 'Arbūn, Khiyār al-Shart*, Islamic profit rate , Islamic Forex, Islamic Cross Currency.

LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institution
ADRM	Alternate Dispute Resolution Mechanism
CLA	Central Lending Agency
IBP	International Best Practices
ICAP	Institute of Chartered Accountants Pakistan
IDB	Islamic Development bank
IFA	International Fiqh Academy
IFIs	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
IRTI	Islamic Research and Training Institute
ISDA	International Swaps and Derivatives Association
IIFM	International Islamic Financial market
PRs	Prudential Regulations
RSS	Regulated Short Selling
SAC	*Sharī'ah* Advisory Council
SBP	State Bank of Pakistan
SBL	Securities Borrowing and Lending
TMA	Tahawwut Master Agreement

CHAPTER NO. 1

INTRODUCTION, SIGNIFICANCE, SCOPE AND LIMITITION OF THE RESEARCH

1.1. Introduction to the Research Topic

The existence of risk in every pace of life cannot be avoided, however, in financial matters, it obtained a special importance rather its management is a stupendous challenge for financial institutions. It may be regarded as the distinctive feature of the modern day business. Even in ancient societies, while making financial decisions, people were well aware that lending to a person who is a bankrupt has a high risk of losing the money as compared to a borrower with sound standing. In the financial market, the participants are frequently exposed to several risk including the most significant "financial risks" i.e. the uncertainty of interest rates, stock prices, exchange rate and commodity prices. The means of dealing with these financial risks are called derivatives.[1] According to Samī al-Suwailem, financial derivatives are the financial instruments used for trading the risk and for the purpose of distribution of risk among the market players; if this is done properly, then each market player will be better off, leading to productivity and efficiency.[2]

Financial derivative has been defined as "a financial instrument whose value depends on the value of other, more basic variables".[3] Derivative instruments includes forwards, futures, options and swaps. Whereas in derivative markets almost all of the world basic

[1] D. M. Chance, *'An Introduction to Derivatives and Risk Management'*, (Ohio: Thomson Learning, 2004), 3.
[2] Sāmi al-Suwailem, *'Hedging in Islamic finance'* (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, 2006), 40.
[3] J. C. Hull, *'Options, futures and other derivatives'*, (New Jersey: Prentice Hall. College, Upper S. River, 2005), 2.

universal commodities, like wheat, corn, cotton, cocoa, rubber, timber, aluminum copper, zinc, coffee, sugar, and various kinds of oil, etc. have been traded. Therefore, the production, investment and pricing of these universal commodities are basically affected through the use of derivatives as a tools of risk mitigation by the market participants. Every individual feels the impact of these markets, for example, 'Oil' is one of the world's most common and important commodity, the price of 'Oil' is usually determined by the use of Oil derivative transaction.[4]

The popularity and growth rate of derivatives is too high, as compared to any other asset or security in the worldwide economy.[5] The growth rate and popularity of derivatives are due to their flexibility and ease of use; as buying and selling of derivatives are easier than the financial asset or underlying commodity, such as, metals, currencies, energy, stock indexes and agricultural commodities etc. They are considered the valuable substitutes, to hold a financial asset or under lying commodity, as relatively quite small amount of wealth is sufficient for trading in derivatives then the amount required to buy the actual asset or commodity.[6]

Derivatives are frequently used for hedging, arbitrage or speculation, apart from other purposes. Hedgers use derivatives to manage uncertainty and to reduce financial risk that the price of things might move against them. On the other side, speculators and arbitrageurs

[4]Muhammad al-Bashir Muhammad al-Amine, '*Risk Management in Islamic Finance an Analysis of Derivatives Instruments in Commodity Markets*', Mark Holy, M. L, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), 11.
[5]Sāmi al-Suwailem, '*Hedging in Islamic finance*', (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, 2006), 30.
[6]Hans R. Stoll and Robert E. Whaley, '*The new option Market in future Markets: their economic role*', ed. Anne. E. Peek (Washington, D.C: American Enterprise Institute for public policy research, 1985), 2.

use derivatives to bet on it, to earn profit from the differences in the market prices and to take advantage from simple speculation.

1.2. Significance, Scope and Limitation of the study:

The apparant purpose of derivatives is to manage risk, to enable hedging, but the irony is that these financial instruments are mostly used for arbitrage and speculation, contrary to their intended objectives.[7] According to the U.S Department of Treasury "hedgers are in minorities in the derivatives market. Speculators dominate the market".[8]

Recently, the financial crises and market instability has been blamed on the speculative usage of these instruments. Due to dominancy of the speculation, apart from other reason, they have been rejected by most of the *Sharīʿah* scholars in Islamic finance and consider them against the norms of *Sharīʿah*.[9] Since the conventional derivative instruments for hedging have been controversial among Islamic scholars and many questions arise regarding the evaluation of these instrument to be *Sharīʿah* compliant or in disharmony with Islamic principles. Moreover, Islamic Investors are also exposed to similar nature of global risks, to improve investors' confidence to participate in international trade and to provide them the possibilities for new *Sharīʿah* compliant avenues of investment. Thus the development and innovation of a wide range of Islamic instruments is the need of the today

[7]Adam Tickell, *'Unstable futures: controlling and creating risks in international money'* (Socialist Register, *1999). http://socialistregister.com/socialistregister.com/files/SR-1999-Tickell.pdf, lat accessed 13.10.2016.*
[8]Sāmi al-Suwailem, *'Hedging in Islamic finance'* (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, 2006), 45.
[9]Toby Birch, *'The role of derivatives in creating the financial crisis'* (Jeddah: in Symposium of the al-Baraka Group, 2009), 6.

business requirement to provide the Islamic financial industry with the effective and sound risk mitigating instruments, to fulfill the public needs and to enable them to compete in the international market.[10]

Islamic Jurists' opinion regarding the permissibility or other wise of the conventional derivative instruments appears to be mixed. Much of the work is that of a juridical nature. Even the basis or stated reason of their objections for non-acceptance have been found variant and based on different grounds. This is further clouded through differences of the scholars among the various *Madhāhib i.e Hanafī , Malikī, Shaf ī and Hanbalī* and their preference on the basis of their affiliation. With respect to derivatives, two main approaches can be categorize, Modernists (which are in minority, including Mohammad Hashim Kamali, ʿAlī El-Gārī, Obiyatullah Ismath Bacha, Sāmi Hamoud and Al-Misri, Muhammad Al-Bashir and Muhammad Al-Amin etc.), appears relatively to be more liberal, they are of the view, that these instruments can be made acceptable and compatible in Islamic Finance subject to certain adjustments and by updating and removing the un-Islamic element from their methods and usage. They have based their reasoning on various grounds such as public interest, needs of the modern business requirements, objectives of *Sharīʿah*, and on the provisions of *Malikī* and *Hanbalī* schools which appears relatively more liberal as compared to *Hanafī* and *Shafʿī*, however, their reasoning are not acceptable to many other jurists.

On the other hand Traditionalist (They are in Majority) are of the opinion that the already existing conventional instruments such as forward, futures options swaps are un acceptable

[10] Ibid, 10.

in *Sharīʿah* due to their involvement of various *Sharīʿah* prohibitions such as *riba, gharar, jahal* or ignorance and excessive speculation etc. However, much of their work is of a juridical nature, even the basis or stated reason of their objections and non-acceptance have been found based on very different grounds and examine the same within the narrow boundaries of contractual arrangements and thereby miss the broader picture i.e. the public needs and *Maqāsid al Sharīʿah* of why instruments like futures and options are needed in modern business environments. Moreover, the prevalence of this negative approach has created hindrance for Islamic financial institutions to dig out and to enter into investment areas openly available to conventional institutions. Hence, it is significant to address and analyze the existing instruments and to hunt *Sharīʿah* compliant avenues of investment as alternative to the existing instruments to eradicate the unfavorable position being faced by the Islamic financial institutions.

Sharīʿah scholars who objected to the permissibility of conventional derivatives have highlighted few objections in their critique. However, most of these objections have been rebutted by some modern scholars, like Kamali, who have mentioned various reason and justification for their acceptance. He said that apparently the upholders of these objections, have ignored the operational procedure of the futures and have premised on theoretical *fiqhī* positions on conventional sale. Point wise elaboration of these objections along with their basis, counter-arguments and rationales have been mentioned in the relevant chapter. However, as per views of the majority jurists, the current practice of forward and future trading in the market is not *Sharīʿah* compliant due to the reason that in the future sale both of the counter values differed which is a sale of debt for debt "*Bayʿ al-*

kāli' bi al-kāli"and is prohibited in Sharī'ah. Further, due to the non-existent of the counter values at the time of contract, the future and option sale is involve high risk and *gharar* causing from the sale of a subject matter which is not with you or an asset which is yet not in the possession of the seller, and debt by debt sale and gambling is prohibited.

On the other side, few modern scholars, have rejected the claim of occurrence consensus on the prohibition of the exchange of debts, they argued against this objection. In this regard Kamali has stated that "the legal schools have recorded divergent rulings as to the definition of "*bay' al-kāli bi al-kāli*". Moreover, he mentioned that this *Hadith* "only appears in some collections and many prominent scholars consider it to be unreliable". Kamali further argued that no clear prohibition on the exchange of debts has been found, and a number of scholars have allowed it. Therefore, in the absence of a clear and definite prohibition on the sale of a debt, the principle of permissibility must prevail, provided that it should be devoid of *riba* and *gharar*.

Further, they argued that keeping in view today's sophisticated nature of business and the nature of futures transactions in today's clearing house environment it is an un-avoidable fact that as per practice, the clearing house acts as (guarantor) the seller for each buyer and the buyer for each seller in all futures transactions. So each transaction is guaranteed by the clearing house. Due to this role of the clearing house, no direct interaction of one trader with that of another trader is involved. Thus, there is no 'exchange of a debt for a debt' as each and every transaction ends with the exchange of buying or selling the futures contract. This study has examined in detail these issues and looked at the applications of these to the conventional derivative instruments.

Keeping in view the evolutionary chain, Forward contract has been recorded as the first and simplest derivative instrument.[11] It plays a pivotal role, in modern financial market and serves as the foundation and basic building block for more sophisticated and advanced financial instruments.[12] It is commonly used in import and export trading, especially in important commodities. It is also a basic tool for business planning and risk hedging. However, in its original form, majority of the *Sharī'ah* scholars, declared it as impermissible contract as it involves the illegal sale of "*bay' al-kāli' bi al-kāli*". (the sale of debt for debt)[13] and the "sale of nonexistent things".[14] The study has elaborated in detail these principles and their application to the conventional forward contract.

Though the forward contracts have overcome some of the issues related with risk management, particularly price risk and better planning of the business but in some respect they are still insufficient to fulfill today's business requirement and public needs and has various embedded problems such as it has the double coincidence, to arrive at forward price through negotiation etc. In order to find out solution to the major problems associated with the forward contract, the future contract was introduced and developed in the modern financial system, not only to overcome the problems associated with the forward contract but also to provide more benefits as compared to that already covered by the forward

[11] Robert E. Fink, '*Future trading concepts and strategies*' (Newyork: Institute of finance, 1988), 3.
[12] Obiyathulla I.B. '*Financial derivatives markets and application in Malaysia*', (Serdang: Penerbit University Putra Malaysia, 2001), 14.
[13] Nazih Hammad, '*bay' al-kāli' bi al-kāli*' (Jeddah: Markaz, Abhāth al-Iqtisād al-Islāmī. Jāmi'at al-Malik Abd al-Azīz, 1986), 28.
[14]Ibid

contract. As a matter of fact, a newly innovated product will not be survived unless it provides some value addition over the already existing products. The increasing popularity of futures and having a huge trading volume in the market is the evidence of its benefits over the forward contract.[15] As stated by Bacha "A futures contract is basically a standardized forward contract with regard to the contract size, maturity, quality, place of delivery and the characteristic of being traded in an organized market".[16] However, this contract might be in contradiction with the *Sharī'ah* principle of "not selling prior to taking possession" and that of the "sale of debt for debt".[17] The present study has elaborated the legal aspects of these two *Sharī'ah* principles and find out how they affected the validity of the futures contract in Islamic finance.

Though the future contract have been able to solve the problems associated with the forward contract but they are associated certain problems such as the futures are unsuitable for the management of contingent claim and contingent liability, probability of exposure to subsequent price movement etc. Thus, a new instrument for management such risks was required and as a result the options contracts have been introduced to overcome these problems. The present study have examined the legality of options trading from *Sharī'ah* perspective by describing their concept, economic benefits, types, and scope etc.

However, on the basis of *Sharī'ah* reservations and arguments advanced by the Islamic Jurists, Conventional Derivatives (as above mentioned) cannot be used in Islamic Finance.

[15]Richard J. Teweles, Frank J. Jones, '*The Futures Game Who Wins? Who Loses? And Why*? (McGraw-Hill, New York. 1999), 20.

[16]Obiyathullah I.B. '*Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration*', (International Journal of Islamic Financial Services Vol. 1 No.1), *11*.

[17] Ibid

This non acceptability have lead and deprived the financial institutions and corporation of many advantages associated with derivatives as a suitable risk transfer mechanisms. Especially when they want to expand their activities well beyond their original jurisdictions to almost all over the world. This global diversification of Islamic finance will definitely require new and more flexible updated instruments to manage the associated currency and other risks. Due to today's un-avoidable international business requirement and considerable demand from the public, a *Sharī'ah* compliant instrument for management of risk and for the competitiveness of the Islamic financial institutions and corporations is essential.

Thus, we have mentioned in detail that *Sharī'ah* has some risk management strategies that may be compatible with *Sharī'ah* principles and at the same time can achieve the same objectives as conventional derivatives. So, the closest alternatives having derivatives like features that are available in Islamic finance as proposed by scholars and practitioners such as the *Bay' Salam* (A sale or purchase of a deferred commodity for the present price)[18], *Wa'ad* (a term used in Islamic transaction which means "promise")[19], *Murābahah* (cost plus profit sale), *Istijrār* (A contract between a client and a supplier, whereby the supplier agrees to supply a particular product on an ongoing basis, for example monthly, at an agreed price and on the basis of an agreed mode of payment)[20], *Khiyār al-Shart* (the option to rescind a sales contract based on condition)[21], *Bay' al-'Arbūn* (*a* sale contract, in which

[18] Siddīq al-Darīr, '*Al-salam wa Tatbiqatuhu al-Mu asirah*' (Jeddah: Islamic Research and Training Institute 2003), 5.
[19] Mohd Noor Mohd Ashraf b. Aripin, '*Mechanism of al-w'ad (Promise): Theory and Application in Islamic Banking in Malaysia*' (Serdang: Penertit University Putra Malaysia, 2003), 26.
[20] Mohammed Obaidullah, '*Istijrār: A Product of Islamic Financial Engineering*' (London: New Horizon, Islamic Institute of Islamic Banks, 1997), 8.
[21] Abu Ghaddah, 'Al-Khiyār wa'Atharuhu fi al-'Uqūd' (Jeddah: Dallah al-Barakah, 2003), 19.

a down payment is paid by the buyer)[22]. These available contracts in Islamic finance can be considered and used as the basis or building block for derivative contracts within an Islamic framework.

After comprehensive Discussion on *Bay' Salam*, we can say that *salam* is in line with *qiyās* and not against it, and it could be form the basis of *qiyās* , and it could be used a financing technique for generating working capital. The salam based structure is basically to replicate the mechanics of conventional short-selling, although different solutions seem more acceptable for different regions, however, many Saudi scholars prefer the Salam contract for equities.

The concept of *Wa'ad* is one of the most flexible and useful concept used in almost all products of Islamic Finance. *Wa'ad* has also been considered to be the possible version of the forward contract in Islamic finance as mentioned by the modern jurists, though, this concept is still under debate among the jurists. However, more financiers look to this concept with sympathy. Since the procedural aspects of conventional forward contract is not correct according to *Sharī'ah* due to deferment of both counter values, *Wa'ad* is seen as the most suitable principle to be adopted in the forward contract. Hence, forward foreign exchange transaction may be done on a promise basis instead of a contract.

Under *Wa'ad* structure, only one party promise to buy/ sell certain asset or currency in the future and he is bound by that promise. While the other party will proceed with the promise undertaken by the promissory. Even though *Wa'ad* is binding upon the promissory, but it is

[22] Al- Bājī, '*Al-Muntaqā Sharh Muwattā al-Imām Mālik*. (Beirut: Dar al-Gharb al-Islami, 1991), 230.

not deemed as contract under Islamic law. This is because contract will bind both parties. Islamic financial institutions can enter into forward foreign currency transactions for hedging purposes based on *Wa'ad* but no fee is to be charged on the promise. This is due to the fact that upfront cash payment for forward currency transaction would lead to a bilateral *Wa'ad* which was not allowed by *Sharī'ah.* This is in line with the view of the majority jurists who opined that unilateral-binding *Wa'ad* without any consideration was permissible in a forward currency transaction.

Murābahah is a sale transaction (also known as cost-plus financing) and commonly used as *Shari'a* compliant financing technique, on the asset side of the bank's balance sheet. *Murābahah* is particularly popular and frequently used as Islamic financing technique in the realms of consumer finance and asset finance. Further, *Murābahah* can also be used as a building block for *Sharī'ah* Compliant derivatives such as profit rate swap and/or a cross-currency swap as discussed in the relevant chapter.

The new innovated concept of *Istijrār* and its industry usage along with its stepwise procedure, price determination and documentation have been analyzed which shows that *Istijrār* is an agreement between the buyer and the seller, where a buyer purchases a particular asset on different intervals on an on-going basis from the seller; there in no need of bargain or offer or acceptance each time. All the terms and conditions upon which *Istijrār* to be executed are confirmed in a master agreement. Bacha described *Istijrār* contract as the most complicated among the Islamic contracts which is based on the complex combination of the options, average prices and *Murābahah* agreement (cost plus profit mode). What the *Istijrār* contract attempts to do is to allow for the impact for price changes but to cap the benefits that accure. Since changes are allowed only within a band, the advantage to one party and the disadvantage to the other is capped. The maximum potential gain or loss is limited. Such a contract fulfills the need to avoid a fixed return on risk less asset which would be considered *riba* and also avoids *gharar* in that both parties know up front price and the range of other possible prices. (This concept is recently developed and use in Pakistani market, although yet, has not get frequent utilization by the IFIs).

From the discussion on *Khiyār al-shart*, it is clear that *Khiyār al-shart*. as a tool of risk hedging could serve and fulfill the benefits of conventional options. Moreover, while considering the legality of charging a fee for giving the option, will bring the *Khiyār al-shart* in a similar position to the conventional option as a tool of risk management. This study have addressed in detail the legal basis, terms and ownership related issue during the period of *Khiyār* and how these contracts can be devised as new tools for risk management.[23]

Although some jurists have objected to such a proposition on the grounds that the subject matter in such a transaction will be a pure right, which is not eligible to be the subject matter of a contract. Though, the others have rebutted the same as we have mentioned in detail in the legality of option. However, after comparison of the available options, we can prefer the use of *Khiyār al shart* without charging fee for it.

[23] Sāmi H. Hamoud, '*Islamic Banking: the adaption of Banking practices to confirm with Islamic Law*' (London: Arabian Information, 1985), 180.

Some jurists are of the opinion that on the basis of *'Arbūn* a *Sharī'ah* compliant effective risk management instrument may be developed in Islamic Finance like option contract. By concluding *al-urbun* contract, the buyer must pay a deposit to the seller in advance, but commodity delivery will not be executed until after the payment of the price in full, either during the option period or when it expires. However, it is not possible for Islamic financial institutions to exploit *'urbun* except in the case of purchase as they cannot use it to sell anything before the good is possessed by them. Hence, the concept of *al-urbun* is suitable only for the right to purchase, not the right to sell. Therefore, Aznan is of the views that "structuring of *al-'urbun* to replicate the conventional call option is complicated and may contradict *Sharī'ah* principles if it not considered carefully". Though, the legitimacy of this contract has been controversial between the classical jurists, however, the modern or contemporary scholars are almost in consensus that it is a valid contract.[24] So the legal status of *'Arbūn is* of great importance to be declared while using *'Arbūn as* an alternative to option. Therefore, the study investigated on these issues.

Swaps contracts are another important and smartest nature of contracts in derivative market frequently used by conventional institutions over the last two decades. They are different in nature from the other derivative instruments, especially, because swaps contracts do not take place in an organized or regulated market, therefore, are not subject to any legal conditions acknowledged in the trading process. However, keeping in view the nature of swaps transaction and their difference from other derivative instruments, this study has not undertaken comprehensive literature review on swap transaction but limited to forward,

[24]Muhammad al-Bashir Muhammad al-Amine, *'Risk Management in Islamic Finance An Analysis of Derivatives Instruments in Commodity Markets'*, Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), *22.*

future and options, however, swaps, being an important aspect the derivative market the concept and Islamic alternative to swaps have been discussed. Thus, Islamic alternative to Swap i.e FX Swaps, Cross Currency Swap and Profit Rate Swap as the main products based on the combination of above mentioned Islamic contracts have been examined.

We have discussed in detail the theoratrical i.e. jurisprudential concept and requirements of these instruments and with proper procedure (modus operandi), process flow, industry practices and usage which may paved the way of competition for the Islamic society in the relevant global financial market as these instruments can simultaneously be used for the same purposes of hedging the risk and achieve the same goals as those provided by conventional derivative instruments.

1.3. Statement of the Research Problem/s

To survive and compete in financial sector, Islamic Finance requires *Sharī'ah* compliant structured derivatives as risk hedging instruments in modern Islamic Finance, as conventional derivatives (i.e. forward, future options and swaps) are not in conformity with the *Sharī'ah* principles. However, *Sharī'ah* compliant instruments with derivative like features can be developed in Islamic Finance to be used as risk hedging tools, which will not contradict with the Sharī'ah principles. To explain statement of the research, the following major questions are raised during the course of study:

a) Question No. 1, deals with the concept, development, philosophy and significance of derivatives in conventional finance. So it is related to the conceptual framework and answers to the following questions:

   i. What are derivatives?

   ii. Why they are needed?

   iii. How they are created and settled?

   iv. What are their various kinds?

   v. What are the functions being performed by the clearing house and futures brokers?

b) Question No 2 deals with the Sharī'ah debate on the legitimacy of conventional derivatives and answers to the following major questions:

   i. Whether conventional derivatives (i.e. Forward, Futures, Options and Swaps) are *Sharī'ah* compliant or not?

   ii. What kind of major *Sharī'ah* prohibitions involved derivatives?

   iii. What can be the grounds for admissibility of these instruments (if any) without compromise on *Sharī'ah* principles (based on juridical debate)?

   iv. Up to what extent public needs/interest, *Maqāsid al- Sharī'ah* can be applied for admissibility?

c) Question No. 3 address the Islamic alternatives to conventional derivatives, which have been proposed by the modern Muslim scholars and are in practice in the Islamic finance industry thereby highlighting their procedure, process flow and industry usage. Thus, this section has given answer to the following important questions:

i. What *Sharīʿah* compliant alternatives to conventional derivatives are available in Islamic finance?

ii. How can *Sharīʿah* compliant hedging instruments be developed to serve the purpose of hedging the risk without violating *Sharīʿah* principles?

d) Question No 4 describe the required legal framework to support and develop the derivative market in Pakistan and therefore, answers to the question that:

i. What kind of legal framework is required to support these instruments?

These and many other important questions have been tackled in this research work in order to prove or disprove hypothesis of the research.

1.4 Hypothesis

a) The available Conventional derivatives (i.e forward, future options and swaps) are not in conformity with the *Sharīʿah* Principles, hence cannot be used as hedging instruments in Islamic Finance.

b) *Sharīʿah* compliant structured instruments with derivative like features can be developed in Islamic Finance to be used for the same purpose i.e. hedging the risk without violation of the *Sharīʿah* principles.

1.5 Objectives of the Research

Objectives of the research can be summarize in the following main points, as this study aims:

a. To discuss in detail the basic concept, evaluation and development of derivative instruments i.e. Forward, Future, Options and Swaps and their industry practices and usage including the problems with each instrument and their benefits, needs and the pertinent issues related to derivatives which have given rise to differences among the Muslim scholars.

b. To elaborate the basic *Sharīʿah* Requirement for the financial transactions and the major *Sharīʿah* prohibitions due to which conventional derivatives have been declared as non-acceptable in Islamic finance.

c. To examine and investigate the *Sharīʿah* stand and position in relation to the conventional derivative instruments i.e. Forward, Future, Options and Swaps. The possibility of admitting forward, Futures and options contracts into Islamic Law, the legal grounds of these contract and the different opinions advanced by modern scholars whether in favor of or against the acceptance of these contracts.

d. To critically analyze the debate of the modern scholar for the legitimacy or otherwise of the conventional derivatives with the aim to declare proper *Sharīʿah* position on these instruments and to thoroughly discuss and analyze the different objections raised against the permissibility of derivatives, such as "*bayʿ al-kali bi al-kal*" (the sale of debt for debt), the "sale of nonexistent things", and the sale prior to taking possession etc.

e. To explore the alternative instruments available in Islamic Finance that have derivative-like features such as *Bay' Salam, Murābahah, Wa'ad, Istijrāra, Khiyār - al Shart, and Bay' al-'Arbūn* which can be used for the same purpose i.e hedging the risk.

f. To discuss in detail the theatrical i.e. jurisprudential concept and requirements of these Islamic instruments and practical procedure (modus operandi) along with process flow and industry usage of these Islamic concept and products that can simultaneously be used for the same purposes of hedging and achieve the same goals as those provided by conventional derivative instruments. These available contracts in Islamic finance can be considered and used as the basis or building block for derivative contracts within an Islamic framework.

g. To address the legal frame work required for these instruments and to evaluate the different functions being performed by the clearing house, the futures brokers. So the regulation of the futures market has been discussed with special reference to Pakistani legal system and further suggestions has been given to bring the system within the proper Islamic structure and to develop the derivative market in Pakistan.

The study have focused and elaborated on those issues which have not been well elaborated by previous works or which have been excluded from discussion despite their fundamental importance in understanding the issue of futures trading and derivatives.

1.6. Research Methodology

This study is non-empirical, and thus, it is based on library research. The basic aim of the research is to discover, explain and critically analyze the contemporary writings on forward, futures, options and swaps trading and to present and compare in a systematic form the facts, principles, provisions, concepts and theories related to Islamic derivative instruments. Almost all of the Methods of doctrinal research have been applied where required such as: descriptive and exploratory method, analytical and critical method, historical method and comparative method to ascertain the status of conventional derivatives in Islamic finance and to provide the alternative instruments having derivative like features in Islamic finance.

The study has relied on the classical sources and relevant study of Islamic law to approve or disapprove of the ideas discussed. It has relied on the work of the major Sunni schools of Islamic Law, namely the *Hanafī, Malikī, Shaf'īe, Hanbalī* and *Zahirī* schools and the writing of modern scholars.

The study has not supported the opinion of a specific school of Islamic law but relayed on the opinion of the majority. The opinion of the International forum such as AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) and the *fatawa* of International Fiqh Academy's which gives opinion on the basis of "*Collective Ijtihād*" (or legal ruling based on the opinion of a number of Mulim Scholars after discussion and consultation) in the modern issues in Islamic Finance have been considered . However, any opinion supported by evidence form the *Quran* and *Sunnah* that could be the basis for solving certain problems have been preferred. On the other hand, the study have reference to Pakistani Legal frame work in order to suggest the required framework to support these instruments.

This study examined the concept of Derivatives trading in conventional sources on the different issues discussed, followed by the views of Muslim scholars, the sources of law they relied upon, and a critical analysis of these views. Thus, throughout the study the four different parts of derivatives instrument trading, namely, forward, futures, options and swaps have been examined.

This study provides a comprehensive analysis of the Islamic Concepts and the views of the Muslim jurists have been frequently quoted where required. Moreover, the method of transliteration is followed for the Islamic terminology of Arabic language.

A brief English translation and introduction to new or un-common Arabic terms have been given to clarify their meaning such as *Istijrār* (A contract between a client and a supplier, whereby the supplier agrees to supply a particular product on an ongoing basis, for example monthly, at an agreed price and on the basis of an agreed mode of payment)[25], *Khiyār Al-Shart* (the option to rescind a sales contract based on condition)[26], *Bay al- Arbūn* (*a* sale contract, in which a down payment is paid by the buyer)[27] and Collective *Ijtihād* (legal

[25] Mohammed Obaidullah, '*Istijrār: A Product of Islamic Financial Engineering*' (London: New Horizon, Islamic Institute of Islamic Banks, 1997), 14.
[26] Abu Ghaddah, '*Al-Khiyār wa Atharuhu fi al- Uqūd*' (Jeddah: Dallah al-Barakah, 2003), 19.
[27] Al- Bājī, '*Al-Muntaqā Sharh Muwattā al-Imām Mālik*. (Beirut: Dar al-Gharb al-Islami, 1991), 56.

ruling based on the opinion of a number of Muslim Scholars after discussion and consultation) etc.

The uniform method of citation of legal sources have been adopted in the thesis. In this regard the Chicago Manual of Style has been followed. The English translation of the Holy Quran has been taken from the authentic commentary of the Holy Quran written by Abdullah Yousuf Ali.

1.7. Organization and Structure of the Thesis

The structure of the research is organized in such a way to evaluate the status and use of conventional derivatives in Islamic finance and to find out Islamic financial instruments having derivative like features. This was done, after a detail introductions to the derivatives and the relevant literature in chapter one and two, by first explaining the basic derivative contracts of forwards, futures, options and swaps and their basic concept and developments. Thereafter the scope of derivatives and their economics benefit and needs have been discussed in chapter no. 03. The paper then has discussed in chapter no 4, the general principles of contract in *Sharī'ah* and the major prohibitions due to which derivatives have been declared as un acceptable, followed by a comprehensive debate (arguments along with counter arguments) between scholars on the admissibility or otherwise of the derivative instruments. Current trends of the contemporary or modern jurists towards permissibility on the basis of public needs/interest, modern business requirements and *Maqāsid -Al- Sharī'ah* have been discussed in detail. Subsequently, in chapter no 5, we have analyzed and tried to declare the status of conventional derivatives in Islamic finance from *Sharī'ah* perspective and in the light of their current practice/usage in the market. Then in chapter no 6, we have devised that *Sharī'ah* has some risk management strategies that may be compatible with *Sharī'ah* principles and at the same time can achieve the same objectives as conventional derivatives.

Thus, the closest alternatives having derivatives like features that are available in Islamic finance as proposed by scholars and practitioners such as the *Bay' Salam, Wa'ad, Murābahah, Istijrār, Khiyār al-Shart* and *Bay' al-'Arbūn* have been discussed in detail. Theoretical i.e. jurisprudential concept and requirements of these instruments and practical procedure (modus operandi) along with industry usage of these Islamic concept/products have been discussed, which may pave the way of competition for the Islamic society in the relevant global financial market. These available contracts in Islamic finance can be considered and used as the basis or building block for derivative contracts within an Islamic framework. Subsequently, in chapter no.7 we have discussed the legal frame work and governance issue for the emerging Islamic financial industry in general and the legal frame work related to Derivatives Market in particular. The legal framework and support of derivative with special reference in Pakistani legal system has been made. It is mentioned that the non-existence of the uniform and definitive guidance on *Sharī'ah* compliance, the lack of uniformity and harmonization is compounded by the absence of a codified body of laws and regulations, divergence of opinions of the jurists based on their own *Fiqhī* Jurisdiction are the overall issues and hindrance in the development of an efficient Islamic Legal system for Islamic Financial Institutions. This is followed by a conclusion, in the last chapter, along with suggestion and recommendations which may help in promoting and developing the overall Banking system and the derivatives markets in Pakistan in particular.

CHAPTER NO. 2

LITERATURE REVIEW

In light of the objectives of this research, a comprehensive review on the theory and practice of Islamic derivative instruments from the available applicable literature has been made. Literature is collected by searching through different databases and library catalogues. A number of books, journal articles, thesis, dissertations, institutional and individual research papers and case studies have been reviewed. Considering the nature and scope of the research, literature in English and Arabic have been reviewed with most of the literature in English.

After methodical and comprehensive review on the subject of financial derivative instrument from Islamic perspective, it was observed that classical sources have not discussed the subject in detail. The contemporary literature or work of the modern scholars has been more of a juridical nature. Even though, inferences of the modern jurists are variant on its permissibility or disharmony with the Islamic principles and their interpretation and reasoning are based on different grounds. For example. in the case of *options,* some have examined their validity under the fiqh doctrine of *al-Khiyārat* (contractual stipulations) while others have drawn parallels between options and *bai-al-urbun*. A 3rd view has been observed which examine options in the light of uncertainty or gharar. In other situation, options have been observed as totally detached from the underlying asset. When viewed solely as a promise to buy or sell an asset at a predetermined price within a stipulated period, *Sharī'ah* scholars find nothing objectionable with options.[28]

The major relevant literature and the available works addressed the subject of Islamic financial derivatives have been divided into two sections. Section one have summarized the important relevant literature on the Forward and Futures contracts and identified the shortcomings and gap in the existing work and have tried to packed the available gap in the present literature through this work. Section two have critically analyzed the relevant literature on the options contracts, identified the short coming in the previous work and have tried to covered the subject issue with this work. Moreover, this review have examined the main relevant arguments of the institutional as well as the individual works and identified the short coming thereof. The institutional work has been discussed 1st followed by the individual work.

2.2 Literature Review on Forward and Futures Contracts:

Position of the Makkah based *Fiqh Academy* (as 1st institutional discussion) is not satisfactory. As various discussion on the subject issue i.e validity of the forward and futures contracts in Islamic finance have been undertaken by the Makkah based *Fiqh Academy*. The benefits of the forward and futures trading has been acknowledged by the Academy in the following words:

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[28] *See*-M. Obaidullah, *'Ethical Options In Islamic Finance'* (India: Xavier Institute of Management, 1997), 6.

"Forward and futures contracts provide opportunity for industrial and commercial institutions to finance their projects through the issuance and sale of stocks and financial instruments... forward and futures also provide a permanent venue for traders in commercial instruments and commodities".[29]

However, according to the Academy's resolution, this clear *Maṣlaḥah* (Public interest as determined in the light of the rules of *Sharīʿah*) is accompanied by the prohibited transactions such as exploitation, gambling and the unlawful devouring of the property of others. After acknowledgement of the benefits and drawbacks of futures contracts, the Academy stated that "In view of these considerations and in the light of the relevant information on the nature of futures market transactions we observe that the benefits of futures markets are mixed with disadvantages which contravene the principles of the *Sharīʿah*".[30]

The Academy have admitted that the futures trading involve various types of contracts, and have felt that all these kinds of contract needs to be addressed separately. However, this is not reflected in the academy resolution but this is clear that contract in currencies are different from contracts in stock indices and bonds and all these are quite different from those in share and commodities. Further, many jurists, have opted for the legality of selling an item before taking position and sale of the *salam* goods before taking delivery, however, this possibility has not been explored by the Academy. Moreover, the opinion of *Malikī*

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[29] see *'Al-Majmā al-Fiqhī al-Islāmī li-Rābitat al-Ālam al-Islāmī, Qarārāt Majlis al-Majmā al-Fiqhī al-Islāmī'*, seventh session, from 11–16 Rabiʿ al-Ākhīr, 1404, "*Sūq* al-Awrāq al-Māliyyah wa al-Badāʾi (al-Būrsah)", 163-165

[30] Ibid

School has not been considered that the price of *salam* can be deferred. Thus, the different views of the Islamic jurists available in the classical sources have not examined by the Academy nor any new alternatives that will guarantee and secure the public interest have been provided, although the benefits of all these has recognized by the Academy.

As for as the position of the Islamic *Fiqh* Academy based in *Jeddah* is concern, several papers were presented, seminars and workshops were held in relation to the stock market practices in general and Islamic derivative instruments in particular. However, the 6th session of the Academy which have discussed in detail the futures trading was covered by another session in Bahrain in 1991 (jointly organized by the *Fiqh* Academy and the Islamic Research and Training Institute (IRTI) affiliated with the Islamic Development Bank.)[31] The session concluded with the endorsement of the resolution issued of the *Fiqh* Academy based in *Makkah* with regard to forward and futures contracts and reproduced the same word by word and called for further research on these issues. After detailed analyses, it was noted that some writers have depended futures contract on the basis of *Maslahah* or public interest, however, this stance was not reflected in the Academy's resolution. Other important issues, which were required to be discussed, were left out. If all these necessary issues were have taken into consideration and more sessions were held on this subject, one could have expected some different position, before concluding any resolution.

Another institution 'The Permanent Research Committee of the Board of Great Scholars in Saudi Arabia' in its study titled "*Min Ṣouwar al-Bursah*" (Forms of Stock Markets) have addressed the issues related to futures contract. This work has been framed in three lengthy

[31] The session was held under the auspices of the Islamic bank of Bahrain from 25–27 November 1991.

articles in *Majallat al-Buhūth al-Islāmiyyah*.[32] Despite its reputable position as an influential institution, various deficiencies were found in its work. They have applied interpretation of the past jurist into the modern or contemporary issues, No doubt that *Sharīʿah* is sacred and unchangeable, yet, interpretation of the the *fiqh* can be changed according to place and time on the basis of *maṣlaḥah*.[33] Moreover, they have just passed a prohibitive judgment and not bothered to propose any viable alternative for the solution of the problem. This stand definitely raises doubts in the mind of the people that *Sharīʿah* has no more capability to respond to the contemporary issues. The Muslim traders will still continue their trading according to the forbidden contracts without any Islamic input. More importantly, if the learned scholars in Islamic Law have not changed their simplistic attitudes, it will be too remote to prevent the Muslim from Haram and invalid business transactions.

Besides these institutional work, many individual *Sharīʿah* scholars have discussed and addressed the issues related to Islamic financial derivatives and futures trading. Mainly, two different approaches were noted and characterized these studies. The first approach have emphasized on the need to remove and replace the forbidden element in the existing future contracts and there by purify the conventional types of futures in order to bring it in conformity with *Sharīʿah* principles. At the same time, they refuting the criticisms of the contemporary Muslim scholars against derivative contracts. The second approach, on the other side, have totally rejected the conventional derivative contracts and have tried to construct and formulate pure Islamic alternative contracts.

[32] General Secretariat of the Great Ulama's Board, *Majallat al-Buhūth al-Islāmiyyah. Min Souwar al-Busra* (Riyadh, Saudi Arabia, 1996). no. 46, 26–140, no. 47, 23–120; no. 48, 27–90.

[33] *See- 'Fatāwā al-Sharʿiyyah fī al-'Amāl al-Maṣrifiyyah'*, Markaz al-Tadrib wa al- Buhūth. (Dubai: United Arab Emirates. 1996), 220.

One of the more extensive and in-depth study related to futures trading is that of Mohammad Hashim Kamali's titled "*Islamic Commercial Law: An Analysis of Futures and Options*".[34] The study represent the major work related to the 1st approach thereby accepting the future contract in Islamic law with the elimination of the un-Islamic elements to bring it in conformity with the Islamic norms. Kamali has addressed the major issues related to futures and options, from the Islamic perspective and have refuted the criticisms of the Islamic Scholars against futures trading.

Kamali has given approval to the legal features of the future contracts and have refuted the resolution of the Makkah-based *Fiqh* Academy and ʿAbd al-Bāsit Mutwalī's fatwā,[35] and especially contended the opinions Yusuf Sulaiman,[36]. He is concluded that the *ḥadith*, "Do not sell what is not with you," does not t applicable to the fungible goods and it is related only to the sale of specific objects. Moreover, he stated that the the *ḥadith* is primarily concerned with the prevention of *gharar* and "since delivery is always guaranteed by the clearing house procedures, the seller's ability to deliver is not a matter of concern in futures trading." Concerning "*bayʿal-kāliʾ bi al-kāliʾ*", he explained that "there is no definitive statement in the sunnah for its prohibition", moreover, Qurʾān's *ʾāyatal-Mudāyanah*

[34] Kamali, *Islamic Commercial Law: An Analysis of Futures and Options*, (Kuala Lumpur, Malayisa 1995), *9-24*

[35] Abd al- Basit Mutwali, 'Bayt al-Tamwīl al-Kuwaiti, *Al-Fatāwā al-Sharʿiyyah fi al-Masāʾil al-Iqtisādiyyah*, (Kuwait: Bayt al-Tamwil al-Kuwaiti 1988), 528.

[36] Yousaf Sulaimān, *'Raiʾ al-Tashrī al-Islāmī fi Masāʾil Bursah'*, (Cairo, International Association of Islamic Bank, vol. 5), 428–443.

authenticated the deferred sales, and the text apparently accommodate an affirmative ruling regarding futures sales.

On the other hand, the study has not commented on the resolution of the Jeddah-based Islamic *Fiqh* Academy. Moreover, the study has discussed in detail the forward and futures contract along with the main differences between the two, however, the author has not addressed the legality of the forward contract from an Islamic perspective separately. Kamali then after discussion of the benefits of the futures trading has approved and declared the futures contract to be valid from shriah perspective on the basis of public interest or *maṣlaḥah.* However, his Islamic analyses is not more enough to address all the relevant *Sharī'ah* issues. Thus important *Sharī'ah* issues related to derivatives such as "sale prior to taking possession, debt trading, or *bay'al-dayn bi al-dayn*" have been elaborated for proper *Fiqhī* discourse on futures trading.

Kamali sustained his conclusion by discussing the opinion of some contemporary Muslim jurists, who expressed a positive judgment on some aspects of futures trading, such as Ali 'Abd al-Qādir[37] in his comment on Sulaymān's article; 'Abd al-Karīm al-Khatīb in his book *al-Siyāsah al-Māliyyah*;[38] al-Jundī in his book, *Mu'āmalāt al-Burṣah*,[39] Aḥmad Muḥyī al-Dīn who defended vigorously the forward contract in one of his books but raised some

[37]Ali 'Abd al-Qādir, *Al-Mawsū'ah 'al-'Ilmiyyah wa al-'Amaliyyah li al-Bunūk al-Islāmiyyah*, (Cairo, International Association of Islamic Banks, vol. 5), 444–451.
[38]'Abd al-Karīm al-Khatīb, *al-Siyāsah al-Māliyyah fi al-Islām wa Ṣilatuhā bi al-Mu'amalāt al- Mu'āṣirah*, (Dār al-Fikr al-'Arabī, Cairo, 1976).
[39]Al-Jundī, Mohammad Shahhāt, *Mu'amalāt al-Burṣah fi al-Sharī'ah al-Islāmiyyah*, (Dār al-Nahdah al-'Arabiyyah, Cairo, 1988).

reservations about it in his later book,[40] and Majd al-Dīn 'Azzām in his reply to 'Abd al-Bāsit's fatwā.[41] We would like to make a brief comment here regarding Majd al-Dīn 'Azzām's methodology that is not addressed by Kamālī's work. Although Majd al-Dīn's conclusion is correct, part of his methodology might not be acceptable. He maintained that:

> *"..the norm concerning mu'amalāt or Islamic commercial transactions is permissibility, which means that contracts are generally permissible unless they are clearly prohibited by the texts (nuṣūṣ) . This prohibition could be either definitive (qaṭi'), which leaves no room for doubt, or speculative (zannī), such as the prohibition conveyed in a solitary ḥadīth (ahād)".*[42]

'Azzām added that we fully accept and rely on the first part of this principle, but concerning its second part, he asserted that the prohibitive evidence pertaining to civil and commercial transactions must not be anything less than decisive. This is because the fundamental permissibility of such transactions is based on decisive evidence, that is, the principle of *ibāḥah*, and this should prevail unless there is decisive evidence to warrant the opposite.

It is worth noting, however, that rejecting any prohibition based on a solitary *ḥadīth* (*āḥād)* is a dangerous precedent which may lead to the rejection of the Sunnah. Yet, there are some differences of opinion about the acceptance of a solitary *ḥadīth* in the area of *'aqīdah*

[40] Aḥmad Ḥassan Muhyi al-Dīn, *'Amal Sharikāt al-Istithsmār al-Islāmiyyah fi al-Sūq al-'Ālamiyyah*, Bank al Barakah al-Islāmī li al-Istithmār, Bahrain, 1986, and *Aswāq al-Awrāq al-Māliyyah wa 'Āthāruhā al, 'Inmā'iyyah fi al-Iqtiṣad al-Isālmī*, (Dallah al-Barakah, Jeddah, 1996)

[41] Bayt al-Tamwīl al-Kuwaitī, *Al-Fatāwā al-Shar'iyyah fi al-Masā'il al-Iqtiṣādiyyah*, 590.

[42] See Ibid, 545.

(belief and creed) but not in *mu'āmalāt* (commercial transaction). Thus, it seems that by adopting such a methodology Majd al-Dīn undermined some of the credibility of his argument, although it is basically correct.

Another important study in relation to the legality of future trading have been undertaken by the learned scholar Fahim Khan in his book "*Islamic Futures and their Markets*".[43] However, Fahim Khan has limited the scope of his work to futures contracts only. This study represents the 2nd approach there by departing from the 1st approach i.e. to identify and remove the un-Islamic element from the future contracts to bring it in harmony with Islamic principles. Fahim Khan have talked the issue of futures markets from an Islamic perspective and to look for the pure viable Islamic alternative. He given preference to opt *bay' al-salam* as the foundation and back bone for any Islamic alternative futures contract. Yet, Fahim khan have discussed briefly *Istisnā' and jualah* (A party pays another a specified amount of money as a fee for rendering a specific service in accordance to the terms of the contract stipulated between the two parties) as viable classical contracts with features of futures contract. He further stated that "we are not looking forward to 'Islamizing' an intrinsically non- Islamic activity, but instead we are trying to revert to our own traditions to develop similar institutions that would not only bring the parallel economic benefits to the society that they are meant to provide but that will also be in line with Islamic legal framework".[44]

[43]Fahim Khan, '*Islamic Futures and their Markets with Special Reference to Their Role in Rural Financial Market*' (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, Saudi Arabia, 1995) 12-23.
[44] Ibid.

While commenting on the scope of futures contract in an Islamic framework, Fahim Khan has rightly concluded, that future trading in stock indices is nothing but pure gambling played in the market place. With respect to foreign currency exchange, he recognized the need for the development of Islamic model of foreign currency futures but he did not elaborate the same.

Since one of the main objective of future market is to present solution to the problem of liquidity, in this respect, Fahim Khan has tried to resolve this issue by suggesting *salam*-based futures market. He maintained that such a market will provide liquidity to the producers instead of to the traders and will curb speculation. However, he has not taken into consideration one of the serious hindrance of advance payment as necessary in the *salam* transaction, as a result even genuine traders may face liquidity problems.

As a result of advance payment, another problem may arise in respect of matching the buyer and sellers of futures contracts. Khan admitted this by saying "this too may not be very conducive in creating competitive conditions in the Islamic futures market." To give solution to this problem, Khan suggested that these "shortcomings arising out of liquidity constraints upon traders can be overcome by the introduction of Islamic banks or of specialized Islamic financial institutions to finance the futures trading." However, practical problems will arise with the implementation of such mechanism.

Fahim Khan's Fiqhī analysis throughout the study is too narrow. For example, he did not dig out the possibility of sale of the *salam* goods before taking delivery. Moreover, he did not analyzed the evidences advanced by the jurists and the *ratio* behind the legality or prohibition of *salam* sale. Moreover, analyses with regard to the jurists' opinion for deferment of payment for three days as per *Malikī's* and other modern writers have not been undertaken by khan to solve the liquidity problem with genuine traders. However, the effect of such analysis on the development of the futures market is obvious.

Another well-known Scholar Sami Al Suwailem have discussed the risk management issue in his work titled "Hedging in Islamic Finance".[45] He made an attempt to frame and develop a general risk hedging strategies for Islamic institutions. The study provides suggestions for the same, he stated that "At the heart of this frame work is the integration of risk management and value creation. This integration improves economic efficiency while it opens the door for unlimited creativity".[46] However, followings are the major shortcomings of the paper, among other:

The framework is that of a general nature as he expressed that "this framework is a general strategy for developing risk management tools that are consistent with Islamic principles".

Applicable *Sharī'ah* principles to the given examples have not been discussed in detail. Moreover, with regard to the practical stated example he stated that "these examples and instruments however are by no means conclusive or final, but hopefully point to directions for fruitful and rewarding future research". He has framed out some instruments, but has said that each of the instruments needs through and independent research whereby detailed

[45] Sāmi Al-Suwailem, '*Hedging in Islamic Finance*', (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, 2006), 12-23.
[46] Ibid

conditions and proper structure to be laid down to fulfill the exact needs of the Islamic financial institutions. Moreover, he has explained the general principles for the Islamic finance and have not focused on the Islamic derivative instruments such as *Salam, Istijrār, 'Arbūn* and *W'ad* based arrangements etc.

While stating the objective he mentioned that "objective of the paper is to explore and highlight millstones of the Islamic approach through which legitimate means can be developed". Unfortunately, these "legitimate means" have not been identified.

Another scholar Muhammad Akram Khān's study entitled "Commodity Exchange and Stock Exchange in Islamic Economy,"[47] has addressed the issue of derivatives contract from Islamic point of view. The author discussed first the general principles of the market's functioning in Islam before addressing the validity of the forward contract. He maintained that Islamic law provided for situations involving forward transactions, different contracts such as *bay' al-salam bay' al-istiṣnā, al-bay' al-mu'ajjal* (deferred sale) and *bay' al-istijrār* and concluded that "There is hardly anything objectionable in the basic operation of the forward market." However, he admitted that "Individual transactions may have certain elements which need to be modified in the light of Islamic law." Unfortunately, he did not specify these elements or how the modification would be implemented. Addressing the legality of futures contracts, Muhammad Akram Khān maintained that:

[47] Muhammad Akram Khān, "Commodity Exchange and Stock Exchange in Islamic Economy," (*American Journal of Islamic Social Sciences*, vol. 5, Issue no. 1, 1988), 92–114.

• A futures contract involves the sale of a nonexistent commodity and does not involve physical delivery; therefore, it is unlawful.

• Moreover, according to Akram Khān, speculators are the winners, small investors hardly ever win, brokers carry out dual trading by conducting business to their account first, which regulation fails to eradicate, and manipulation persists despite all the safeguards undertaken so far.

However, Sayyid Abdul Jabbār Shahhabudīn, the chief executive of the Kuala Lumpur Commodity Exchange, dismissed these shortcomings, contending that there are adequate safeguards to protect users of the market, such as the time-stamping of orders, the prohibitions of trading ahead or against clients' orders, the segregation of clients' accounts, reportable position and position limit, etc. Moreover, there is a free flow of information into and out of the market on a real time basis around the world.[48]

Addressing the issue of currency exchange, Akram Khān concluded that the conventional spot currency exchange, which allows a two-day lag, cannot be accepted in an Islamic framework and the alternative could be that the exchange is effected simultaneously by involving correspondent banks or agents at the same time. Regarding the forward currency exchange, he concluded that it is illegal in Islam. Moreover, he added that:

[48] Sayyid Abdul Jabbār Shahhābudin, "Comments on Muhammad Akram Khān's Commodity Exchange and Stock Exchange in an Islamic Economy," *Journal of Islamic Economics*.

"At best the two banks 'agree' or 'promise' to transact an exchange business at a future date. Such an agreement is only morally enforceable and no court in an Islamic state would enforce it."[49]

However, the categorical rejection of the possibility of enforcing such a promise may not be justified. This is true because of the decision of the Islamic Fiqh Academy endorsing such an "agreement" as enforceable in the sale of *murābaḥah*, and the extension of this rule by some scholars to currency exchange. Moreover, the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) in its standard on currency has clearly endorsed the permissibility of such transaction. The author ruled out any possibility of swap and futures currency exchange in the Islamic economy while admitting that the need for Islamic financial institutions to deal in forward and futures transactions arises, partly, from the desire to invest their surplus funds over short periods of time. Regarding options trading, he compared it with *bay ʿal-salam* and *bayʿ al-khiyār* (sale with option) and concluded that it did not fulfill the conditions of either of the two contracts and, therefore, options trading is unlawful.

Mohamed ʿAlī El-Gārī also have discussed some issue related to futures and options in his paper (Toward in Islamic Stock Market).[50] With regard to commodity forward and futures, El-Gārī uphold that ".in futures contracts. the commodity in the first contract could be sold prior to taking possession, which is not the case in *salam*". However, he stated that there is no legal problem to sale the *salam* goods prior to taking position and there is a room for the

[49] See, Muhammad Akram Khān, "Commodity Exchange and Stock Exchange in Islamic Economy," (*American Journal of Islamic Social Sciences*, vol. 5, Issue no. 1, 1988), 94

[50] Mohamed ʿAlī El-Gārī., '*Toward an Islamic Stock Market*' (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, Saudi Arabia, 1993), 19-27.

approval of such transaction but he did not explored this possibility. He raised the point that "the *illah* or cause of prohibition of many contracts here is risk-taking or *gharar*. It is a complex issue, which needs a careful investigation in relation to the modern types of contracts". However, he did not explored further, though many of the *gharar* related objections he raised may not be exist in the current future market.

Further he concluded: "Building a model of futures trading on the basis of a *salam* contract should not be excluded altogether." But, he did not move a head beyond this statement to prove this possibility.

Muhammad Taqi Usmani determined in his study titled "Futures, options, swaps and equity instruments"[51] that the "futures contract is a *ḥaram* (not permissible) transaction". However, he based his stand on weak *ḥadith* that is "*bay' al-kāli' bi al-kāli'*" and the alleged *ijma* (consensus on the subject, although some scholars have already disputed its authenticity. However, Sheikh Taqi keep silent to mention the weakness of the hadith.

With respect to forward contract. Usmani stated that "Islamic law provided for situations involving forward transactions, different contracts such as *bay' al-salam bay' al- istisnā'*, *al-bay' al-muajjal* (deferred sale) and *bay' al-Istijrār*"[52][A contract between a client and a supplier, whereby the supplier agrees to supply a particular product on an ongoing basis, for example monthly, at an agreed price and on the basis of an agreed mode of payment] and concluded that "There is hardly anything objectionable in the basic operation of the

[51] Usmani M.T, '*Futures, options, swaps and equity instruments*' (New Horizon, 1996), 10-11.
[52]Usmani M.T, '*Commodity Exchange and Stock Exchange in Islamic Economy*' (New Horizon, American Journal of Islamic Social Sciences, 1988), 6-7.

forward market." However, he admitted that "Individual transactions may have certain elements which need to be modified in the light of Islamic law".Unfortunately, he did not specifically mentioned these elements and have not mentioned that how these modification would be applied.

Another scholar who written on the issue of futures contract is Husein Salmon in his paper titled "The problem of Speculation in the Stock Market from the Islamic Perspective".[53] He stated that "that some degree of speculation is essential in any financial activity." It is here to be noted, that many scholar considered futures trading invalid due to the problem of speculation. However, some issues he elevated about speculation may not acceptable, moreover, his analyses regarding the issue is also too narrow and followed the conservative approach.

Salmon acknowledged that some degree of speculation is essential in any financial activity. However, some issues he raised about speculation may not be easily accepted. He divided speculators into two types: first, there are careful investors who invest their capital after making a careful assessment. They analyze the strengths of the company based on reliable fundamental factors, including real assets and property as well as the performance of the company in the past. This is what he termed rational speculation. The second kind of speculators are those who do not conduct any study or analysis. They study the trend of

[53]Husein, Salmon, '*The Problem of Speculation in Stock Market From Islamic Perspective*' Investment as an Alternative." *The First International Conference on Islamic Management: Management of Economic Development in an Islamic Perspective*, Jointly Organized by the Islamic Development Management Project (IDMP), The School of Social Sciences, University Sains, Malaysia, and the Islamic Research and Training Institute affiliated to Islamic Development Bank (IDB), Jeddah, Saudi Arabia, from 8–10 December 1998), 1-50.

price movements and market sentiment, and sometimes they base their decisions to buy on whispered rumors in the market.

The evaluation of the second group may not be totally accepted due to the fact that rumors and manipulation are unacceptable in principle in the Islamic stock market, and, therefore, to invalidate futures trading on this aspect is baseless. On the other hand, many other commentators, without any legal grounds, have also advanced the claim that any benefit from price movements or price fluctuations is not legitimate. Salmon suggested that it is necessary that traders keep their shares for at least six months to one year before selling them to a third party.

It seems that there is nothing in Islamic law which prevents a person from buying and selling without having the intention to make use of the commodity or to keep it for a long time. The topic will be investigated later since many commentators rely on it as grounds to invalidate futures. Salmon calls for a total exclusion of options contracts because they bring additional uncertainty and they are not comparable to *bay' al-salam*. He rejected the possibility of taking a fee for a premium or option without any discussion. However, it seems that there are no grounds for comparison between the two contracts. On the other hand, his criticisms of short-selling and margin sale deserve consideration.

Furthermore, Aḥmad El-Ashkar in his article, "Towards an Islamic Stock Exchange in a Transitional Stage," observed that speculation could hardly be viewed as a game of chance or be equated with gambling. He pointed out the difference between speculation and *najash* (to bid up the price of the item, not with the intention to purchase the item, but rather to raise the price for the customers intending to deceive the buyers) to refute the allegations of some scholars. He concluded that "the Islamic securities Market should not be envisaged as a speculation free market. A reasonable degree of speculation would be required, and indeed needed, if the market is to be active and operative."[54]

Frank E. Vogel and Samuel L. Hayes III in their study *Islamic Law and Finance, Religion, Risk, and Return* also dealt with the issue of derivatives and futures trading. Concerning the sale of debt, especially that of *bay' al-kāli' bi al-kāli'*, they acknowledged that the profound implication of the prevailing restrictions in this area may be an obstacle for the development of a futures market. Thus, they maintained that on such matters Islamic law has many complex rules, all designed to avoid *ribā* and *gharar*. The restrictions these rules impose were less important in the past, when most contracts were promptly executed on at least one side. However, in today's world, futures financial obligations are among the most important forms of property; indeed, such obligations are the core of many forms of investment traded in huge volumes in financial markets. Accordingly, Islamic law restrictions in this general area are very significant in the development of new instruments, particularly if these are to be traded on secondary markets.[55]

However, their discussion regarding the issue is very narrow and almost followed the conservative approach. We may be able to understand the reason behind this conservative

[54] Aḥmad El-Ashkar, *"Towards an Islamic Stock Exchange in a Transitional Stage,"* (Islamic Economic Studies, Islamic Development Bank, Jeddah, Saudi Arabia, vol. 3, no. 1, December 1995), 79-112.
[55] Frank E. Vogel and Samuel Hayes, III, *Islamic Law and Finance, Religion, Risk, and Return*, (Kluwer Law International, The Hague, 1998), 114.

approach if we examine their methodology in this area. For instance, they maintained that "of course the most direct way to achieve the goal of risk management would be a bold redirection in *fiqh* thinking (*ijtihād*) drawing on new interpretations of the revealed sources and of basic principles". This *ijtihād* will declare what about risk management is legitimate in Islamic law, and what is illegitimate. But it is ordinarily the most conservative, literal and legalistic approach that are followed in Islamic finance and accordingly, we will follow only such an approach. While doing so, however, we should try not to lose sight of the larger issue just sounded the proper scope, if any, for risk management in Islamic law.[56]

At the end of their discussion on the sale of debt for debt, they concluded that the general agreement among the scholars including Ibn Taymiyyah is against the bilateral executory contract; the force of the debt for debt maxim in this matter is unlikely to dissipate soon. They went on to argue that recently two authors have argued for its reversal. One did it on the ultimate ground of necessity,[57] while another offered more nuanced and challenging arguments. He argued that delayed payment should be permitted in supply contracts until the goods are delivered even for fungible goods or goods by description. Pointing to the more liberal rules that apply to delay in contract with an *'ayn* (tangible property) on the one side, he argued that, first, the central distinction between *'ayn* and *dayn* (debt) should not rest on whether the goods are unique, but on whether they already exist. Second, where goods under a supply contract are continuously available in the market, the contract should tolerate postponement of paying until the goods are received, just as they would if the

[56] Ibid, 154-155.

[57] Nazīh Ḥammād, *Bay' al kāli' bi al-kāli'*, (Markaz Abhāth al-Iqtiṣā d al-Islāmī, Jāmi'at al-Malik 'Abdul Azīz, Jeddah, Saudi Arabia, 1986), 28-29.

goods were *ayn*. The *Maliki* position requiring payment delay in sales of absent *'ayn* should apply to such modern contracts.[58]

However, the point which we would like to make here is that to claim that just two authors have argued for the reversal of the prohibition to postponing both countervalues is out of touch with reality. Many Muslim scholars have argued against this maxim, sometimes even before Nazīh Ḥammmād and Abū Sulaimān, both in Arabic and English works. However, a close look at the data adopted in this work, especially in the area of derivatives and futures trading, reveals that the authors confined themselves to limited sources of information.

Regarding forward contracts, the study maintains that *salam* contract is the closest Islamic approximation to the conventional forward contract. With regard to futures contracts, the study concluded that there is no direct equivalent of futures contracts in Islamic finance. In addition to the already discussed problem of forward contracts, namely the postponement of both the price of the goods and the payment, futures require a daily marking to market, which is also forbidden in Islam. But the study did not exclude the possibility of a kind of Islamic futures based on *salam*. Here again some proposals have been made based on parallel *salam* whose legality will be ascertained in subsequent chapters. As in the case of our review of the studies on forward and futures contracts, the present study will review the institutional studies in options, followed by the individual studies.

[58] 'Abd al-Wahhāb abū Sulaimān, "'Aqd al-Tawrīd." Unpublished paper. In the forthcoming *Mawsū'at al-Mu'āmalāt al-fiqhiyyah*, (Islamic Fiqh Academy, OIC Jeddah, as quoted by Vogel and Hayes), 87.

2.2 Literature Review on Options Contracts:

Several institutional as well as individual studies have addressed the validity of options contracts in Islamic finance on the same way as opted for forward and futures trading.

In the 7th Session of the Islamic Fiqh Academy, different papers related to the options trading have been presented by the Islamic Scholars. Almost all of the papers have touched on the definition of options, their status in the contract, their relation with *bay' al-'Arbūn* , *salam*, *Khiyār al-sharṭ*, especially sale through description, gift, and the possibility of buying and selling an absolute "right".

Almost all the paper, after close look, explained the different rulings in the resolution. For example, some of the scholars, have passed prejudgment on the issues of option prior to any deliberation or discussion on the issue. Sheikh al-Salami, for instance, has said "from their introduction and objectives, options would not accept any Islamic modification. Moreover, any modification to make these types of contracts come in to compliance with *Sharī'ah* principles could be considered only if it is possible to implement them. However, options in their market do not accept any alteration and the Islamic world is not in need of these contracts in its economy."[59] Al-Darīr in the very 1st sentence of his research paper on options has stated that "This is a new type of contract and it is an illegal contract." He concluded, by saying that "There is no need to look for alternatives to these transactions

[59] Mohammad, Mukhtar al-Salami, *"al-Ikhtiyarat". Majallat Majma' al-Fiqh al-Islāmī* (Cairo: Dar al-Fikr al-Arabi, 1992), no. 7, vol. 1, 241.

from the Islamic point of view because it does not lead to any significant public interest which needs to be safeguarded".[60]

With respect of the above mentioned approach, Muhammad Bashir have stated in his study *(An Analysis of Derivatives Instruments in Commodity Markets)* "It is worth noting that a great deal of Islamic law is based on *maslahah* (public interest) and need. However, it seems that the benefits of options, as tools of risk management, had not been very well explained to these jurists and scholars by the Muslim economists associated with the Islamic *Fiqh* Academy. Accordingly, some of these jurists concluded that the Muslim economy is not in need of these contracts. It is clear that this attitude of prejudgment would not be of much help in reaching a systematic and fair conclusion. Perhaps because of the misgivings, the participants did not even make the effort to modify these new types of contract or to look for an Islamic alternative.

He further stated that:

> *"..to think that options have no benefit at all is to deny an internationally recognized reality. Still, it is possible to argue that despite their benefits, options may involve high risk and harm, and, therefore, should not be allowed in Islamic finance in their present form. But to exclude them altogether is out of touch with reality. If there were no benefits in options, one might ask why the issue has been raised from an Islamic point of view*

[60]Siddīq, al-Darīr. "Al-Ikhtiyarat". *Majallat Majma al-Fiqh al-Islāmī*, (Cairo. Dar al-Fikr al-Arabi, 1992), 272.

by Muslim economists and financial institutions, such as the Islamic Development Bank".[61]

However, it should be admitted that the major part of the Muslim world economy is based on commodities such as oil, petroleum, rubber cotton, tin, etc., these commodities are traded in futures markets through derivatives whether in relation to forward, futures, or options contracts. Therefore, one cannot deny the benefits of options and the recognized international reality.

Another example of the prohibitive attitudes, is that of Sheikh al-Salami, he stated in in his paper that "options are just an expansion of gambling and new ways to gain money without effort".[62] However, when Sheikh 'Ali al-Taskhiri cautioned against tagging these contracts as gambling contracts without solid and strong evidence, Sheikh al-Salami reversed from his initial position by saying "Yes, sometimes they may involve gambling but sometimes they are a kind of buying and selling with the intention of hedging against the risk of price fluctuation".[63]

Among those who addressed the legality of options is Kamālī. He reviewed some of the existing literature on options, addressing its shortcomings, especially that of 'Abd al-Wahhāb Abū Sulaimān, "*al-Ikhtiyārat:Dirāsah Fiqhiyyah Taḥlīliyyah Muqāranā* in "*Majallat al-Buḥūth al-Fiqhiyyah al-Mu'āṣirah*," and that of Aḥmad Ḥassan Muḥyi al-Dīn, " *'Amal al-Sharikāt al-Istithmār al-Islāmiyyah Fi al-Sūq al-'Ālamiyyah*." He compared

[61] Muhammad al-Bashir Muhammad al-Amine, '*Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets*', Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), 21.

[62] Mohammad al-Mukhtār al-Salāmī. (1992). "al-Ikhtiyārāt". *Majallat Majma al-Fiqh al-Islāmī*, 581-584.

[63] Ibid, 582.

options with *khiyār al-sharṭ* and *bay' al-'arbūn*. He also discussed the issue of whether it is lawful to charge a fee for granting an option and whether an option could be bought and sold as a valuable instrument in its own right. He concluded that:

> *"This analysis is affirmative not only on the parties' freedom to insert stipulations in contracts but also that a monetary compensation or a fee may be asked by one who grants an option or a privilege to the other. If the seller is entitled to stipulate for a security deposit or a pawn then it is a mere extension of the same logic that he may charge the buyer and impose a fee or compensation in respect of such options and stipulations that are to the latter's advantage. When the buyer, for example, stipulates that he will ratify or revoke the contract within a week or a month, this may well prove to be costly to the seller and he may therefore charge a fee/ compensation for granting the option. We thus conclude that options may carry a premium and [there] should be, therefore, no objection to this".*[64]

However, this argument will solve the problem only if we consider the premium as part of the whole price of the underlying commodity and that it cannot be traded separately. Still, although Kamālī's argument here is similar to that of the *Ḥanbalī* school in allowing *bay'al-'arbūn*, and it will really fulfill some of the benefits of options, the question that remains is the following: is it permissible to trade such an option separately from the

[64]See, Mohammad Hāshim Kamālī, *Islamic Commercial law: an Analysis of Futures and Options,* (Research Center International Islamic University, Malaysia), 356.

underlying commodity? This is what Kamālī's work did not discuss and the present study proposes to address it in detail.

Moreover, this argument limits such a benefit to the seller, and it may be asked if it is possible for the buyer to make a similar stipulation. And only at that stage, could we state that at least the simple types of options, namely put and call options, could be accommodated in Islamic law. It should be noted that the classical scholars did not discuss such things in their works. However, the door is not totally closed. Thus, we believe that the issue of buying and selling just a "right," like the one in options, needs more investigation, especially when we find that it was the main grounds for the rejection of options by the Islamic *Fiqh* Academy and the different workshops jointly held with the Islamic Development Bank.

On the other hand, despite the fact that Kamālī considers *bay' al-'arbūn* as closely resembling options, especially in respect to options that relate to the payment of a nonrefundable premium, and in the sense that both can be used as risk reduction strategies, Kamālī preferred to accommodate options through *khiyār al-sharṭ*. He stressed that "Although *khiyār* and *'arbūn* share the same rationale and can both provide the necessary juristic support for options trading, they are nevertheless not identical and each can be utilized for different purposes.[65]

[65] Ibid, 369-370.

The present study proposes to utilize *bay' al-'arbūn* as the juridical premise for validating options, while the possibility of accommodating options through *khiyār al shart* will also be thoroughly investigated. This is because, first, *bay' al-'arbūn* is *khiyār al-shart* plus the permission to buy and sell this option. Second, *bay' al-'arbūn*, as pointed out by Kamālī, closely resembles options, especially in that aspect of options that relates to the payment of a nonrefundable premium and in the sense that both can be used as risk-reduction strategies. Despite the fact that the legal foundation of *bay 'al-'arbūn* in the sunnah is weaker than that of *khiyār al-shart*, it could be accommodated under the general theory of freedom of contract. Moreover, it has been accepted by some Companions, including 'Umar, the second caliph, and the *Ḥanbalī* School of law. In addition, the Islamic *Fiqh* Academy has given its permission in its resolution no. 72(3/8)52 about *'arbūn*, which eliminates any reluctance about its permissibility and acceptance. But these arguments will be discussed later at the right place.

In conclusion, Kamālī maintained that there is nothing inherently objectionable in granting an option, exercising it over a period of time, or charging a fee for it, and that options trading (like other varieties of trade) is permissible, (*mubāh*) and as such, it is simply an extension of the basic liberty that the Qur'ān has granted to the individual with respect to civil transactions and contracts (al-Baqarah 2:275; al-Mā'idah, 5:1). Needless to say, options trading, like all other varieties of commerce, can be distorted by malpractice and abuse and the likelihood of this is perhaps widespread in options on futures and, indeed, options over assets that involve high levels of speculative risk-taking. It is, therefore, essential that we adopt a vigilant attitude toward refining our safeguards against malpractice at all levels.[66]

Another scholar, Aḥmad Muhyī al-Dīn in his book, "*'Amal Sharikāt al-Istithsmār al-Islāmiyyah fi al-Sūq al-'Ālamiyyah*"[67] have claimed that all kinds of options are invalid because they are in contradiction with the general principles of *Sharī'ah*. Moreover, they could not be accommodated within the ambit of *Khiyār al-sharṭ* or its objectives. Moreover, he stated that they are in conflict with the principle of justice as the option holder will get benefits from the loss of the one who provided them this option. He mentioned that such options are just like *al-shurūt al fāsidah* which have been rejected by all of the four school of thought. Further he mentioned that these are similar to the combination of two contracts in a single transaction (*bay'ataini fi bay'atin wāhidah*) which is forbidden by law. However, it is to be noted that all of the above stated objections are baseless having no link with the validity of options. We have discussed all these in their proper places.

On the other hand, a renowned scholar Aḥmad Yussuf Sulayman has opted for the acceptability of options under *Khiyār al-sharṭ* in his article "*Rai' al-Tashrī' al-Islāmī fi Masā'il al-Bursah.*"[68] A similar approached was adopted by Mohammad Obaidullah. He has discussed *Khiyār al-sharṭ* in different articles to be a viable Islamic tool of risk management and alternative to conventional options, Moreover, in his article "Istijrār: A

[66] Mohammad Hāshim Kamālī, *Islamic Commercial Law: An Analysis of Futures and Options*, 270-271.
[67] Aḥmad, Ḥassan Muhyi al-Din, '*Amal Sharikāt al-Istithsmār al-Islāmiyyah fi al-Sūqal- Ālamiyyah*, (Jeddah: Dallah al- Barakah, 1996), 43.
[68] Youssuf Sulaimān. "Rai' al-Tashrī' al-Islāmī fi Masā'il al-Bursah". *Al-Mawsūa'h al-'Ilmiyyah wa al-'Amaliyyah lil bunūk al-Islāmiyyah*, (Cairo. 1998, al-Ittihād al-Dawli lil-Bunūk al-Islamiyyah, vol. 5), 384–410.

Product of Islamic Financial Engineering," he compared *Istijrār* with other similar conventional products and made a case study for its use.

Another scholar Frank E. Vogel's and Hays' also have explored the probability of options through *Khiyār al-shart* and *bay' al-'Arbūn*.[69] The study concluded that "*Khiyār al-shart* or the stipulation of an option has little apparent significance for the creation of islamically valid derivatives, since the party giving the option cannot be compensated for doing so; thus, the option right itself is not paid for". With respect of *'Arbūn*, the study concluded, "that of all Islamic contracts, *'Arbūn* offers the closest analogy to options". However, they admitted that classical sources provide little hope for the validity of the options. Rather poses a series of objections. It is worth mentioning that these objections are mostly those mentioned by the scholars in the Islamic *Fiqh* Academy sessions held on options. Moreover, neither Vogel and Hayes's study nor that of the Islamic *Fiqh* Academy discussed the genuine grounds of these objections. We do believe that if a thorough investigation is made, many of these objections, if not all, could be reversed.

Another contemporary scholar Obiyathullah khan deliberated the issues of Islamic derivatives. in his paper (*Derivative Instruments and Islamic Finance*)[70]. He explained evolution of derivatives, their benefits, and presented a case as to why they are needed. Further, he discussed the *salam* and *Istijrār* contracts as Islamic financial instruments having derivative like features. However, he has limited the scope of his study, saying "The

[69]Frank, E. Vogel and Samuel Hayes, '*Islamic Law and Finance, Religion, Risk, and Return*' (The Hague: Kluwer Law International, 1998), 110-114.
[70]Obiyathullah I.B. '*Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration*' (International Journal of Islamic Financial Services Vol. 1 No.1.), 18.

objective of this paper is not to reevaluate these instruments in the light of the *Sharī'ah*, nor is it intended as a critical examination of the juridical works of *fuqahā* (*Sharī'ah* scholars). What is intended here is to provide a deeper understanding and an appreciation of these instruments: how they evolved, why they are needed, their diversity use, and the serious handicap that could be posed to Islamic businesses from ignoring them".[71] He described these instruments in detail and have pointed out the critical issues on why they are needed in the market place as well as highlighting several consequences that would affect the Islamic business if these instruments are ignored.

From the above analyses and discussion it is concluded that the following gaps and shortcoming have been identified in the current literature on Islamic financial derivatives:

- Sharī'ah rules and principles relating to Islamic Financial Derivatives have not yet been explored in detail in the original and classical sources. Further, no comprehensive study has yet been undertaken in respect of the Sharī'ah principles referred to by the modern scholars as the bases of prohibition of financial derivatives to explain the actual position and ratio behind these principles.

- The contemporary literature or work of the modern scholars have been more of a juridical nature there by ignored the practical and modern aspects of new business procedure and requirements and public needs.

[71] Ibid, 20

- A comparative study between conventional and Islamic Derivatives has yet not been undertaken. Current conventional derivatives instruments have not yet been properly analyzed from Shari'ah perspective to determine the actual status of these instruments. Similarly, futures trading involve various types of contracts, and scholars have felt the need that all these kinds of contract needs to be addressed separately in detail. However, this is not done yet and not reflected in any work of the modern jurist.

- The different views of the Islamic jurists available in the classical sources have not examined by any work in detail nor any new alternatives that will guarantee and secure the public interest have been explored with proper procedure, although the benefits of all these has been recognized by all.

- Just prohibitive judgment have been passed by various scholars and not bothered to propose any viable alternative for the solution of the problem. This stand definitely raise doubts in the mind of the people that *Sharī'ah* has no more capability to respond to the contemporary issues. The Muslim traders will still continue their trading according to the forbidden contracts without any Islamic input or alternative.

- No comprehensive legal framework, derivative governance Code and derivative Exchange for IFIs is available in Pakistan, hence there is no legal recognition and no separate Islamic Financial Accounting, Auditing and Governance Standards of these instruments which have created doubts in the minds of general public regarding their Shari'ah compliance.

This study is an attempt to fill up the above mentioned gaps and have suggested more viable, efficient and Shari'ah compliant derivative instruments in Pakistan. However, the study is restricted to the followings:

- To investigate and explore Shari'ah rules and principles relating to derivatives instruments in the original sources of Islamic law. Hence, detail discussion on the application of important Sharī'ah principles and the *ratio* behind the legality or prohibition of these principles in relation to derivatives such as "Do not sell what is not with you, "sale prior to taking possession, debt trading, or *bay' al-dayn bi al-dayn, bay' al-kāli' bi al-kāli'*" have been undertaken to elaborated for proper *Fiqhī* discourse on futures trading.

- Compatibility of the conventional derivatives with Shari'ah rules and principles have been examined and Islamic instruments having the same features have been elaborated along with detail and comprehensive procedure. Almost all of the jurists have felt the need and urged that each derivative instruments needs thorough and independent research whereby detailed conditions and proper structure to be laid down to fulfill the exact needs of the Islamic financial institutions. This study is an attempt to fill this gape as expected by the jurists and researchers. So, more viable, efficient and Shari'ah compliant instruments having

Derivative like features have been devised along with complete structure and procedure along with the legal model/requirements and further suggestion has been given at the end for further development and improvement in the derivative market.

CHAPTER NO. 3

CONCEPT AND DEVELOPMENT OF DERIVATIVE INSTRUMENTS

In this chapter the basic concept and development of derivatives for common understanding have been discussed such as the meaning and definition of derivatives, the concept of underlying for derivatives, history and growth of derivatives, their creation, use, needs and benefits along with their shortcomings. The common form of derivative instruments and their evaluation such as forward, futures, options and swaps have been explained along with illustrative example. Functions and characteristics of these instruments along with the associated problems have been identified. Comparison of these instruments has been given for proper differentiation and identification of inadequacies of these instruments and to understand how these instruments have contributed in the evolutionary chain. In the last section, the main players in the derivative market namely hedgers, arbitrageurs and speculators have been discussed to understand their role in the execution of the derivative transaction which will enable us to properly evaluate these instruments from *Sharī'ah* perspective in the subsequent chapters.

3.1. Meaning and Definition of the word "Derivatives"

The word "Derivatives" is the plural of "Derivative" which literally means, something derived or a word formed from another word or base, a word formed by derivation[72]. In the commercial world, comparatively it is a new term used by US courts as late as in 1982 and

[72]www.merriam-webster.com/dictionary/derivatives.accessed dated 11.2.2016.

UK courts in 1995[73], therefore, it is not surprising that historical cases, books and articles have not mentioned the word derivatives rather have used the word 'forwards', 'futures' and 'options'. Due to innovative and sudden growth in financial engineering it become necessary to create a common terminology to represent the instruments that display the same feature.[74]

3.1.1. Definition of 'Derivatives'

'Derivative' is a generic term and has been defined as "a financial instrument whose value depends on the value of other, more basic, variables".[75] The Economic Times describes 'Derivatives' as "a financial instruments which derives its value/price from underlying assets". GIFR (Global Islamic Finance Report 2010) has defined 'Derivatives' as "financial contracts the inherent values of which are derived from, and exist by reference to, independently existing underlying(s)".[76]

From the above mentioned definitions, it is cleared that derivatives are depends on the underlying, so it is pertinent to now the underlying.

[73]E.J.Swan, *'Building the Global Market: A 4000 Year History of Derivatives'*, 1st edn. (Dordrecht: Kluwer Law International, 2000), 23.
[74]See, e.g. *'Market Traders Institute in Forex Trading Terms and Definitions'* (2002) http://www.forextips.com/forex-terms-e.htm. access dated 7.5.2017.
[75]J. C. Hull, *'Options, futures and other derivatives'*, (New Jersey: Prentice Hall. College, Upper S River, 2005), 3
[76]D.R. Capasso, *Trading on the Seattle Merc*, (1995) quoted in Global *Islamic Finance Report-GIFR'*, (Edbiz Consulting-2010) 128.

3.1.2. The concept of underlying for Derivatives

The underlying(s) for a derivative contract can be an asset or a pool of assets, an index or any other item to which the parties may choose to link their derivative contract.[77]

Merriam Webster has explained 'Derivatives' as "a contract or security that derives its value from that of an underlying asset (such as another security) or from the value of a rate (as of interest or currency exchange) or index of asset value (such as stock index)".[78]

Originally, underlying corpus is 1st created which can consist of one security or a combination of different securities. The value of the underlying asset is bound to change as the value of the underlying assets keep changing continuously.[79] Another scholar stated that the underlying asset could be a basic financial asset like common stocks, bonds, currencies or commodities.[80] Since by this definition, a derivative is a "claim on a claim" the value of the derivative will depend on the value of the asset (stocks, bonds, etc.) on which it has a claim.

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[77]Ibid,130

[78]www.merriam-webster.com/dictionary/derivatives, accessed dated 11.02.2016

[79]Economictimes.com/definition/derivatives, accessed dated 03.03.2016

[80]Jorion, Philippe and Marcos De Silva, '*The Importance of Derivatives Securities Markets to Modern Finance*', (Catalyst Institute, Chicago: Catalyst Institute, 2010.

3.2. History and Growth of Derivatives

The 1st record of organized trading of derivatives can be traced back in the seventeen century in Japan, where Feudal Japanese landlords after storage of the surplus rice in the ware houses issue tickets there by promising delivery of rice in future at a specified price. These tickets were traded in the Japanese rice markets (i.e Dojimarice market) of Osaka, allowed Feudal Japanese landlords and merchants to lock the prices at which rice was bought and sold, consequently reducing the risk they faced.[81] In Japan, the agriculture production, was the main motivation for the development of these financial instruments, resultantly, the Chicago Board of Trade has been established in1848.

In the 19th century, in the USA, Chicago was the center for the development of derivative instruments. In the US, others exchanges involved in futures trading were the New York Cotton Exchange established in 1870, and the New York Coffee Exchange established 1885.[82]

In 1985, ISDA (International Swaps and Derivatives Association) has been formed to standardize documentation for derivative contract. This standardization has been considered as a major milestone.

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[81]D.R. Capasso, *Trading on the Seattle Merc* (1995) quoted in Global *Islamic Finance Report-GIFR',* (Edbiz Consulting-2010), 131.

[82]*The origins of derivative instruments*, available at http://people. brandeis.edu/cecchett/Textbook%20inserts/ the%20Origin%20of%20Derivatives.htm, accessed dated 10.03.2016.

In 1987, various standardized Agreements have been published by International Swaps and Derivatives Association ISDA e.g. the Interest Rate Swap Agreement and the Interest Rate and Currency Exchange Agreement, which have been globally accepted and considered as the 1st standardized derivative contracts.

These were followed by the 1992 ISDA Master Agreement (Multicurrency Cross Border) and the 1992 ISDA Master Agreement (Local Currency -Single Jurisdiction). The ISDA Master Agreement (Multicurrency-Cross Border), developed in 2002, was ISDA's reaction to market developments since 1992, and sought consolidation of the prevailing market practice till that date. With the growth of sophisticated derivative instruments, specific standardized documents, such as the 2003 ISDA Credit Derivatives Definitions, and related updates have been published by ISDA which have now obtained worldwide acceptance.[83] Today almost all the major cities, worldwide, have standardized derivative markets.

3.3. The needs for Derivatives or why derivatives are needed?

Creation and development of derivative instrument is the result of financial innovation, like any other financial product. Innovation that helped out the public need to manage risk in today's increasing sophisticated global business environments. Derivative instruments, if used prudently, can contribute significantly to the wellbeing of all market players.[84]

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[83] Ibid

[84] Balvinder, S. Sagha, '*Financial Derivatives: Applications and Policy Issues*', (Business Economics, the Journal of The National Association of Business Economists, (1995), 319

Andreas A. Jobst, has mentioned several contribution of the financial derivatives, he stated that the use of derivative instruments for hedging purposes contributes to risk management and enables such users to formulate more accurate business plans by reducing uncertainties. Derivatives are crucially important to facilitate price discovery, as futures market prices depend on a continuous flow of information from around the world and require a high degree of transparency. They increase trading volumes lead to lower transaction costs, leading to an increased 'value-for-money' for market participants. Derivative instruments help to channelize more institutional money to emerging markets, as such instruments can be effectively used to manage market, credit and interest rate risks in underdeveloped local capital markets. The availability of derivatives increases liquidity in underlying cash markets, since market makers inject substantial liquidity into (i) the options and warrants markets; and (ii) the underlying stocks that they trade in; to hedge their market making activities in the derivative markets. Derivatives also contribute significantly to portfolio diversification and effective portfolio management[85].

Each derivative instrument down the evolutionary chain, added value. For instance forward contracts, originally innovated to manage risk of agro-based products, the subsequent instrument needed as and when risk environment changed. Forwards and Futures have reduced Liquidity risk, counterparty risk and avoid price squeeze etc. Futures and Options have increased flexibility and ability to take advantage of favorable price movements (unlike *lock-in)*

[85]Andreas A. Jobst, '*Derivatives in Islamic finance*, available at http:// papers.ssrn.com/sol3/papers. *Derivatives increase liquidity*, available at http:// www.asx.com.au/profession- als/companies/derivatives increase_liquidity.htm, last accessed dated 10.05.2016.

3.4. Benefits of Derivatives

The growing statistical data (i.e. the average daily volume of derivative trading)[86] is the evidence of popularity and usefulness of these instruments because of their flexibility and ease of use; e.g., as compare to the underlying commodity or financial asset they are easier to buyand sell, such as metals, energy, agricultural commodities, stock indexes and currencies. Moreover, for trade in derivatives less or small amount of capital is sufficient as compared to the actual amount of money required to buy a financial asset or commodity itself. Therefore, derivatives are a useful alternative for holding a financial asset or underlying commodity.[87] Moreover. as have mentioned earlier under the benefits of derivatives that, at a basic level; derivative instrument enable the avoidance of unnecessary risks. Other benefits, such as better risk allocation and reduced the information asymmetry have been noted.[88]

3.5. The concept of Risk Management in *Sharī'ah* and the use of 'Derivatives'

There are two basic kinds of risks. The 1st one is the risk associated with normal financial transactions, i.e. wealth creating and value-adding activities and the 2nd one is the risk connected with creating wealth for nothing or zero sum activities, where no further wealth

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[86]See, the average daily volume of derivatives for the 1st quarter of 2013 reached a record 4.87 million contracts at the Chicago Board of Trade (CBOT) See, e.g., Craig Grabiner, CBOT Sets Records for Quarterly ADV (2015); http://www.cbot.com/cbot/pub/cont_detail/0,3206,1036+47036,00.html, last accessed dated 12.1.2016.

[87]Anne E. Peck (Ed.), '*Futures Markets: Their Economic Role*' (Washington, DC: American Enterprise Institute for Public Policy Research, 1985), 33.

[88]Andreas A. Jobst, '*Derivatives in Islamic finance*, available at http:// papers.ssrn.com/sol3/papers. *Derivatives increase liquidity*, available at http:// www.asx.com.au/profession- als/companies/derivatives increase_liquidity.htm, last accessed dated 10.05.2016.

is created. This latter concept is basically considered as gambling activities and is against the principles of *Sharī'ah*.[89]

Risk management is the process of identification of the actual risk level that a firm currently has and identification of the risk level that a firm has desires and the use of derivatives or other financial instruments to adjust the actual risk level to the desired risk level.[90]

This concept of risk management is in line with principle of *Sharī'ah* that is the maintenance and protection of wealth. In this regard Al-Saati states:

> *"Since not protecting wealth from these risks can be considered squandering of wealth, which is prohibited in the Quran. Moreover, as risks are undesirable and unpleasant events, they can be considered as a damage which has to be avoided or eliminated. If risks cannot be eliminated, they must be reduced through risk management. Thus, Sharī'ah obliges businesses to take measures to hedge undesirable risks*"[91]

Here a main question raised by Al-Suwailem that "the issue is how to reach this goal, and what means should be employed to attain this end. The means are not supposed to be prohibited by *Sharī'ah* or norms of financial ethics"[92]

[89]Sāmi Al-Suwailem, '*Hedging in Islamic Finance*', (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, 2006), 9.
[90]D. M. Chance, '*An Introduction to Derivatives and Risk Management*', (Ohio: Thomson Learning, 2004), 4.
[91]See Al-Saati, Abdul Rahim A, 'Sharia Compatible Futures, (Journal of King Abdulaziz University: Islamic Economics, Vol. 15, No. 1, 2002), 46, available at SSRN: https://ssrn.com/abstract= 3073926.
[92]Sāmi Al-Suwailem, '*Hedging in Islamic Finance*', (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, 2006), 6.

3.6. Common Forms of Derivative Instruments

Derivative instruments are depending on the specific embedded contracts to attend the required commercial ends. The most common forms of these contracts are forwards, futures, options and swaps they leads to be the structure blocks for more advance and complex derivative instruments. These are called the "plain vanilla derivatives" while others forms of derivative are called "exotic derivatives".[93] These can be either bilateral over- the-counter (OTC) instruments or exchange-traded instruments and can be used for hedging (risk management), arbitrage and speculation.[94]

3.7. Evaluation of Derivatives

Product innovation is the requirement of today sophisticated business environment. Derivative instruments developed in response to increasingly complex needs. To satisfy the needs, better and new financial products are required. In order to survive, the newly developed product must provide value addition or must increase benefits over existing products equally applies to derivatives. Each derivative instrument down the evolutionary chain, added value. For instance forwards and futures contracts have reduced Liquidity risk, counterparty risk and avoid price squeeze etc. Futures and Options have increased flexibility and ability to take advantage of favorable price movements.[95]

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[93]Francesca Taylor. '*Mastering Derivatives Markets A Step-by Step Guide to the Product, Application and Risk*' (London: Financial Times Pitman Publishing, 1996),18

[94]Jorion, Philippe and Marcos De Silva, '*The Importance of Derivatives Securities Markets to Modern Finance*', (Catalyst Institute, Chicago: Catalyst Institute, 2010), 78.

[95]Ibid

We have examined below the detail evolutionary chain of the derivative instruments and have tried to clarify that how each step down the evolutionary chain led to value added products. Though a derivative is a widely encompassing term, we have restricted our discussion here only to the "plain vanilla derivatives" i.e., forwards, futures, options and swaps.

3.7.1. The Forward Contract

A derivative instrument, in a simple words, is a financial instrument or asset that derives its value from the value any other underlying commodity or asset. "Forward Contract" was probably, the 1st instrument used as derivative, it is the simplest type of derivative instrument among all others. It has been defined as "a contract where two parties undertake to complete a transaction at a future date but at a price determined today". The parties, for example may be a producer who promise to supply the product (underlying asset) and the consumer who needs that product.[96]

Forward contract serves as the basic building block for other advanced nature of instruments and plays a vital role in the financial markets.[97] This contract has been commonly used in the trading of merchandise and commodities. Without using forward contract, trade and business planning would be greatly hindered. In this regard Herbst has given a simplest example that:

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[96]Francesca Taylor. '*Mastering Derivatives Markets A Step-by Step Guide to the Product, Application and Risk*' (London: Financial Times Pitman Publishing, 1996), 24

[97]Hans R. Stoll & Robert E. Whaley, '*Futures and Options Theory and Applications.(South-Western.* Publishing Co., Ohio. 1993), 52

"If a small baking company could not order flour in advance for its immediate needs, for example, it would have to buy a large quantity at a prevailing price and store it for future use. There would be uncertainty about what the price would be when the next order is placed. The miller will have a more difficult task in planning how much flour to produce without orders in hand, and shortages would be more likely to occur".[98]

3.7.1.1. Functions of the Forward Contract as Derivative instrument

The primary function of the forward contract as mentioned by Philippe is that it work like a vehicle to hedge against the unexpected and undesirable price fluctuations. The forward market directly affects the "spot market" as it also offers arbitrage and speculation opportunities.[99]

3.7.1.2. Example of the Forward Contract

Dr. Sherin Kunhibava has stated one good and simple example he said that a farmer who anticipates his crop (maize) to be harvested in the near future and a consumer who is in need of maize in the near future as well. Both parties are faced with the possible risk that the price of the maize may decrease or increase respectively. Therefore, to hedge their risk

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[98]Anthony F. Herbst, *'Commodity Futures Markets, Methods of Analysis, and Management of Risk'* , (John Wiley and Sons, United States, 1986), 3

[99]Philippe Jorion and Marcos De Silva, *'The Importance of Derivatives Securities Markets to Modern Finance'*, Catalyst Institute (Chicago: Catalyst Institute-1996), 222.

they enter into a forward contract to "lock in" the price of the maize to be paid and delivered in the future. At this point there is no exchange of money or commodity.[100]

3.7.1.3. How a forward contract work

To understand how a typical forward contract works, let us examine that there is a farmer (producer) who produce cocoa for his business and a confectioner who needs cocoa for his consumer product. To more simplify, we may say that the farmer (producer) has planted cocoa with the expectation that the yield will be 100 tons of cocoa in the future 6 months. On the other hand, the confectioner (who needs the cocoa for his consumer products) has the cocoa stock in his inventory to be last him in the next six months but he will need to replenish his stock inventory in the 6 months with 100 tons. This is a very common business situation.

Here both of the parties clearly faced with the "price risk", the farmer would have the fear of fall in the spot price in the future six months (in which he will harvest the cocoa) from now, and the confectioner would be fearful for the increase in the spot price. Since both of them face "price risk' but in opposite direction. Now it will be fruitful and logical for both them to hedge against this price fluctuation by negotiation and agreement on the price to be "locked in" today for the transaction (payment and delivery) to be carried out in the future

[100]Sherin Kunhibava, *'Derivatives in Islamic Finance'* (International Shari'ah Research Academy for Islamic Finance (ISRA), Research Paper No.7/2010), 13

(in six months). Once the terms of the contract are formalized and documented by the parties with the mutual consent, a forward contract existed.[101]

3.7.1.4. Benefits of Forward Contract:

The benefit of such a forward contract accrues to both parties. First, both parties as a result of the forward contract have eliminated all price risk. The farmer now knows the price he will receive for his cocoa regardless of what happens to cocoa prices over the next 6 months. The confectioner too has eliminated price risk since he will only have to pay the agreed price regardless of spot prices in the next 6 months. There is a second benefit to this. Since both parties have "locked-in" their price/ cost, they would be in a much better position to plan their business activities. For example, the confectioner can now confidently quote to his customer the prices at which he can deliver them products in the future. This would not have been possible, if he were uncertain about his input price. The benefits of a forward contract therefore, are often much more than merely hedging price risk.[102]

3.7.1.5. Problems with the Forward Contract

The forward contract, despite of its benefits, it has various embedded problems, out of these, one of the main issue is that of the double coincidence, to arrive at forward price through negotiation, here, a number of factors will have to coincide before to reach that. For example, the interested party to a forward contract will have to find a counter party

[101]Francesca Taylor. 'Mastering Derivatives Markets A Step-by Step Guide to the Product, Application and Risk' (London: Financial Times Pitman Publishing, 1996), 32
[102]Ibid

who will also have the opposite needs not only with the respect of the underlying asset but also about the right time of delivery and quantity of the assets as well. Secondly, since the forward price is arrived at by the parties through negotiation, here is the possibility that one party may impose a price on the other, it may be due to strong bargaining position, urgency at the part of other part or due to informational asymmetry, the most common reason. A third and perhaps the most significant problem with forward contract is that of counterparty risk (i.e. the risk that one of the party will default), this is also called the "default risk", though this is not so much arise due to dishonesty of the counter party but from the increased incentive on default as a result of subsequent price movement. When spot prices rise substantially above the forward price, the short position (seller) has the incentive to default. Oppositely, if the spot price falls heavily, the long position (the buyer) would have the incentive to default.

To remove the above mentioned shortcoming and to provide the same benefits of risk management as of forward contract, a new instrument was needed. Resultantly futures were introduced.[103]

3.7.2. The Future Contract

The next pace in the evolutionary chain of derivative after forward contract is that of future contract. Future contract was the result of innovation to overcome the problems associated

[103]David Haddock & Roger Kormendy, *Grain Futures Contract An Economic Appraisal,* (Kluwer Academic Publishers: Boston,1993), 24

with the forward contract and to provide the best risk hedging instrument to the market participants.

3.7.2.1. The need for Futures Contracts

To find out solution to the major problems associated with the forward contract, already mentioned in the previous section, the future contract was introduced not only to overcome the problems associated with the forward but also to provide more benefits as compared that already covered by the forward contract. As a matter of fact, a newly innovated product will not be survive unless it provides some value addition over the already existing products. The increasing popularity of futures and having a huge trading volume in the market is the evidence of its benefits over the forward contract.[104]

3.7.2.2. Nature and Meaning Future Contract

In simple words, future contract, is an agreement between two parties, the seller and the buyer, to deliver an asset at future date against a particular price. It is a contract to be implemented at a future period of time, all other requirements binding between the parties must be taken into consideration. Based on that, Futures contract is defined by *Hanafī* "as an agreement to exchange financial instruments, through buying or selling, for specific terms and conditions with the delivery of both the article and the price at a specified future

[104] Ibid

date"[105].Another scholar defined the future contract as "it is an agreement between a buyer and seller at time 0 to deliver a specified asset at a certain time in the future for a certain price".[106]

Future contract is primarily a forward contract, however, it has been made standardized in respect of size of the contract, maturity of the contract, product quality and place of delivery, etc. With this standardization, it become possible to trade them on an organized exchange which in turn increases liquidity and therefore, reduces transaction costs.[107]

The nature of the futures markets was described by Lockhart in *Australian Stock Exchange Ltd* (1995) 13 ACLC 369 as:

> *"A futures market is a market in which people buy and sell things for future delivery. A futures contract generally involves an agreement to buy and sell a specified quantity of something at a specified future date. The price is variable, determined competitively by 'open outcry' on the trading floor or through a computer-based marketplace. Futures markets perform the economic function of managing the price risk associated with holding the underlying commodity or having a future requirement to hold it. The futures market is a risk transfer mechanism whereby those exposed to*

[105]Quoted by Abdel Karim and Ali Zarai, '*Investment in Financial Derivatives Contracts from an Islamic Perspective*', (International Finance and Banking, Vol. 1, No. 1, 2014), 5.

[106]A. Saunders & M.M. Cornett, '*Financial Markets and Institutions*' (New Delhi: Tata McGraw-Hill Publishing Company Limited, 2007), 54.

[107]David Haddock & Roger Kormendy, *Grain Futures Contract An Economic Appraisal,* (Kluwer Academic Publishers: Boston,1993), 24

risks shift them to someone else; the other party may be someone with an opposite physical market risk or a speculator".[108]

3.7.2.3. Example of the futures contract

A simple illustrative example of the Future contract has been stated by Abdel Karim and Ali Zarai for understanding purpose, he said that. the investor (X) trades in fixed income securities (bonds), so he bought bonds of a market value equal to one million riyals for only (800) thousand riyals; and due to interest rate fluctuations and the expectations of a rise and then a drop in the price of the bonds, he concluded a futures contract to sell those bonds for (795) thousand riyals to be handed over after three months. However, by the time the handover was due, the market value of the bonds decreased to (790) thousand riyals. Moreover, the value of the bonds in the futures contracts market dropped to (780) thousand riyals. And based on these changes, the equation of gains and losses will be as following: Loss in normal market = change in market value = 800-790 = 10 thousand riyals. Profit in futures contracts market = change of value in futures contracts market = 795-780 = 15 thousand riyals. Net profit = Profit - Loss = 15-10 = 5 thousand riyals.[109]

3.7.2.4. How future contract solved the problems associated with the forward?

As mentioned earlier, Futures contracts are traded on an organized exchanges that monitor the transactions of all buyers and sellers on the exchange. Since many buyers and sellers

[108] Ibid

[109] See Abdel Karim and Ali Zarai, '*Investment in Financial Derivatives Contracts from an Islamic Perspective*' (International Finance and Banking, Vol. 1, No. 1, 2014), 13.

carried out transaction through the organized exchange, so the issue of multiple coincidence has been resolved. Furthermore, determination of futures prices as on today are considered to be fair, as market clearing prices are quoted in the exchange, thus the situation of imposing a price on the other party will not occur as the prices are arrived at by the interaction of many buyers and sellers in the exchange. As for the problem of counterparty risk is concerned, the exchange itself being the guarantor for each buyer to the seller and each seller to buyer, has solved the problem of counter party default risk[110].

Now, after the transfer of the risk to the exchange by the counter parties, the exchange has to manage and minimize this potential default risk. However, the exchange achieves this by two processes, one known as "margining" and the other as "marking to market". The exchange obtains from each party the initial deposits, known as initial margins, whenever losses occur, it will require the party whose position is losing to pay up as the losses occur. This is also called as "margin call". The 2nd process which is known as "Marking to market" means that the loss or gain in position of the contact resulting from changes in the price of the futures (or option) contracts at the end of each trading day is added or subtracted from each account balance, this is called "marking to market".[111]

3.7.2.5. Unique Features of the Future Contract

One of the major unique feature of the future contract is that it provides the ability to the buyers and to the sellers to reverse out from their position before maturity or delivery of the

[110]Obiyathulla I.B, '*Financial derivatives markets and application in Malaysia*' (Serdang: Penerbit Universiti Putra Malaysia, 2001), 39

[111] Ibid

goods, consequently, in commodity futures market, physical delivery scarcely ever takes place, as compared to the forward contract where actual delivery does take place.[112]

3.7.2.6. Advantages of the futures contracts

As compared to the other similar nature of contract, future contract required less liquidity cost to enter into the contract of the underlying asset of greater value, deposit guarantee, initial margin or margining deposits are required as compared to other similar instruments. Future contract can be used as risk hedging instrument, the risks derived from the price fluctuation before expiration of the contract. The future contract being traded on an organized standardized exchange, the contracting terms gives liquidity and the opportunity of closing positions on a date before the expiration, and the clearinghouse being guarantors to the counter parties minimize the risk of default, risk of insolvency and the risk of liquidation of the contract.[113]

3.7.3. Types of Futures Contracts

There are many types of futures contracts, they can be classified on the basis of the nature of the market to which they belong, i.e. mainly the capital market and the money market. Capital market can further be divided into financial market and commodity market. Actually, all these markets can accommodate many types.

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[112] David Haddock & Roger Kormendy, *Grain Futures Contract An Economic Appraisal,* (Kluwer Academic Publishers: Boston,1993), 13

[113] Hans R. Stoll & Robert E. Whaley, *Futures and Options Theory and Applications,* (*South-Western.* Publishing Co., Ohio 1993), 81

3.7.3.1. Capital Market

All the future contracts related to the deal of any material goods, assets or financial instruments come within the ambit of the capital market. Physical commodity cover all the goods consistent with the provision of trade, this means that the goods must be subject to specification in terms of description, amount, type, quality, and size etc. These are also called commodities futures contract. For example, metals, vegetables etc. are traded in commodity futures. It should be noted here that the physical commodity must be savable in nature because what cannot be saved may not meet the maturity date. Although determination of the goods is the prime responsibility of the brokerage house. So far as financial futures are concerned they are not different from commodity futures except the underlying assets of both are different. In financial futures contract, diverse financial instruments like stock exchange indexes, bonds, equity shares, debentures, treasury securities, etc. are traded.[114]

3.7.3.2. Money Market

The money market includes all the futures contracts that deal in currencies exchange. In money market, currencies swaps contracts concluded according to their exchange rates based on the forces of supply and demand. Generally, the traded currencies are international or global currencies such as all types of dollar, the euro, the Japanese yen, the pound sterling, and others. The futures contracts in currencies play a vital role in achieving

[114]Abdel Karim and Ali Zarai, '*Investment in Financial Derivatives Contracts from an Islamic Perspective*' (International Finance and Banking, Vol. 1, No. 1, 2014), 5.

big goals for the dealers in the money markets, especially for those trades between the countries. It is well known that the frequently or rapid change in the price of the currencies have a great effect on the actual costs of trade between the countries, rather it play a big role in maintaining a relative economic stability, and prevent financial losses resulting from the change in foreign currencies exchange rates. That is why the dealers with futures contracts try to monitor the prices of currencies and conclude the future currency contracts to hedge against sudden cash fluctuations.[115]

3.7.4. Characteristics of a successful Futures Market

a. For a successful future market, demand and supply for the underlying commodities must be in large number. As in all small markets, the producers and users give preference to deal directly with each other instead of to bear the expenses of the future standardized market.

b. There must be fluctuation or volatility in prices, if the prices are stable or nearly so then there is no incentive for hedgers to hedge or motivation for speculators to participate in the market.

c. The underlying asset or commodity to be traded must be quantifiable to permit standardized tests to grade quality. Quality of the commodity should be described objectively to be accepted in the industry. Grading of the commodities must be ensured to have not changed for that purpose a regular government inspections may be carried out.

[115]Ibid

d. Price information should be objectively and readily available to the market players, the spot or current quoted prices should be accurate and to properly show its relation into futures prices.[116]

3.7.5. Comparison between Forwards Contracts and Futures Contracts

The main features of the futures contracts already stated above seem to have some similarities with the forward contract and the overlap between them in the written works of some scholars. It is necessary to enumerate a proper distinction and clarification between these two types of contracts. Following are some of the differences between forwards and futures contracts based on their concepts and specific criteria:

a. Futures contracts concluded in an organized market place to which only listed members are allowed. While in the case of forward contract, the contracts concluded on the decision of the counterparties through negotiations and interactive relationships.

b. In futures market trading is done by the open outcry (That is to say, a bid or offer must be made aloud to the whole market place and may be accepted openly by any member). The price changes in future contract over the time period of the contract will in return have effect on the movement of profits and losses between the contractors; however, in the forward contract, the price is fixed by the parties as they wish until the end of the contract.

[116]Robert E. Fink and Robert B. Feduniak, '*Futures Trading Concepts and Strategies*', (New York Institute of Finance, 1988), 14–16; Edward J. Swan (ed.), '*Derivatives Instruments Law*', (Cavendish Publishing Limited), 60–61.

c. Trading in future market is confined to standardized specification of the commodities as specification in standard quantities generally known as lots. Likewise, grade or quality of the underlying asset is specified along with delivery time and intermediary involvement, to enhance the quality of the market. Whereas in the forward contract no standard size and no intermediary between the parties are there, they are just tailored according to the specific needs of the contracting parties.

d. The most important feature of the future contract is that at any time before delivery, any party to the contract, obtain a discharge of his obligations by entering into opposite or a matching contract with any member of the market for the same delivery date or month. In this regard an example given by Ottino that "A, who has sold five lots of cotton, for instance, to B for delivery in March at $150 per ton, may at any time before the close of trading day for March buy the same quantity from C for delivery in that month. Once this matching contract is registered with the market's clearing house, and A has asked for the two contracts to be closed out or settled, he will be fully discharged of his original obligation to deliver cotton to B and to take delivery from C".[117] Meanwhile, in a forward contract, the counter parties are under obligation to take delivery at the maturity date.

e. In a futures contract, the period of delivery, relatively, is limited to a brief period during a year, (which vary from commodity to commodity) and the delivery must

[117]See P.J. Ottino, '*Oil Futures: The International Petroleum Exchange of London*,' (*Journal of Energy & Natural Resources Law*, London, Sweet & Maxwell, 1985), 1–2.

be made at a specific single location. Whereas in a forward contract the delivery will be the same as per agreement of the counter parties.

f. In case future contract is breached, the exchange will be responsible for providing the damages to the aggrieved and not the party on the other side. The exchange must therefore undertake any action necessary to secure damages from the breaching party.[118]

The above mentioned comparison have been summarized in the following table for better understanding purpose.

	Item	**Futures**	**Forward**
1	Market Place	Specific market place that is reserved to listed members only	Does not need any specific market
2	Mode of Contract	Through open outcry	The parties have the right to conclude the contact as they wish
3	Subject Matter	Confined to commodities of standard specification (lots)	Tailored according to the specific needs of the contracting parties
4	Discharging of Obligation	Possible to discharge obligations by entering into a matching contract	Parties are under obligation to take delivery at the maturity date.
5	Delivery Time	Limited to only brief periods during a year.	According to what agreed upon between the parties
6	Breach of Contract and Claim for Damages	Entangles the individual party with the Futures Exchange and not the party on the other side of the agreement.	The settlement of the dispute will involve the two contracting parties only.

[118]See S. Craing Pirrong, David Haddock and Roger Kormendy, '*Grain Futures Contract: An Economic Appraisal,*' (Kluwer Academic Publishers, Boston, 1993), 2.

3.7.6. Inadequacies with the future contract

Although futures contracts have covered the main problems associated with the forward contracts, yet, there were significant deficiencies that lead to further search of the product innovation to overcome the same. The 1st one is that the futures have easily hedged the risk of price fluctuation by "locking in" the price at which one could buy or sell but being locked-in also means that one could not get benefit from the subsequent favorable price movements. Secondly, participants having no option to handle the contingent liabilities. Thirdly, as futures are traded on a standardized exchange, therefore, futures contracts for all the instruments does not exist nor for all the merchandise which may not cover exactly all the cash positions.[119].Therefore further innovation to overcome the above mentioned shortcoming is must, resultantly options were introduced.

3.8. Options Contract

Option contracts are considered among the basic tools of risk management, they have been able to overcome the problems associated with futures. Options depends on the prediction or forecasting of the price changes in the market and affect the market relations. They differs in this aspect from the Islamic option contracts.

[119]Ibid

3.8.1. First extensive application of Options in the market

The first extensive application of options in the market started when "Tulip Bulb Option Market" developed by the Dutch, where the growers and dealers of the tulips were involved in call and put option to hedge their risk exposure. However, this market was completely unorganized and unregulated due to which it was easy for the speculators to take advantage from this imperfect market.[120]

3.8.2. The needs for Options or why options are needed?

The futures contracts were introduced to overcome the problems associated with forwards contract but still there were inadequacies in some respects (which we have already mentioned in earlier section). Particularly, out of these, two were the major issues which have prompted the search for further innovation.

The first problem with the future is that, in fact the futures have been able to easily hedge the price fluctuation risk by "lock in" the price at which one can buy or sell but it does not allow him to benefit from subsequent favorable price movements. In this regard Bacha has stated "Although, reversal of future position can take place subsequently but subsequent unfavorable price movements could really hurt"[121].

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[120] John Hull, *Introduction to Futures and Options Market*, (Prentice Hall, Inc. John Prebbe, *Dimensions in Banking and Foreign Exchange Law*. Wel-lington, Butterworths, 1992),17

[121] Obiyathullah I.B. '*Derivatives Instrument and Islamic Finance: Some-Thoughts for Reconsideration*', (International Journal of Islamic Financial Services Vol. 1 No.1), 6.

The second and more important problem or inadequacy is that futures (and forwards) were unsuitable to manage the contingent liabilities or contingent claims (these are liabilities or claims on a business entity that could arise depending on an uncertain outcome). To manage such complicated risks, options were innovated[122]

3.8.3. Concept and Definition of Option Contract

Option Contract has been described as a contract which confers the option holder a right without obligation to sell or purchase an underlying asset at a predetermined price at the end or within the specific time period i.e. before maturity. All options traded on exchange can be divided into two kinds, Call options and put options. A "call option" enables the option holder with the right but not the obligation to purchase the underlying asset at a predetermined price at the end or within the specific time period i.e. before maturity. A "put option" on the other hand enables the option holder with the right to sell but not the obligation to sell the underlying asset at a predetermined price at the end or within the specific time period i.e. before maturity.[123]

Hans Stoll & Robert E, have defined options in the following words "An option is a contract between two parties in which one party (the buyer) has the right, but not the obligation, to buy or sell a specified asset at a specified price, at or before a specified date, from the other party (the seller).The seller of the option, therefore, has a contingent liability or an obligation, which is activated if the buyer exercises that right". Thus, "An option

[122] Ibid

[123] John Hull, *Introduction to Futures and Options Market*, (Prentice Hall, Inc. John Prebbe, *Dimensions in Banking and Foreign Exchange Law*. Wel-lington, Butterworths, 1992), 38.

contract conveys the right to buy or sell an underlying commodity at a specified price within a specified period of time".[124]

Another scholar defined the option contract as a "contract through which the contract editor gives the buyer of that contract the right to buy or sell something at a specified price, during a certain period of time, or on a specific date".[125] It is also defined as a "substitute contract on an abstract right that entitles its owner to buy or sell something at a specified price, for a certain period of time, or on a specific date, either directly or through a committee that guarantees the rights of the two parties".[126]

To explain the concept of options in simple words for common readers, we can say that when the option holder have the right to purchase a commodity is called 'call option' and when the option holder have the right to sell a commodity is called 'put option'[127]

Since options provide the holder the right but not impose the obligation on the holder, therefore, the holder may exercise it if the price move favorable for him. Due to this non obligatory nature of the contract, it has provide and increase flexibility over the forward and future and it is also considered the key advantage with the option contract. For this privilege, the buyer of the options pays the seller a non-refundable premium. Therefore,

[124]Hans R.Stoll & Robert E.Whaley, *Futures and Options: Theory and Applications* (South Western PublishingCo., Ohio, 1993), 6.
[125] Hammad, Tareq Abdel Aal, '*Financial derivatives: concepts, risk management, accounting*', (Academic House, 2003),46
[126] Decision of the Islamic Fiqh Academy (1992). *Seventh session, Jeddah. Resolution No. 65/6/7.* Jeddah: Islamic Fiqh Academy, No. 7.
[127] Muhammad Ayub, Derivatives and Islamic Finance, Research paper available at www.sbp.org.pk/departments/ibd/derivatives_islamic.pdf, last accessed dated 16.08.2016.

the losses of the buyer is limited only to the premium he paid. The loss will be occur if he choose not to exercise the option.[128]

An option contract has a minimal size, this being the amount of underlying asset that the option holder may buy or sell at the "strike price" (the price at which the holder may buy or sell the underlying asset upon exercise of the option).[129]

3.8.4. Example of Option Contract

Option can be understand by the following example as explained by Muhammad Ayub. He stated "A call option purchase at a price of say Rs. 5 on bond or stock 'A' provides a right to Mr. M to purchase the stock at price of Rs. 50 three months from now. If as per his expectations the price of 'A' increases to Rs. 60 on the maturity date, then the buyer of the call has a net gain of Rs. 5 (on an investment of Rs. 5). This is what the seller or the writer of the call would lose. But if the price of the stock falls below Rs. 50 on the maturity date, say to Rs. 40, the buyer would allow the option to expire without exercising it since he can buy from the market at a lower price. His loss would amount to Rs. 5 or hundred percent with the call. This Rs. 5 would be what the seller of the call would gain on zero investment. In the game, the buyer and seller have diametrically opposite expectations. The possibility

[128] Obiyathullah I.B, 'Derivatives Instrument and Islamic Finance: Some Thoughts for Reconsideration', (*International Journal of Islamic Financial Services Vol. 1 No.1*), 15.
[129] Muhammad Ayub, Derivatives and Islamic Finance, Research paper available at www.sbp.org.pk/departments/ibd/derivatives_islamic.pdf, last access dated 16.08.2016.

of risk and returns are magnified, the gains of the buyer being equal to the losses of the seller and vice versa."[130]

3.8.5. Important Features of the Option Contracts

The most important features of option contracts can be summarized in the following points:

a. The far most important feature of the option contract is that the buyer or the holder of the option is not bound or under obligation to enter or complete the deal. He choose to do so if the changes in prices move favorably and make it profitable for him. Thus the buyer of the option is protected from loss due to unfavorable market movements, although he is able to earn profit from the price movement in his favor. The risk of loss is limited only to the premium he paid to the seller for getting this privilege.[131]

b. One of the main features of the option contract is that it gives its owner the flexibility to move and choose in the market as he does not deal only with the specific stocks, rather it gives the right to possess or sell shares.

c. Another important feature of the option contract is that it consists of a vendor and a buyer of the right of option. But it is binding to the vendor only not to the buyer.[132]

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[130] Muhammad Ayub, Derivatives and Islamic Finance, Research paper available at www.sbp.org.pk/departments/ibd/derivatives_islamic.pdf, last accessed 16.08.2016.

[131] Securities Commission and Securities Institutes Education, *Malaysian Futures and Options Registered Representatives* (MFORR) course, (Kuala Lumpur, 1997), 2.

[132] Fayyad, Attia. '*Stock Market in the Balance of Islamic Jurisprudence*', (Cairo: Universities Publishing House-1998), 41

d. The unique nature of the option right is that it depends on the existence of a non-refundable reward or a price for the option (bonus) and "option reward" depends on several other factors such as duration, type of asset, degree of risk etc. that determine the price level at the implementation.[133]

e. Another feature is that this right will be exercised at a given period or at a specific time. In all cases, the buyer will make profit only if that same option is sold during that period at a favorable price.[134]

3.8.6. Types of Option Contracts

There are three main types of option contracts namely, call option, put option and double option, each type has its special feature that distinguish it from the others.

3.8.6.1. Call Option Contract

A call option contract is defined as "an agreement between two parties through which the first party, called the editor or the seller of the contract, gives the other party the right to choose between buying a particular asset or not at a specified date and price".[135] It consists, a vendor of the right also called (Contract Editor), a buyer of the right of option, and the price of the option (the premium) paid by the buyer to the vendor. The counter parties that is the buyer and the vendor aim to protecting themselves from the risk of price fluctuations,

[133] Balboul, Mukhtar Mohammed, '*How to invest your money in stocks and asset*' (Alexandria: Modern Egyptian Office-1992), 22

[134] Kharyoush, Hosni Ali, '*Financial Markets: Concepts and Applications*' (Amman: Dar Zahran-1998),8

[135] Hammad, Tareq Abdel Aal. 'Financial derivatives: concepts, risk management, accounting', (Academic House-2003),51

this process is also called the "hedging" process. Call options can covered the capital market, money market and also applies to the foreign exchange market.[136]

3.8.6.2. Put Option Contract

The put option contract is defined as "an agreement between two parties through which the first party, called the editor or the seller of the contract, gives the other party the right to choose between buying a particular asset or not at a specified date and price"[137]. This contract is the same as that a "call option contract" as pillars of both are the same that is vendor, buyer and the price of the contract. However, here the owner of the option is a "seller" not a "buyer".

The seller's (option editor) decision to edit a "Call option" or a "Put option" will be determined in the light of the market data. If he seems that expectations are of higher prices, he would edit a "Put option"; whereas, he would choose a "Call option" at times of lower prices expectations. In both cases, the other party will neither be able to sell in the case of "put option" because the market value is higher than the implementation price, nor to purchase in the case of "Call option" because the implementation price is higher than the market value.[138]

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[136] Hanafi , Abdul Ghaffar, '*Stock Exchange*' (Alexandria: Dar New University-2003), 58

[137] Hammad, Tareq Abdel Aal, '*Financial derivatives: concepts, risk management, accounting.*(Academic House 2003),42

[138] Ibid

3.8.6.3. Double Option Contract

The double option contract is the combination of both the "Call option" and the "Put option", therefore the holder of such option is entitled to be a seller or a buyer of the same financial asset. Thus, if the implementation price is less the holder of the option would buy and if the implementation price is higher than the price level he would choose to sell. On the contrary, the editor of the option would face higher risks which would lead to an agreement to increase the option reward (bonus). [139]

Hamami stated regarding this contract that "This type of option contracts brings forth profits to its holder when the market is witnessing sudden and great swings in price levels. As a result, the holder of the option pays a high reward because he has expectations of abrupt price changes. So, if the prices rise up he would carry out a "call option", in which his profits will be achieved through the difference between the implementation price, at which he has already bought, and the high market price, at which he is now selling. But if the prices fall down, he would implement a "put option", gaining, thus, profits from the difference between the implementation price, at which he has already sold, and the low market price, at which he is now buying. All this cannot be fulfilled unless his predictions are correct; otherwise, he won't perform any operation and bear the loss in the form of the option reward.[140]

[139] Radwan, Sāmi r Abdel-Hamid, '*Securities Markets*, (1st ed. International Institute of Islamic Thought -1996), 16
[140] Hamami, Abd al-Karim Qasim, '*Investing in Stock Options and Stock Indexes Options*', (Riyadh: Al-Farazdaq Commercial Printing Presses-2003), 23

3.8.6.4. American and European Options

There are two other fundamental kinds of options contract, the "American option "and the "European option". An American option contract allow the option holder or the owner to exercise "at any time before or at the expiration". Whereas the owner of a "European option" can exercise only at "the expiration".[141]

3.9. Comparison between Forward, Futures and Option Contracts

Major differences between forward, future and options may be clarified through the following points:

In future contracts, both the counter parties are under obligation for the accomplishment of the contract. However, the same is not the case in options contract, where the buyer have the flexibility with regard to the accomplishment of the contract and the seller commits himself to the completion subject to the buyer's desire. Moreover, the potential loss or gain to the speculator is large in future contracts as compared to the options contract where his loss is limited to the amount paid for the options.

In option contract, the inactivity of the option holder will just lead the option contract to expire, and the premium paid by the option holder will be lost; whereas, in a futures or

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[141] Robert W. Kolb, *Option The Investor's Complete Toolkit*,(New York Institute of Finance, United States, 1991), 7.

forward contract, inactivity of the holder will have cause to pay up or deliver the commodity.[142]

In future contracts, the subject of the contract are the investment instruments. Where as in options contracts, the whole operations goes around the right to buy or sell the stocks.

The risk in the future contracts is higher than options contract as the degree of risk in future contracts is nonspecific, which requires a care full study at the time of investment and constant follow up of the change in prices, where as in options contract the size of the risk is limited which cannot exceed the value of the option reward (bonus).[143]

3.10. Swap Contracts

Swaps contracts are another important nature of contracts in derivative market. They are different in nature from the other derivatives instrument, especially, because swaps contracts do not take place in an organized or regulated market, therefore, are not subject to any legal conditions acknowledged in the trading process. The most important aspects of swaps can be clarified as follows:

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142 Options are priced according to a number of methods, the discussion of which is beyond the scope of this study. F. Black & Scholes, M. "The pricing of options and corporate liabilities," *Journal of Political Economy* (1973); J. Cox, Ross, S., Rubenstein, M., "Option pricing: a simplified approach," *Journal of Financial Economics* 7, no. (1979).

143 Obiyathullah I.B. *'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration'* (International Journal of Islamic Financial Services Vol. 1 No.1.), 58

3.10.1. The concept and meaning of Swaps

Various definitions of swaps have been carried out by the scholars based on their nature and forms. However, swaps are generally defined as "a contractual commitment to exchange cash flow or a particular asset for another cash flow or asset with certain agreement conditions"[144]. Others have defined as "swap representing an agreement between two or more parties to exchange a series of cash flows during a future period"[145]or as "series of contracts that are subsequently implemented and settled at periodic intervals"[146]

From the above mentioned definitions, we can derive a set of criteria or contents, which may help in the understanding the nature of swaps contract, important ones are:

- Swaps include a huge bowl that makes it possible to swap in securities, interest rates and to exchange goods and currencies through swaps etc.
- Swaps are binding contracts in nature, they are binding on both of the counter parties, unlike options contract. Moreover, swaps contracts are settled on a regular basis rather than a daily basis as is the case of futures contracts.
- Swaps are devised to manage risks especially in the area of interest rates and currencies. In reality, the speculators continuously in struggle to divert the interest

[144]Ramadan, Ziad, '*Principles of Real Financial Investment*. Amman: Dar Wael. Trade, Ismail, 1998), 133
[145]Hammad, Tareq Abdel Aal, '*Financial derivatives: concepts, risk management, accounting*' (Academic House, 2003),120
[146]Henawi, Mohammed Saleh & Ibrahim Sultan, 'Analysis and Evaluation of Securities. (Alexandria: Academic House, 2002),42

rate and exchange rate movement towards their interests, and to reduce the risk of any unexpected losses.

3.10.2. Types of Swaps

As we have mentioned earlier, that swap is a big bowl which accommodate many types that differ according to the nature and the term of the swap. Here, we will mentioned only the most important types of these contracts. These are:

3.10.2.1. Interest Rate Swaps

Change in interest rate is a complex nature of issue and involve high risk, which even leads lenders' and borrowers' to bankruptcy. Therefore, the interest rate swap has been innovated and emerged with the idea to hedge against interest rates fluctuations. So the process of the interest rate swap has been defined as "the existence of an agreement to swap debt obligations or benefits which will achieve profit for the parties of the contract"[147]. From the above mentioned process it is understood that the nature of this contract is based on the basic elements such as "fixed" and "variable" interest rate, so fixed and variable interest rate cause the value of the swap contract and the settlement.[148] In the interest rate swap, there are further two basic types, depends on the determination of the paying and the receiving sides. These are "payment swap" (where the first party, who expects an increase

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[147]Habash, Mohamed Mahmoud, '*Global financial markets and their derivative instruments*',(Oman: Al-Warraq Institution -Habash, 1998),66

[148]Henawi, Mohammed Saleh & Ibrahim Sultan, 'Analysis and Evaluation of Securities. (Alexandria: Academic House, 2002),53

in interest rates, goes through a (paying) swap of a fixed interest rate for a variable one for a definite period of time) the second type is "receipt swap" (where the first party, on expectations of lower interest rates, engages in a (receiving) swap of a fixed interest rate for a variable one at a definite time).[149]

3.10.2.2. Illustrative Example of interest rate swaps

The following example will further clarify that how the interest rate swap works. For example "Both the financial institution (x) and the financial institution (y) agreed to swap a fixed interest rate for a variable for a period of 10 years. The agreement stated that the institution (x), which expected high interest rates, would pay a fixed interest rate of 3 % on the value of a swap contract equivalent to ten million riyals, while the institution (y) would pay a variable interest rate of 5 % based on the prevailing market price for each quarter of the year. This sort of agreement can be mathematically portrayed as following: Commitment of the financial institution (x) = percentage of the fixed interest × the sum × quarter of the year = 3% × 10,000,000 × (90/360) = 75000 SR Commitment of the financial institution (y) = percentage of the variable interest × the sum × quarter of the year = 5% × 10,000,000 × (90/360) = 125,000 SR

Loss of the institution (y) = the change between the two commitments = 125,000 – 75,000 = 50,000 SR

This means that the institution (y) would be committed to a loss if: the percentage of the variable interest rate > the percentage of the fixed interest rate whereas it would gain

[149] Yaser Abdel Karim Mohammed Hourani and Dr. Mohammed Ali Zarai, 'Investment in Financial Derivatives Contracts from an Islamic Perspective', (International Finance and Banking 2014, Vol. 1, No. 1),8

expected profit if: the percentage of the variable interest rate < the percentage of the fixed interest rate".[150]

3.10.3. Foreign Currency Swaps

In the swap currency contracts, the parties swap one currency for another to take advantage of the exchange rate variations. It has been defined as "a contract between two parties to buy specific amounts of foreign currencies from each other, on the basis of the instant price, and sell them, on the basis of future prices".[151] In other words we can say that these contracts are 'a swap of one loan for another at an interest rate which differs according to the contractors' expectations. Karim and Zarai stated that:

> "*Generally, these contracts are concluded in order to ensure the necessary liquidity to finance operations, or to speculate on currencies in order to achieve the dealers' interests, and thus reach the expected exchange rates at maturity. In addition, the central banks tend also to exchange currencies in order to control the amount of domestic and foreign currencies liquidity through swap operations with the local banks in a manner consistent with the monetary policy. In this way, currencies swap is similar to what is known in economics as 'Comparative*

[150]Yaser Abdel Karim Mohammed Hourani and Dr. Mohammed Ali Zarai, 'Investment in Financial Derivatives Contracts from an Islamic Perspective', (International Finance and Banking 2014, Vol. 1, No. 1),14
[151]Habash, Mohamed Mahmoud, '*Global financial markets and their derivative instruments*',(Oman: Al-Warraq Institution -Habash, 1998),66

Advantage' (where each of the two parties needs what the other has, and so does his best to obtain from him the required benefit)".[152]

3.10.3.1. Illustrative example (foreign currency swaps)

We can illustrate the above mentioned currency swap with the existence of two parties: "The first party (x) who works in the export of petrochemicals in Saudi Arabia; the second party (y) and works in America in the field of technology export. If we assume that (x) has ten million riyals, which he does not need at the moment, because of debt obligations equivalent to that sum in dollar, and (y) has the same value in dollar, which he also does not need at the present time because of debt obligations equivalent to it in Riyal. And assuming that both (x) and (y) are known for their rational behavior, they would sign a currency swap contract that involves the riyal and the dollar, and determines the forward rate for each of the two currencies. Therefore, it becomes clear that both (x) and (y) have simply achieved the type of currency immediately needed, the quantity required, and the forward rate desired, saving thus any expected increase in the costs that may result from either the variation of exchange rates, or the borrowing from the banking system at an interest rate".[153]

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[152] Yaser Abdel Karim Mohammed Hourani and Dr. Mohammed Ali Zarai, 'Investment in Financial Derivatives Contracts from an Islamic Perspective', (International Finance and Banking 2014, Vol. 1, No. 1),10
[153] Ibid

3.11. The Main Players in Derivative Markets

Like in any other financial markets, various traders and institutions are involved in financial derivatives market, however, they could be broadly categorized into the following three types, namely, namely (i) Hedgers, (ii) Arbitrageurs, and (iii) Speculators.[154]

3.11.1. Hedgers

Hedging is the main purpose of the innovation of derivatives, thus, hedger are the major players of the derivative market. The use derivative instruments to manage and reduce their business risk. In our earlier, examples, the cocoa farmer and the confectioner were hedgers. Typically businesses use derivatives to offset exposures resulting from their business activities.[155]

3.11.2. Arbitrageurs

The 2nd category of players are arbitrageurs they use derivative instruments to engage in "arbitrage" i.e. (The process of trying to take advantage of price differentials between markets). Arbitrageurs closely follow up the quoted prices of an asset/instrument and looking for the price divergence in different market of the same asset/instrument. So they buy on the market with lower price and sell in the market where the quoted prices are high.

[154] Obiyathullah I.B. 'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration' (International Journal of Islamic Financial Services Vol. 1 No), 22

[155] Hans R. Stoll & Robert E. Whaley, '*Futures and Options Theory and Applications, (South-Western.* Publishing Co., Ohio. 1993), 67

This divergence is good enough for them to make profit. Therefore, Institutions (commercial banks, investment banks, currency dealers etc.) that engage in this kind of activity have to invest huge amounts of money. Arbitrage of opportunities quickly disappeared, therefore, quick action is needed for the same.

While commenting on the activities of arbitrageurs Bacha stated that "In addition to merely watching the prices of the same asset in different markets, arbitrageurs can also arbitrage between different product markets, for example, between the spot and futures markets or between futures and options markets or even between all three markets. It is in this type of arbitrage that sophisticates financial engineering techniques come into play".[156]

3.11.3. Speculators

The final and most important category of the players in derivative market is that of "speculators". They merely speculate as it is evident from the name. Speculators takes positions in an assets or markets without taking offsetting position. For instance, if they expect about an asset to be all in value accordingly they short the asset. However, if their expectation become true they would make profit from having a shorted the asset but if the price increases instead, they would make losses on their short position instead of profit. Therefore, speculators expose themselves to high risk and hope to earn profit from taking

[156] Ibid

on the risk.[157] Unfortunately, in derivatives market as speculators, dominant the market the very opposite of their intended purpose.

3.11.4. Summary:

To summarize the main discussions of the chapter, it can be said that the new terminology "Derivatives" is a generic term and has been defined as a financial instrument whose value depends on the value of other, more basic, variables. The inherent values of these contracts are derived from independently existing underlying which can be an asset or a pool of assets, an index or any other item to which the parties may choose to link their derivative contract. Creation and development of derivative instrument is the result of financial innovation that helped out the public need to manage risk in today's increasing sophisticated global business environments. These instruments are popular and useful because of their flexibility and ease of use. They are easier to buy and sell, such as metals, energy, agricultural commodities, stock indexes and currencies. Further, for trade in derivatives less or small amount of capital is sufficient as compared to the actual amount of money required to buy a financial asset or commodity itself. The basis aim of derivatives is to adjust the actual risk level to the desired risk level.

Common form of derivatives as mentioned above include forwards, futures, options and swaps. They leads to be the structure blocks for more advance and complex derivative instruments. These are called the "plain vanilla derivatives. Each derivative instrument

[157] Obiyathullah I.B. *'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration'* (International Journal of Islamic Financial Services Vol. 1 No.1.), 59.

down the evolutionary chain, added value. For instance forward contracts, originally innovated to manage risk of agro-based products, the subsequent instrument needed as and when risk environment changed. Forwards and Futures have reduced Liquidity risk, counterparty risk and avoid price squeeze etc. Futures and Options have increased flexibility and ability to take advantage of favorable price movements (unlike *lock-in)*

The detail evolutionary chain of the derivative instruments have been mentioned and tried to clarify that how each step down the evolutionary chain led to value added products. For example, forward contract has been recorded as the first and simplest derivative instrument. It plays a pivotal role in modern financial market and serves as the foundation and basic building block for more sophisticated and advanced. It has been defined as "a contract where two parties undertake to complete a transaction at a future date but at a price determined today". The parties, for example may be a producer who promise to supply the product (underlying asset) and the consumer who needs that product. The primary function of the forward contract is that it work like a vehicle to hedge against the unexpected and undesirable price fluctuations. The forward market directly affects the "spot market" as it also offers arbitrage and speculation opportunities.

The forward contract, despite of its benefits, it has various embedded problems such as the double coincidence, chance of exploitation due informational asymmetry. Though the forward contracts have overcome some of the issues related with risk management, particularly price risk and better planning of the business but in some respect they are still inadequate.

To order to overcome these problems and to provide the same benefits of risk management as of forward contract, a new instrument was needed. Resultantly futures were introduced in the modern financial system to provide the best risk hedging instrument to the market participants. A futures contract is basically a standardized forward contract with regard to the contract size, maturity, quality, and place of delivery and the characteristic of being traded in an organized market. Futures contract is defined as an agreement to exchange financial instruments, through buying or selling, for specific terms and conditions with the delivery of both the article and the price at a specified future date.

The unique feature of the forward contract is that it provides the ability to the buyers and to the sellers to reverse out from their position before maturity or delivery of the goods, consequently, in commodity futures market, physical delivery scarcely ever takes place, as compared to the forward contract where actual delivery does take place. The future contract have been able to solve the problems associated with the forward contract but they are associated certain problems such as the futures are unsuitable for the management of contingent claim and contingent liability, probability of exposure to subsequent price movement etc. Thus, a new instrument for management such risks was required and as a result the options contracts have been introduced to overcome these problems.

Option contracts are considered among the basic tools of risk management, they have been able to overcome the problems associated with futures. Options depends on the prediction or forecasting of the price changes in the market and affect the market relations. They differs in this aspect from the Islamic option contracts. Option Contract has been described as a contract which confers the option holder a right without obligation to sell or purchase an underlying asset at a predetermined price at the end or within the specific time period i.e. before maturity. All options traded on exchange can be divided into two kinds, Call options and put options. A "call option" enables the option holder with the right but not the obligation to purchase the underlying asset at a predetermined price at the end or within the specific time period i.e. before maturity. A "put option" on the other hand enables the option holder with the right but not the obligation to sell the underlying asset at a predetermined price at the end or within the specific time period i.e. before maturity.

Swaps contracts are another important nature of contracts in derivative market. They are different in nature from the other derivatives instrument, especially, because swaps contracts do not take place in an organized or regulated market, therefore, are not subject to any legal conditions acknowledged in the trading process. Swaps are generally defined as a contractual commitment to exchange cash flow or a particular asset for another cash flow or asset with certain agreement conditions. Swap representing an agreement between two or more parties to exchange a series of cash flows during a future period. Swap is a big bowl which accommodate many types that differ according to the nature and the term of the swap like Interest Rate Swaps, Foreign Currency Swaps. At the end three main players in derivatives market i.e. hedgers, arbitrageurs, and speculators been discussed to understand their role in the execution of the derivative transaction which will enable us to properly evaluate these instruments from *Sharī'ah* perspective in the subsequent chapters.

CHAPTER NO.4

MAJOR *SHARĪ'AH* PROHIBITIONS RELATED TO DERIVATIVES AND GENERAL PRINCIPLES OF ISLAMIC LAW OF CONTRACT

In this chapter we have briefly examined, the major prohibition related to Islamic Financial Transaction in general and to derivatives in particular. The purpose is to properly analyze the conventional derivatives whether these are *Sharī'ah* Compliant or not and to identify that why these instruments are not *Sharī'ah* compliant or in others words, what kind of *Sharī'ah* violations are found in these instruments. After discussion of these prohibitions, the general *Sharī'ah* requirements for financial instruments have been discussed along with the general principle of permissibility applicable to financial transaction and the need of risk management in Islamic finance has been discussed. In the light of these prohibition and general principles then, we have examined the status of conventional derivative instruments from *Sharī'ah* perspective in the subsequent chapter.

4.1. Foundation of the Business Transaction In Islamic Law

Islam is a principles-based religion. There is no aspect of life on which Islam has not given its clear guidance. Financial contract, being the backbone of everyday dealings, the basis of these contracts have been derived from the basic sources of *Sharī'ah* (a) the *Quran*, (b) the *Sunnah* (the practices, writings, pronouncements and examples of the Prophet Muhammad (SAW), (c) *ijma*'(consensus, particularly the consensus of the community of scholars or the assembly of the learned), and (d) *qiyās* (or analogical deductions and reasoning).These are called the primary sources of the *Sharī'ah*. Islam is not only governs the relationship between man and God but also relationships among mankind. A devoted Muslim must always be sure that actions of him are *Sharī'ah* compliant. That is why Allah (SWT) has mentioned in several versus in the *Quran* about contract "Oye who believe! Fulfil (all) obligations".[158] In another verse has said "Fulfil the covenant of Allah when ye have entered into it, and break not your oaths after ye have confirmed them".[159]

In another place has said "O you who believe! Squander not your wealth among your selves in worthless dealings, but let there be trade by mutual consent".[160] These verses have established the foundation of various commercial contract and attendant liabilities.[161]

4.2. Essential *Sharī'ah* Requirements for Financial Instruments

As per *Sharī'ah* requirement, all financial instruments and transactions must meet a number of requirements in order to be considered halal. Unlike conventional financial engineering, Islamic financial engineering gains a special feature while innovating a new product as it should be developed within the boundaries prescribed by the *Sharī'ah* without violating any of the conditions defined by the Islamic law or *Sharī'ah*. The rules of *Sharī'ah* that identifies the boundaries of the financial engineering are considered the narrow rope for heaven waiting opposite side.

[158]14 The Quran 5:1
[159]15 The Quran 16:91
[160]16 The Quran 4:29
[161] N. Mohammed, *'Principles of Islamic Contract Law'*, (Journal of Law and Religion 6(1) (1988), 115-130.

Based on Islamic law of contract, every financial instrument must be designed in such a way that, at a primary level, it must be free at least the following items; (i) *Gharar*, (ii) *Riba* (usury), (iii) *Qimar* and *Maysir* (gambling and Game of chance) (iv) fraud and cheating (v) Two mutually in consistent contracts are not permissible, (vi) A contract should not be contrary to *Maqāsid al-Shari'ah*. These and other more basic and important principles of commercial contracts have been discussed in detail by various scholars, specially, Mansoori in Islamic Law of Contract and business transaction.[162] Here our main focus is on the major prohibitions and other related *Sharī'ah* principles to which derivatives have been linked, have been discussed.

4.3. Major Prohibitions:

4.3.1. The contract should be devoid of *Gharar*

Gharar in financial transaction is forbidden by *Sharī'ah*. The prohibition of *gharar* is another important principle that governs all contracts and transactions in Islamic law of contracts. The Arabic term *Gharar* literally means "deceit, risk, fraud, uncertainty or hazard that might lead to destruction or loss". It is a general term which also includes to other elements like *Jahalah* and *Maysir*.

Although there is no specific verse in the *Quran* which connotes "*Gharar*", however, Allah has mentions "Eat not your property among yourselves unjustly by falsehood and deception".[163]

[162] Mansuri, Muhammad Tahir, '*Islamic Law of Contract and Business Transactions*', (Adam Publishers & Distributors, 2006) 3-16.
[163]The Quran 2:188

There are several *Ahādith* where the Prophet (SAW) strictly prohibited *gharar*. For instance, 'Ahmad and 'Ibn Majah narrated on the authority of Abu Said Al Khudriy (RTA):

> *" The Prophet (SWA) has forbidden the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to their distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver".*[164]

Gharar has been defined by the Islamic jurists as 'danger'[165] and 'risk'[166] but also as a transaction equal to a 'zero-sum game with uncertain payoffs'.[167] Al-Zarqa, and Al-Zuhayli,[168] has defined a *gharar* sale as "the sale of probable items the existence or characteristics of which are uncertain, therefore making it a risky business similar to gambling."

It is defined by *Hanafī* scholars as Gharar is "something which its consequence is undetermined." While *Shaf ī* scholars have described it as "something which in its manner and its consequence is hidden. According to Al-Sarakshi, "anything that the end result is hidden or the risk is equally uncommon, whether it exists or not." Therefore, *Gharar* in Islamic Law refers to any transaction whose existence or non-existence is not certain or due to lack of knowledge and information the ultimate outcome, nature, quality of the

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164 Ibn Mājah *Sunan Ibn Mājah*, Al-Maktabh al-'Ilmiyyah vol. 7, p. 66.
165 Wahbah al-Zuhaili, *Bay al-Dayn fi al-sharī ah al-Islāmiyyah*, (Dār al-Maktabi, Damascus, 1997), 80
166 M.A.El-Gamal, *An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence*. 4th International Conference on Islamic Economics, (Leicester, UK2 (13-15August2000), 23
167 Sāmi Al-Suwailem, "*Towards an Objective Measure of Gharar in Exchange*". Islamic Econ.Studies, 7/1, 2 (2000), 1.
168 (Wahbah al-Zuhaili, *Bay al-Dayn fi al-sharī ah al-Islāmiyyah*, (Dār al-Maktabi, Damascus, 1997), 83.

subject matter of the contract is not certain which leads to controversy between the parties.

It is necessary to clarify that "Risk" which is in inherent in every business by nature, for example, no one can predict that at the end of the year there will be a profit or loss but this is not a *"gharar"*.

As pointed out earlier that no consensus among the scholars is found on what *gharar* means, it has been taken to means unnecessary risk, deception or excessive uncertainty. However, in the context of a financial contract, a transaction is presumed to have suffer from *gharar* if it involves: (a) quantum of the subject matter is un known, (b) if it is unknown whether it exists or not, (c) a thing which is not in the knowledge of the parties, and (d) the parties are unknown whether a sale will take place or not. [169]

4.3.2. The contract should be free of *riba*

Literally the word *"Riba"* has been derived from the derivative word "raba-wa" which has been used in the meanings of "to increase; to grow; to grow up, to exceed, be more than. In the specific sense, *Riba* is generally translated into English as usury or interest but in fact it has a much broader sense under *Shari'ah*."[170]

Prohibition of *riba* is one of the major principles of Islamic law of contract. *Riba* can be in various forms and is forbidden in all its forms. All the jurists are unanimously agreed that

[169] Ibid., 6
[170] Haqqi, A. R. A, '*The philosophy of Islamic law of Transactions*', (CERT Publication-2009), 36.

"*riba*" is the excess in return of which no reward or equivalent counter value is paid, in other words, all unjust encashment is considered as "*riba*". The direct *Quranic* verses which connotes the prohibition of "*Riba*" can be found in four *surahs* or chapters i.e. (Al-Rum, 30:39; Al-Nisa, 4:161; Ali-Imran, 3:130 and Al-Baqarah, 2:275-9).These verses are an ascending order which at initial stage pass mere a judgment of value, this is followed by an implicit prohibition, then a limited one and finally, a total and conclusive prohibition and declared a war against those who do not refrain from such evil.

Moreover, the detail of all kind of usurious transactions have been explained and elaborated by the *Sunnah* of the Prophet (SAW).For example, the Prophet (SAW) has said to the effect that: "(Exchange) gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, measure for measure and hand to hand. If the (exchanged) articles belong to different genera, the exchange is without restraint provided it takes place in a hand to hand transaction."[171]

Although exact definition of "*Riba*" and its interpretation may be open to debate, however, there is no doubt as to what is being intended by the *Sharī'ah* is that all financial transaction and instruments shall be free from the above evils for fair play and justice to all the parties to a transaction and hence to the entire society.[172]

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[171]Muslim, *Sahih Muslim with Sharh al-Nawawī*, Mu'assasat Manāhil al-'Irfān, Beirut, 1986,vol.III,p.121
[172]Obiyathullah I.B. *'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration'*, (International Journal of Islamic Financial Services Vol. 1 No.10),19

4.3.3. The contract should not contain an attribute of "*Qimar*"and "*Maysir*" (gambling and game of chance)

Qimar and *Maysir* or gambling with all forms are strictly and categorically prohibited in Islam. As stated in the Quran, verse 219 of Surah 2: "They ask thee concerning wine and gambling. Say: "In them is great sin, and some profit, for men; but the sin is greater than the profit".[173] In another verse Allah (SWT) has said "O ye who believe! Intoxicants and gambling (dedication of) stones and (divination by) arrows are an abomination of Satan's handiwork: eschew such (abomination) that ye may prosper."[174]

"*Qimar*" includes to every form of increase or gain of money which entirely depends on luck and chance, for example as income or money received as outcome of lucky draw or lottery. On the other hand, "*Maysir*" means the easy acquisition of wealth by chance, whether or not it deprives the other's right.[175] It means something attained without effort.[176] That is one of the main reasons that Islam forbids gambling. Other reasons includes that "gambling can result in the loss of one's property without legal or proper exchange".[177]

In contrast, "*jahālah*" which means ignorance and hence invalidate the contract. For instance, if object of the sale or price is unknown to the buyer, due to ignorance, it

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[173]The Quran 2:219

[174]The Quran 5:90

[175] Md Akther Uddin, *'Conventional Futures: Derivatives from Islamic Law of Contract Perspective'*, (INCEIF the Global University of Islamic Finance, 12 November 2015, MPRA), 30

[176]A.K. Damansar, *The Sin of Gambling Explained*, 2007, available at:http://revivalry.blogspot.com/search/label/Mu'amalat%20-%20Rulings, (accessed dated 01.05 2017)

[177] Y. Al-Qardawi, The *Lawful and the Prohibited in Islam* (*Al-halal wa l-haram fi l-islam*, trans. K. el-Helbawy) (US: American Trust Publ., 1994).312

would not be possible, due to *jahālah,* to buy, sell or exchange money for the goods.[178] A comparison between *Qimar*, *Maysir*, *Gharar* and *jahālah* has been stated by Sherin Kunhibava in the following word "*maysir, qimar* and *jahālah* can be described as subsets of gharar. While excessive uncertainty makes all jahalah transactions gharar, not all gharar sales are jahālah, e.g., "in the case of buying a runaway slave with known characteristics".179 Likewise, high risk and an uncertain outcome make all maysir or qimar transactions gharar, while not all gharar transactions are maysir or qimar. While gharar does not always result in a zero-sum outcome, e.g., the sale of milk from an udder, gam- bling always results in a zero-sum game. 180 jahālah and maysir or qimar are unrelated unless, in cases of extreme ignorance, a person makes a transaction that could be a gamble or is ignorant of the consequences or other facts about the game. Thus, jahālah and maysir or qimar are subsets of gharar.181 All the scholars are however, unanimous on the prohibition of Qimar, Maysir or gambling and jahālah.

4.3.4. The contract should be free from "fraud' and "cheating"

Fraud and cheating have been strictly condemned by the *Quran* and the *Sunnah*. Fraud covers a number of illegal practices including giving short measures and weight, false bidding, false swearing, etc. to raise price of an item, hiding defects of an item etc.

[178]W. Al- Zuhailī, *Financial Transactions in Islamic Jurisprudence* (*Fiqh al-Islami wa' adillatuhu*, trans. Mahmoud El-Gamal) (Dar al-Fikr. 2003).114

[179]Ibid

[180]Sāmi Al-Suwailem, '*Hedging in Islamic Finance*', (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, 2006), 64.

[181]Sherin Kunhibava and Balachandran Shanmugam, '*Sharī ah and Conventional Law Objections to Derivatives: A Comparison*', (Arab Law Quarterly 24 (2010) 319-360.brill.nl/.alq),46.

Allah (SWT) says in Surah al-Muṭaffifin: "Woe to those that deal in fraud. Those who, when they have to receive by measure, exact full measure. But when they have to give by measure or weight to man, give less than due. Do they not think they will be called to account on a Mighty Day."[182]

4.3.5. Two mutually inconsistent contracts are not permissible

As per principles of Islamic Law, if more than one contract combine in a single contract they must be consistent with each other as the the Prophet (SAW) has prohibited "two mutually inconsistent contracts". For example, the sale of two articles for two prices, the contingent sale, and the sale of single object for two prices.[183]

4.3.6. A contract should not be contrary to *Maqāsid al- Sharī'ah.*

If any transaction or contract jeopardize or offends any of the higher objectives (*Maqāsid al-Sharī'ah*) are considred to be unlawful. Maqāsid -al *Sharī'ah* incudes *Hifzu -al-Din, Nasl, Nafs,Erz* and *Mal* these are also called as 'Huquq Allah' (rights of Allah) in Islamic Law.[184] These objectives have been mentioned in various versus of the Holy Quran: "In the law of Equality, there is saving of life to you, o man of understanding".[185]

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[182]The Quran 83:1-5

[183]R.H. Nawawi, '*Islamic Law on Commercial Transactions*', (Kuala Lumpur CERT Publication Sdn. Bhd; 2009), 90.

[184] Ibid

[185]The Quran 2:179

4.3.7. Entitlement of after acceptinf liability for risk

One of the major principles of Islamic Commercial Law is that of "entitlement to profit is subject to liability for loss. That is expressed by *Sharī'ah* maxim as "*Alkhiraj Bezzaman*" and "*Al gurm, bil gurm*" with profit comes liability or risk. These legal maxim provides the principle and rationale of profit and loss entitlement in various types of contracts including *Sharikah (*partnership) contract. This principle means that a person is only have entitlement to profit when he bears the risk for loss. This principle operates in number of contracts such as contract of partnership, sale, or hire.

4.3.8. Permissibility as a general rule "What is not explicitly prohibited is permissible"

Another most important and general principle of Islamic Law is that "In *mumamalt* everything that is not prohibited is permissible". This rule has been stressed in a number of verses in the *Quran*. Allah (SWT) ordains: "Say, "Who has forbidden the adornment of Allah which He has produced for His servants and the good [lawful] things of provision?" Say, "They are for those who believe during the worldly life [but] exclusively for them on the Day of Resurrection." Thus do we detail the verses for a people who know"[186]

After analyzing the governing principles of Islamic law of contract, we can state that Islam is a complete code of life and it provides governing principles for every aspects of

[186]The Quran 7:32

life including commercial transactions. In the following section we are going to discuss the pillars of contract in Islamic Law. As per requirement of Islamic Law has a valid sale should be fulfill the basic condition described by *Sharī'ah*. Since a derivative instruments being is a financial assets dependent on the value of its underlying asset (real asset in most cases), *Sharī'ah* conditions for the validity of a sale as per Islamic law is therefore a relevant area which will be briefly discussed.

In this respect Maji-al-Din stated that "the norm concerning *muamalat* or Islamic commercial transactions is permissibility, which means that contracts are generally permissible unless they are clearly prohibited by the texts (*nusus*). This prohibition could be either definitive (*qati)*, which leaves no room for doubt, or speculative (*zanni*), such as the prohibition conveyed in a solitary *hadith* (ahad)". In this regard Azam have added that we fully rely on the 1st part of the above stated principle, however, concerning its 2nd part, he stated that "the prohibitive evidence pertaining to civil and commercial transactions must not be anything less than decisive. This is because the fundamental permissibility of such transactions is based on decisive evidence, that is, the principle of *ibahah*, and this should prevail unless there is decisive evidence to warrant the opposite. It is worth noting, however, that rejecting any prohibition based on a solitary *hadith* (*ahad*) is a dangerous precedent which may lead to the rejection of the sunnah. Yet, there are some differences of opinion about the acceptance of a solitary *hadith* in the area of *aqidah* (belief and creed) but not in *muamalat* (commercial transaction)". [187] Thus, it is evident that by accepting such a methodology Majd al-Din weakened the credibility of his argument, though it is fundamentally correct.

[187] Majid-al-Din, Bayt al-Tamwīl al-Kuwaitī, *Al-Fatāwā al-Shar'iyyah fi al-Masā'il al-Iqtiṣādiyyah,* 590)

4.4. *Aqad* and the fundamental pillars of Islamic Law of Contract

4.4.1. The Meaning of "*Aqad*" In Islamic Law

Literally, the word "*Aqad*" means tying tightly, as in "tying a rope". To tie between two ends of something either physically or morally. Generally it covers everything a person commits himself to do which includes unilateral and bilateral action. In Islamic jurisprudence, its usage means an agreement between two persons in a legally acceptable and binding manner. Ala al-Din Kharofa has mentioned that:

> *"It is an expression of the matching between a positive proposal made by one of the parties and the acceptance of the other party in a way which has an impact on the subject matter of the contract".*[188]

Al-Zuhayli defined *aqad* as "the meeting of offer and acceptance in conformity with the formality prescribed by *Sharī'ah*".[189] Razali has mentioned that "the term *aqad* in general refers to a legal transaction which involves a bilateral declaration namely the offer and acceptance. The *aqad* is a legal transaction which creates a new legal situation.

A significant statement has been given by Ibn Qudama "that Allah permitted sale but did not specify the manner in which it was to be concluded".[190] In favour of this idea Niazi has mentioned and emphasized that "there is no fixed formalities in contract under

[188] Ala al-Din Kharofa. *'Transactions in Islamic Law'*, (Kuala Lumpur: A.S. Noordeen, 1997), 11.
[189] W.Al-Zuhayli, *'Financial transactions in Islamic jurisprudence'* (E.-G. M.A, Trans. Vol. 2). (Damascus: Dar al-Fikr: 2003), 17.
[190] Ibn Qudama as quoted by N. J Coulson in *Commercial Law in the Gulf States* (London: Graham & Trotman, 1984), 39.

Islamic Law. He further added that what under Islamic Law, the fundamental proof of consent by each party is required as in any other legal system. Consent is discovered by the use of the offer and acceptance methodology. The offer or *ijab* and acceptance *qabul* must meet at the same time and meeting or *majlis*".[191]

It is clear from the above mentioned definitions that a valid contract in Islamic law should have fulfilled certain conditions. Therefore, fundamental pillars of contract include: (i) Mutual Consent of the parties (ii) *Sigha* (statement or a form), (iii) two contracting parties and (iv) the subject matter of contract.

4.4.2. Free mutual consent of the contracting parties

In any contract under Islamic Law, mutual consent and agreement of the contracting parties are the basic pillar and main requirement. Allah (SWT) emphasizes on the mutual consent in all trades and transactions and explicitly prohibits obtaining the property of others without their consent by illegal means. Regarding this concept Quran states:

"O you who believe! Squander not your wealth among yourselves in worthless dealings but let there be trade by mutual consent".[192] In al-Nisa 4:160-161 Allah (SWT) also blamed the Jew for taking others property in a wrongful way.[193] This is also supported by various *Ahādith* of the prophet (SAW) such as:

"The trade should be concluded by mutual consent" and is unlawful for a person to

[191] L. A. K. Niazi, *Islamic Law of Contract* (Lahore: Research Cell, Dyal Singh Trust Library, 1990), 23
[192] The Quran 4:29
[193] The Quran 4:160-161

take his brother's property unless by the pleasure of his soul" Another stance is "The contract of sale is valid only by mutual consent".[194]

These principles clearly states that a contract will be considered invalid if not concluded with the free consent of the parties.

4.4.3. *Sigha* or the statement

The majority Muslim jurists have supported the significance of the statement or *sigha* as it expresses the mutual consent of both parties to the contract. It is formed through a valid *ijab* (offer) and *qabul* (acceptance). The statement made by the first party is called "*ijab*" because it gives and confirms the freedom of acceptance to the second party. If the second party accepts and agreed then his statement is called "*qabul*". The combination of both *ijab* and *qabul* shaped a valid contract.[195]

"*Ijab*" offer and "*Qabul*" acceptance can be performed in various ways, such as, by words, gesture or indication and by conduct. Acceptance must be made to be in conformity and correspondent with the Offer. This conformity could either be explicit or implicit.[196] Offer should have been made in the same meeting i.e. *Itihad al-Majlis* (unity of session).

Although there is different of opinions among the scholars whether a contract is

[194]Ibid.

[195]Abdurrahman Raden Aji Haqqi, '*An Islamic Legal Framework Input in the Validity of Electronic Contracts, Electronic Transactions Conference*', (Brunei Darussalam: 2000), 25

[196] Arzim Associates Chartered Accountants & Chartered Islamic Finance Professionals, '*The Islamic Commercial Law Principles*', (Kuala Lumpur: 2007),51

obligatory promptly following an offer and acceptance in the same session, or delay is allowed for further thinking. Majority of scholars (except *Hanafi* and *Malikī*) uphold that both parties may be given permission to rethink and delay until end of the session and based this view on the *Hadith* of the Holy Prophet (SAW): "Both seller and purchaser have the choice (to revoke the contract) unless they have separated from each other".[197]

4.4.4. Contracting parties

As per Islamic Law both of the contracting parties should have legal capacity to enter into a valid contract. Therefore, both the parties to a contract should have at least the following attributes to be considered legally capable. (i) Puberty, (ii) sanity, and (iii) maturity. In the Quran, Allah (SWT) says: "Make trial of orphans until they reach the age of marriage; if then you find sound judgment in them, release their property to them".[198]

4.4.5. Subject matter

Subject matter is another most important pillar of the contract in Islamic Law. Without subject matter contract can not be performed. Subject matter can be in the form of goods or property. Following specification in the subject matter must exist in order to be considered as valid in Islamic law of contract:

[197] Ibid.,

[198] The Quran 4:6

4.4.5.1. **Legality or suitability of the subject matter**, it means that the subject matter must have a valuable thing and should be permissible article from shraiah. Legality, also means that there should be no hindrance or right attained to it. Legitimacy of subject matter also needs ownership (it must be possessed) before to sale it further.

4.4.5.2. **Proper determination of the subject matter,** it should be accurately determined by both parties and must known to them by its nature, quantity and value along with the certainty of the timing for completion and delivery for the contractual obligations. The price of the subject must be definite for the validity of a sale contract. If the price is uncertain, the sale will be invalid.[199]

4.4.5.3. **Existence of subject matter**, Islamic law also maintain that the subject matter of the transactions must be in actual existence at the time of contract and must be in the ownership and actual or constructive position of the seller, it should also be capable to be delivered to a prospective buyer. If the subject matter of the contract does not exist at the time of the sale or it cannot be transferred, the contract will be void and Certainty of the Sale is another requirement as per Sharī'ah, for a valid sale it is compulsory be instant and absolute. A sale should not be depend on the possibility or chance. The sale which is made conditional to the occurrence of an event is void, moreover, a sale of goods to be delivered at a future date is also considered invalid_by the majority scholar, although there are two exceptions provided by Islamic Law as in the case of *salam and*

[199] Al-Kāsānī, '*Badā i al-Sanā i*', (Cairo, Egypt. al-Matba a al-Jamāliyyah, 1967), 123

'*Istisnā*' transactions.[200]

4.5. Risk categories and the need for hedging

The concept of "Risk" needs to be distinguished from the "uncertainty" as happens in financial derivatives. The word "risk" is normally used to refer to any kind of uncertainty occurred from the position of the unfavorable contingency, while the term "uncertainty" is used with reference to the favorable outcome. Thus, we speak of the "risk" of loss; and "uncertainty" about gain or future profitability. Knight differentiates between the "measurable" and "non- measurable" uncertainties and stated that "while the former relate to the risk, the latter pertains to the real uncertain situations. If responsibility of any of the parties with regard to finalization of a contract is vague, and the contract in question does not comprise the condition of *Khiyār as* provided in Islamic law of contract, the contract would be void because of *gharar*".[201]

Measures should be taken to reduce the risks and to make other people genuinely share it, which are in line with the Sharī'ah norms, however, business risk can neither be eliminated nor can it be transferred to others by separating it from the ownership[202]. In this regard Saleh stated that "The risk which is prohibited is 'risk from the within' i.e. deliberate injection of avoidable uncertainty at inception of the transaction, regarding identification of the subject matter and the price because such uncertainty leads to *riba*

[200] Muhammad Ayub, *Understanding Islamic Finance*, (West Sussex: John Wiley & Sons Ltd, 2007), 99-127.
[201] Ibid
[202] Sāmi Al-Suwailem, '*Hedging in Islamic Finance*', (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, 2006), 106

and *gharar* and to injustice and inequity"[203]

4.6. Hedging vs Gambling

Hedging may be different from *gharar*/gambling, that could be natural economic cooperative tool for risk management. However, financial derivatives make hedging and gambling undistinguishable. Therefore, the main challenge before the Islamic scholar working on risk management is to distinguish the essential risk taking from *gharar* and gambling like transactions[204]. Similarly, according to Obaidullah:

> *"The Sharī'ah does not disapprove of hedging, since it brings in some benefits and maslahah. It is the zero-sum nature of the game that the Sharī'ah finds objectionable, as in it lies the roots of social disharmony and discord."*[205]

4.7. Speculation vs Gambling

El-Ashkar (1995) defines speculation as "the practice of (a) using available information to (b) anticipate future price movements of securities so that (c) an action of buying or selling securities may be taken with a view to (d) buying or selling securities in order to (e) realize capital gains and/or maximize the capitalized value of security-holdings."

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[203] Saleh al-Marzūqī,'*Tijārat al-Zahab fi Aham Suwarihā wa Ahkāmihā' Majallat Majma' al-Fiqh al-Islāmī*. Ninth session, 1996), 149–158.

[204] Sāmi Al-Suwailem, '*Hedging in Islamic Finance*', (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, 2006), 112-142.

[205] Obaidullah, '*Istijrār: A Product of Islamic Financial Engineering*' (London: New Horizon, Islamic Institute of Islamic Banks, 1997), 176).

However, the speculative practices in the markets is the evidence that the speculators seeking knowledge not for any real business or to get any underlying assets, but just for making money which in long run may lead to the negative impacts on the real sector businesses and create instability in the financial markets. Particularly, the netting-of the payable / receivable value by the parties renders it a type of gambling in the light of the prohibition of *gharar* based sales. El-Ashkar have stated that "Hence gambling and speculation both may lead to loss to the competing parties which should not have been in the first place. Therefore, while speculation in the stocks trading may not be exactly similar to gambling, it has a number of ingredients that render it gambling in one way or the other. It has necessarily to be avoided in derivatives markets.[206]

4.8. The impact of major prohibition on Derivatives and Risk Management process

Prohibiting of *riba, gharar* and gambling in *Sharī'ah* aims to ensure that no party should get undue return or transfer undue burden or loss to the counter party of a transaction. As stated by Vogel & Hayes "Risk and uncertainty are inalienable features of life, *Sharī'ah* accepts them as genuine part of the business but, while the normal business risk justifies the return, too much or too little risk incurs a ban, under the rules of *gharar*".[207] The requirement of *Sharī'ah* "that risk must not be separated from the real transaction" is of crucial nature and hence with the conformity of the natural and economic reality[208].

[206] Ahmad 'Abdel Fattāh El-Ashkar, '*Towards an Islamic Stock Exchange in a Transitional Stage*', (Islamic Economic Studies. Islamic Development Bank. Jeddah, Saudi Arabia, 1995), 88

[207] Frank, E. Vogel and Samuel Hayes, '*Islamic Law and Finance, Religion, Risk, and Return*' (The Hague: Kluwer Law International, 1998),78

[208] Sāmi Al-Suwailem, '*Hedging in Islamic Finance*', (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, 2006), 59

Vogel & Hayes contends that Islamic law prohibits all risk free and chance free return is to prevent the exploitative and unfair situations that may occur. Thus the prohibition on sale which before possession or which one does not have aimed that consequent upon a sale agreement, delivery should be given and possession should have taken place, mere netting-off (*Muqassah*) to settle only the difference in prices, and the transfer of business risk by each party to others are not acceptable as per *Sharī'ah* rules.[209] Which is almost the prevailing situation in the derivative market due to which they are considered invalid by many scholars, this issue has been discussed in detail in the subsequent section.

Now it will be possible and easy to understand how these major prohibitions i.e. *gharar, qimar, maysir,* and *jahalah* are relevant to *Sharī'ah's* objections to the use of derivatives in Islamic finance.

It is now much clear that, financial engineering in Islamic finance must be in close collaboration with Islamic scholars of *fiqh*. Unfortunately as Vikor states in his comprehensive study; *"There is not just one Islamic law. There are many different Islamic laws and different schools, time period and countries."*[210] Considering this fact, every financial product, contract or instrument designed with the Islamic label and have got approval from the *Sharī'ah* will still have the risk of being stamped as *haram* (unlawful) by another Islamic scholar reside in a different religious domain, and

[209] Frank, E. Vogel and Samuel Hayes, *'Islamic Law and Finance, Religion, Risk, and Return'* (The Hague: Kluwer Law International, 1998), 79

[210] Quoted by Atila Yanpar, *'A New Approach to Derivatives: Financial Engineering With Islamic Rules, Capital Markets'* (Board of Turkey, Expert Eskisehir Yolu 8. Km No:156 Ankara)

practically various, example of the same are exist. For example, transactions based on "*'Arbūn*" structure have been declared valued by the majority of the modern scholars, especially working in Malisya, however, the same is not acceptable to the Islamic scholar here in Pakistan. This important issue must be left to the big forum like AAIOFI and religious scholars to resolve the same as it is beyond from our limitations, just we can give our opinion based on valid reasoning.

While financial markets are becoming more and more sophisticated, and competitive, financial engineering and innovation are becoming more imperative in Islamic finance. If the needs are genuine, then the innovative instruments could either be adapted from conventional menu, or new *Sharī'ah* compatible alternatives could be invented.[211] This process must, however, take into consideration of rules outlined above and every contract or financial instrument must be analyzed for approval of scholars whether it is *Sharī'ah* compliant.[212]

4.9. Summary:

To sum the above mentioned discussion, we can say that financial contract, being the backbone of everyday dealings, the basis of the Islamic contracts have been derived from the basic sources of *Sharī'ah* (a) the *Quran*, (b) the *Sunnah* (c) *Ijma'* and (d) *qiyās* (or analogical deductions and reasoning). As per *Sharī'ah* requirement, all financial instruments and transactions must be devoid from a number of prohibitions and at the same

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211 Munawar, Khan , '*Islamic Contract*', (Palgrave Macmillan, 2005), 27

212 A New Approach to Derevatives: Financial Engineering with Islamic Rules, Atila Yanpar Capital Markets Board of Turkey, Expert Eskisehir Yolu 8. Km No:156 Ankara

time should also fulfill certain requirements in order to be considered halal. That is why the process of innovation and engineering in Islamic finance has been viewed as passing Al-Sirat

Based on *Sharīʿah* principles, every financial instrument must be designed in such a way that, at a primary level, it must be free at least from (i) *Gharar,* (ii) *Riba* (usury), (iii) *Qimar* and *Maysir* (gambling and Game of chance) (iv) fraud and cheating (v) Two mutually inconsistent contracts are also not permissible, and (vi) A contract should not be contrary to *Maqāsid al-Shari'ah.* All these prohibitions have been discussed in detail to make it possible and easy to understand how these major prohibitions are relevant to *Sharīʿah's* objections to the use of derivatives in Islamic finance.

After all these clear evidences from the original sources of *Sharīʿah* and classical definitions of Islamic jurists, and derivation of essential internal and external attributes, we can definitely affirm that the concept of contract and its associated rights and obligations are not alien concept in Islamic Law. It is further derived that in order to be *Sharīʿah* compliant, any financial product or contract must have complied with these principles and must not include any of the above mentioned prohibitions, If any discrepancy is found, the contract in generally, will be considered as void.

It is much impotent to mention here that on the basis of *Sharīʿah* requirements, namely (i) the subject matter or commodity must be currently in existence in its physical, sellable form and (ii) the seller should have legal ownership of the asset and should have possessed directly or constructively before to sale it. These conditions have rendered derivative transactions invalid and not acceptable to the *Sharī'ah* scholars. For example, an authentic hadith *"Do not sell what is not with you"* is one of the major prohibition of contract in *Sharī'ah*. Most of the scholars have agree that a person is not allowed to sell something unless he owns it or its constructive possession. So this hadith has a great importance on futures and other kinds of derivatives, which we have discussed in detail in the later section. However, it is to be noted that, Islamic Law have provided exceptions to these conditions and some of the modern scholars have based their opinion on these exception and validated deferred sale on the basis of public needs and necessity which have been discussed in detail in the subsequent section.

CHAPTER NO.05

THE STATUS OF CONVENTIONAL DERIVATIVES IN ISLAMIC FINANCE

In this chapter, we will discuss in detail the arguments and counter arguments advanced by the scholars related to derivatives, *Sharī'ah* scholars who objected to the permissibility of conventional derivatives have highlighted few major grounds in their critique. Point wise elaboration of these objections along with their basis and counter counter-arguments and rationales will be discussed which will enable us to ascertain proper *Sharī'ah* position and stand in relation to conventional derivatives in Islamic finance. Before, to enter into the discussion that why the permissibility of conventional derivatives is controversial in Islamic finance. It is to mention that risk management or hedging for the protection of wealth and investment is one of the higher objective of *Sharī'ah* and acceptable to all *Sharī'ah* scholars. However, there is disagreement among the scholars on the permissibility of conventional derivatives in Islamic finance. Opinion of Islamic scholars on the permissibility or impermissibility of derivatives In Islamic finance is divided:

The predominant view in Islamic law is that conventional derivatives i.e forwards, futures options and swaps in the present form are impermissible instruments from *Sharī'ah* point of view, and instead, there is a need for innovation and search of instruments that should comply *Sharī'ah* prerequisite and serve the same purpose as conventional derivatives. These alternatives may be referred to as "Islamic derivatives" which may be the instruments based on Islamic contract such as the *Salam, Murābahah and Wa'ad* based arrangements, *Istijrār, 'Arbūn,* and *Khiyār al shart etc.* Various individual Scholars and institutional work have subscribed this view including Islamic Fiqh Academy, AAOIFI, Akam Khān, Taqi Usmani, Aḥmad Ḥusein, Salmon, Mukhtar al-Salami, Aḥmad Ḥassan Muḥyi al-Dīn, 'Abd al-Wahhāb Abū Sulaimān etc.

The minority opinion is that conventional derivatives are not totally impermissible instruments in *Sharī'ah.* Thus, these instruments can be used and sanctioned in Islamic finance with some adjustments as these are greatly needed in today's sophisticated business environment to enable Islamic finance to kept fulfilled needs of the public, the upholder of this approach includes Kamali, 'Alī El-Gārī, Bacha, Sāmi Hamoud, Muhammad al-Bashir Muhammad al Amin and Al-Misri etc.

In this regard Bacha (1999) stated that, "some of the Islamic instruments that are similar to derivatives and the objection of Islamic scholars regarding derivatives might need some rethinking and evaluation".[213] Although they have suggested certain adjustments but still they have doubt that how these instruments be made *Sharī'ah* compliant. However, they are unanimous on the need for *Sharī'ah* complaint derivatives. As a matter of fact, Islamic finance has provided an effective and efficient risk management mechanism for Islamic institutions. Further, volatility of prices and currencies is a modern phenomenon which scholastic *fiqh* has not specifically addressed.

[213] Sherin Kunhibava and Balachandran Shanmugam, *'Sharī'ah and Conventional Law Objections to Derivatives: A Comparison', (Arab Law Quarterly 24 (2010) 319-360.brill.nl/.alq.), 14*

These different views along with their detail arguments and counter arguments have been discussed in the following section to determine the actual status of these instruments in *Sharī'ah* and stands of the various jurists in relation to these instruments.

5.1. Why the permissibility of conventional derivatives is controversial in Islamic finance?

Discussion about the derivatives and their legality in the light of Sharī'ah began in 1980s when modern Islamic finance itself began to emerge and develop. Therefore, debate of Sharī'ah Scholars and their objections to derivatives will focus on the period from 1980 onwards. However, reference to classical fiqh authorities and sources will be made to explain how and why contemporary Islamic scholar have objected to financial derivatives.[214]

5.2. *Sharī'ah* Objections to Derivatives along with Counter arguments

Sharī'ah scholars have objected to the permissibility of conventional derivatives. They have highlighted the following main grounds in their critique. These main Sharī'ah issues mentioned by Sharī'ah scholars on which they have based their opinion have been summarized first and then a detailed discussion on each point have been made for the proper assessment these arguments.

a. Futures sale, where counter values of a transaction are postponded into a future date

[214] Sherin Kunhibava and Balachandran Shanmugam, *'Sharī'ah and Conventional Law Objections to Derivatives: A Comparison'*, (*Arab Law Quarterly 24 (2010) 319-360.* brill.nl/.alq.), 16

turns these transaction as invalid in *Sharī'ah* and considered as *bay' al-kāli' bi al-kāli'* (exchange of one debt for another). As per Islamic Law a transaction is valid only where one counter value i.e. price or delivery, but not both counter values, is deferred in to a future date.

b. As per *Sharī'ah* Law, goods must exist at the time of contract, where as in future trading, neither counter vale (money or goods) is present at the time of the conclusion of the contract, no price is paid no goods are delivered. Hence considered it as exchange of promise and not a genuine sale.

c. Future transaction, not complied with the *Sharī'ah* requirement of "*Qabd*" or taking posession of the subject matter before to resell it, so futures, being short selling transaction where the seller does not own or possess the item sold is invalid sale. [215] Very rare sell take place with physical deliver in future market.
   For a sale to be valid there must be a transfer of ownership of the item sold; if the seller does not own the item he cannot transfer ownership. The rationale behind the requirement of taking possession is to prevent *gharar*.
   This issue is sometimes separated from another legal objection against derivatives, that futures sale fall short of meeting the requirements of *qabd* or taking possession of the item prior to resale.

d. Transaction concluded in future market involve *Gambling* and *Gharar* as these transactions involve speculation instead of hedging.

[215]Kasani, *'Badai al-Sanai fi Tartib al-Sharī'ah'*, (Cairo: Sharikah al- Matbu'at al-Islamiyyah, 193),210

e. Option sale is only the right to buy or sell, charging fees for the same is not allowed in *Sharī'ah.*

However, it is important to mention here that most of these objections have been rebutted by some modern scholars including Kamali and have mentioned various reason and justification. They said that apparently the upholders of these objections, have ignored the operational procedure of the futures and have premised on theoretical *Fiqhī* positions on conventional sale.[216]

They uphold that, Futures contracts play an important role in risk management and hedging. Kamali and 'Alī El-Gārī, [217]concluded that Futures contract are permissible, if they are clear of *riba* do not include excessive *gharar or gambling*, and when it does not violate a decisive principle.

Point wise elaboration of these objections along with counter-arguments have been discussed in detail below.

[216] Atila Yanpar, *'A New Approach to Derivatives: Financial Engineering With Islamic Rules'*, Capital Markets Board of Turkey, Expert Eskisehir Yolu 8. Km No:156 Ankara, 43

[217] M. H. Kamali, *"Commodity Futures: An Islamic Legal Analysis"*, Thunderbird International Business Review, 49(3) (2007), 309-339.

5.2.1. **Futures Sales, due to the deferment of both counter-values is a sale of one debt for another (*Bay 'al-kāli' bi al-kāli'*), which is forbidden in *Sharī'ah***

Islamic scholars generally found the forward and future contracts as the exchange of one debt for another debt where both parties -seller and buyer agree to defer both price payment and delivery of item in the future. It is also known as *Bay 'al-kāli' bi al-kāli'* which is prohibited in *Sharī'ah*.[218] So the deferment of both counter values i.e. delivery of the item and its final payment is one of the main criticism to conventional futures transaction.[219]

There is a consensus of the Muslim scholars on the prohibition of *bay' al-kāli' bi al-kāli'*. The prohibition of *bay' al-dayn* is a logical consequence of the prohibition of *riba*. Ibn Taymiyah and Ibn al-Qayyim considered *bay' al-kāli' bi al-kāli'* as a means to *riba*, *gharar* and excessive risk, and hence leads to the conflict between the parties.[220]

Imam Ahmad ibn Hanbal, founder of the *Hanbalī* School, ruled that "common consensus (*ijma al-nas*) has forbidden the sale of debts. This is based on a *Hadith* which reports: "The Prophet prohibited *bay' al-kāli' bi al-kāli*."[221]

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[218] Wahbah al-Zuhaili, '*Financial Transactions in Islamic Jurisprudence*', El-Gamal M.A. vol. 1 (Damascus: Dar al-Fikr, 2003), 79.

[219] A. Salehabadi & M. Aram. '*Islamic Justification of Derivatives Instruments*', (*International Journal of Financial Services*, 4(3) (2002), 8.

[220] Ibn Taymiyyah, Ahmad Ibn 'Abd al-Halīm, *Nazariyyat al-Aqd* (Dār al-Ma'rifah.Beirut, 1960), 301. Ibn Qayyim al-Jawziyyah, *I'lām al-Muwaqqī'n an Rab al-Ālamin*. (Beirut, Lebanon, Dār al-Kutub al-Ilmiyah,1991.),350

[221] Al-Shawkāni, *Nayl al-Awtār*, (Dār al-Jīl, Beirut, 1973), vol. 5, 157.

This general prohibition has been applied to futures contracts, because in the future contracts the parties offset their transactions by selling the "debts" owed to them to other parties before the delivery of the underlying asset. The contention is that, this sale amounts to "sale of a debt' and is, therefore, prohibited.[222]

For example, A (trader) buys 500 litters of milk from 'B' (a farmer) to be delivered after 6 months at the price Rs.10,000/-. Both the delivery of milk and the price are deferred except the 'A' trader has to pay a small margin amount. 'A' after 3 months sells the 500 litters of milk to 'C' at price Rs.12,000/-, both counter-values to be handed over in three months. Here, yet the milk has not received by 'A', and it is a debt that he is selling. This has been declared the selling of a debt for a debt, i.e. the Rs.12,000/- payable in 3 months is prohibited in *Sharī'ah.*[223]

5.2.2. Arguments against the criticism *Bay' al-kāli' bi al-kāli* and in favor of acceptance of Derivatives in Islamic Finance

On the other side, few modern scholars, have rejected the claim of common consensus on the prohibition of the exchange of debts. Kamali argued against this objection.[224] He stated that "the legal schools have recorded divergent rulings as to the definition of *bay' al-kāli'*

[222] Mohamed Obaidullah, *'Financial contracting in currency markets: an Islamic evaluation', International Journal of Islamic Financial Services* 3, no. 3 (2001). http://islamic-finance.net/journals/journal11/obaidvol3no3.pdf, last accessed 01.12, 2016.
[223] M.D Akther Uddin, '*Conventional Futures: Derivatives from Islamic Law of Contract Perspective*', INCEIF The Global University of Islamic Finance, 12 November 2015, MPRA,33
[224] M.H. Kamali, '*Islamic Commercial Law: An analysis of futures*', The American Journal of Islamic Social Sciences, 13(2) (1996), 214

bi al-kāli'". Moreover, he mentioned that this *Hadith* "only appears in some collections,[225] and many prominent scholars consider it to be unreliable".[226] Kamali further argued that no clear prohibition on the exchange of debts has been found, and a number of scholars have allowed it. Therefore, in the absence of a clear and definite prohibition on the sale of a debt, the principle of permissibility must be prevail, provided that it should be devoid of *riba* and *gharar*.[227]

In respect of the above mentioned *Hadith*, Al- Albani stated the *Hadith* of *bay' 'al-kāli' bi al-kāli'* is weak.[228] A part from that, no conclusive proof in the Sunnah was found on prohibition sale of debts. The quoted *Hadith* is weak and thus cannot be used as inference for the prohibition, and for the contract and its effects.

After rebutting the objection, they turns to futures trading itself and have given justification that the practical nature of the futures contract, as traded in the clearing house, has made it a contract between the purchaser (or seller) and the clearing house only. No third party is involved in the transaction, hence, no uncertainties over clearance and delivery is found. In simple words, the price is a debt on the clearing house, which is the principle party in the transaction and the clearing house acts in the capacity of a fully committed guarantor.

[225] Muhammad Abdul-Qadir Ata, *Al-Bayhaqi, al-Sunan al-kubra*, ed., (Makkah: Maktabat Dar al-Baz, 1994), 5:290. Quoted by kamali, It was also attributed to Musnad al-Bazzar and al-Mustadrak of al- Hkim by al-Busayri in *Ithaf al-Khiyār ah al-maharah bi zawa'id al-masanid al-asharah*, 3:96, in *al-maktabah al-shamilah*, version 3.28.
[226] M.H. Kamali, *"Islamic Commercial Law: An analysis of futures"*, The American Journal of Islamic Social Sciences, 13(2) (1996), 212.
[227]Ibid
[228] Al-Albani quoted by M.H. Kamali, *'Islamic Commercial Law: An analysis of futures', The American Journal of Islamic Social Sciences*, 13(2) (1996), 217

Therefore, in futures contracts the fulfillment of obligations have taken place that is repayment of debt by the debtor, which are allowed in *Sharī'ah*.[229]

Some other Muslim Scholars, have accepted the deferring of delivery of the underlying items and price payment. They are of the opinion thast deferring both price and subject matter is accepted in the forward markets for the "underlying commodities" only. While for "financial securities", it is impermissible.[230] Meanwhile, Hamoud stated that "deferring both in exchange is accepted based on *muawadhah*. This type of contracts which include selling debt for debt is in the needs of traders and industrialists, so based on *hajah* (need) and *dharurah* (necessity), it can be used as soon as it retains the legal standard. Deferring is accepted as long as it does not include foodstuff asset or any form of *gharar*"[231].

Few contemporary specialists in Islamic finance, have accepted deferring (postponement) in both price and item but subject to certain conditions that should be fulfilled before. The reason behind this flexibility is that, there will be no easy available room for speculation in price differences. They also have given the example of some contracts that involve deferring of both price and item and they were accepted such as supply and *'Istisnā'* contracts, where supply contract is permitted.[232] Further, Al-Ashqar (1998) stated that "*'Istisnā'* contract is debt for debt sale but is excluded from the prevention.

[229] M.H. Kamali, *'Islamic Commercial Law: An analysis of futures'*, The American Journal of Islamic Social Sciences, 13(2) (1996), 213

[230] A. M Ahmad, *'Securities markets and its development effects in Islamic economic'*. Saleh Kamel Series for University Thesis. (1995),110

[231] Sāmi Hamoud, *'The Development of Banking Business Consistent with Islamic Sharī'ah*, (Amman: Maktabat al-Aqsa, 1976).51

[232] Al-Misri, R. Y. (2007). *Jurisprudence of Financial Transactions*, (2th ed.) (Damascus: Dar al-Qalam, 2007),62

International Islamic *Fiqh* Academy concluded that *'Istisnā'* contract is permissible contract and can be used to defer price payment only".[233]

To sum up, we can say that, keeping in view today's sophisticated nature of business, traded in clearing house, and the argument advanced by modern scholars, these may be considered proper and effective response to this objection against futures, because of the nature of futures transactions in today's clearing house environment. It is an un-avoidable fact that as per practice, the clearing house acts as (guarantor) the seller for each buyer and the buyer for each seller in all futures transactions. So each transaction is guaranteed by the clearing house. There is no direct interaction of one trader with another trader.

5.2.3. Counter-values in Futures and Options Sales are Nonexistent at the time of the Contract

In futures and options contract both the counter-values are non-existent at the time of the contract, hence these are considered as invalid because as per Islamic Law of contracts only one of the counter-values of the contract is allowed to be deferred and not both, as in the case of *salam* contract. However, where both counter value are differed into a future date, this kind of sale lead to *gharar*. Dawabah,[234] and Obaidullah, [235]stated that the underlying asset in these contracts contains where the asset does not exist on their ground and not in the seller ownership as well. Likewise, opinion has been expressed by Al- Satti

[233] Ibid.,
[234] A.M. Dawabah, '*Studies in Islamic Finance,* (Cairo: Darussalam, 2007),31
[235] M. Obaidullah, "Islamic Risk Management: Towards Greater Ethics and Efficiency", International Journal of Islamic Financial Services, 3 (4) (2002), 13

that short selling in the futures trading is against the principles of *Sharī'ah* as the item must be in existence and must be owned by the seller at the time of the contract.[236]

Future sales, therefore, considered as the sale of *al-ma'adum* and are basically invalid on the account of non-existent items. Further, in this regard, Mahmassani has stated that:

> *"..contracts to sell future things, except for the salam and 'Istisnā' contracts, are invalid in the Sharī'ah because such things are nonexistent. In the case of salam or even 'Istisnā', only one of the counter value is deferred at the time of the sale. This is allowed in the Sharī'ah. However, the nonexistence of both counter-values of the contract in both futures and options amounts to unwarranted risk taking and gharar that creates massive uncertainty over the prospects of fulfillment"*[237].

Organization of the Islamic Conference (OIC) Islamic *Fiqh* Academy also endorsed the same opinion related to financial markets and have described various commodity sale, in its Resolution No. 63 (7/1), 7th session in 1412 H (9-14 May 1992, stating that

> *"The contract provides for the delivery of described merchandise (as a pending obligation) at some future date, with payment of its price on delivery. It also stipulates that it shall end with the actual delivery and receipt of the merchandise. This contract is not permissible because of the deferment of both elements of the exchange. It may be amended to meet the well-known conditions of salam (advance payment). If that is done, it*

[236]See Al-Saati, Abdul Rahim A, '*Sharia Compatible Futures*, (Journal of King Abdulaziz University: Islamic Economics, Vol. 15, No. 1, 2002), 56, available at SSRN: https://ssrn.com/abstract= 3073926.

[237] Subhi Mahmasani, '*Al-Mujibat wa al-uqud fi al-fiqh al-Islami*', (Beirut: Dar al-Ilm li al-Malayin, 1983), 204.

shall be permissible".[238]

This decision is also in consensus with many other major fatwas, for instance: 'The European Council for Fatwa and Research confirmed Decision 63 (7/1) taken by the OIC Islamic Fiqh Academy concerning options trading and dealing in Commodities, Currencies and Indices in Organized Markets"[239] Usmani also found futures transactions impermissible because the sale or purchase cannot be affected for a future date, and these transaction also leads to excessive speculations is prohibited in *Sharīʿah*. Accordingly, he stated "Firstly, it is a well-recognized principle of the *Sharīʿah* that purchase or sale cannot be affected for a future date; secondly, because in most futures transactions the delivery of commodities or their possession is not intended. Therefore, all forward and futures contracts are invalid in *Sharīʿah*. In most cases the transactions end up with the settlement of the difference in price only, which is not allowed in *Sharīʿah*".[240]

The above mentioned opinions are based on a number of *Ahaadiths* and on the opinions of the majority classical *Fiqhī* jurists of the *Shafʿī*, *Hanbalī* and *Hanafī* Schools. For example, According to Art.197 of the *Mejelle* (the Ottoman Civil Code) stated that "the thing sold must be in existence" and Art. 205 further explains that "the sale of a thing which is not in existence is void".[241]

[238] OIC International Islamic Fiqh Academy, seventh session, 9-14 May, 1992. Retrieved from http://www.fiqhacademy.org.sa/qrarat/7-1.htm, accessed on 29.01.2016.
[239] "European Council for Fatwa and Research, final statement of the Twelth Ordinary Session, 6-10 of Dhul-Qidah, 1423 AH, 31 December, 2003 - 4 January, 2004", http://www.e-cfr.org/eng/article.php?sid=37,accessed May 11, 2016.
[240] Muhammad Taqi Usmani, *'Futures, options, swaps and equity instruments'*, *New Horizon*, June, (1996). p. 10.
[241] C.R. Tyser, D.G. Demetriades, I. Haqqi Effendi (trans.), *The Mejelle English Translation of Majallaj El-Ahkam-i- Adilya and a Complete Code on Islamic Civil Law*, (Petailing,Malaysia: The Other Press, 2001),86

Classical Scholars like Ibn Qudamah (1401H) also has mentioned that selling a thing one does not own in Islamic law is prohibited. [242] Ibn Abdeen (n.d) explained that this kind of sale is void for the lack of ownership.[243] Ibn al-Qayyim and Ibn Taymiyah claimed that "sell does not own is a part of *qimar* and *maysar* (gambling).[244] Moreover, al-Zuhaili, has agreed that "the sale of nonexistent objects and objects that may cease to exist is not valid, for instance, the sale of fruits and plants before they appear sale of pearls in shells, milk in the udder, wool on the back of sheep, and a book before it is printed".[245]

Following are the sampling of *hadiths which* prohibits "the sale of nonexistent goods", for instance, Jabir narrated that "the Messenger of Allah (peace be upon him) forbade the sale of fruits until they ripen".[246] Another hadith on the authority of Ibn Abbas, when he was asked about selling of dates. He reply, "The Prophet (peace be upon him) forbade the sale of dates until they become fit for eating and can be weighed." A man asked: "What does „to be weighed" [mean exactly]?" Another man sitting beside Ibn Abbas replied, "Until they can be estimated."[247]

[242] Ibn Qudamah, '*Al Mughni*',(Dār al-Ma rifah.Beirut, 1960), 211-225
[243] Ibn Abidin, *Hashiyat Ibn Abidīn*, vol. 4, 284
[244] Ibn Taymiyyah, Ahmad Ibn Abd al-Halīm, *Nazariyyat al- Aqd* (Dār al-Ma rifah.Beirut, 1960), 301
[245] Wahbah al-Zuhaili, *Bay al-Dayn fi al-sharī ah al-Islāmiyyah*, (Dār al-Maktabi, Damascus, 1997), 74-75.
[246] Sahih Muslim, vol. 1, no. 915, Riyadh: Darussalam, n.d.), Bukhari, "Complete Sahih Bukhari," 1, Book 8 (n.d.). http://www.usc.edu/dept/MSA/fundamentals/hadithSunnah/bukhari/008.sbt.html#001.008.364, accessed March 12, 2015), no. 1487.
[247] Ibid no. 916.

Further, in another hadith, Ibn Abbas reported: "The Messenger of Allah (peace be upon him) prohibited the sale of fruit before its quality is known, the sale of wool on the back of sheep, and the sale of milk in the udder."[248]

The main reason for ruling of the invalidity of sale of the nonexistent assets is due to indeterminacy (*jahalah*) and the existence of *gharar*. Moreover, there is also ignorance and uncertainty in relation to the quality and quantity of the nonexistent asset, which leads to excessive risk[249]

5.2.4. Arguments against the criticism of sale on non-existent thing or does not own

Contrary to the above mentioned approach, Imam Malik considered it lawful to sell a non-existent thing for a specified number of days for instance, he said that:

> *"...the milk from the udders of a herd of sheep whose milk is homogeneous and productivity is known. On the other hand, he considered the sale of one sheep's milk from the udder to be unlawful."*[250]

He allowed the postponement of both the counter value for three days, and for more than three days in some cases.[251] The emphasis is not on ownership or possession, but rather on the seller's effective control and ability to deliver[252]. This approach, proves that where

[248] Al-Tabarani, quoted in al-Zuhayli, p. 75.
[249] Ibid
[250] Al-Tabarani, quoted in al-Zuhayli, p. 75.
[251] Al Hattab, n.d., 4/516 quoted in Al-Saati, Abdul Rahim A, 'Sharia Compatible Futures, (Journal of King Abdulaziz University: Islamic Economics, Vol. 15, No. 1, 2002), 46, available at SSRN: https://ssrn.com/abstract= 3073926.
[252] Ibn Taymiyyah, Ahmad Ibn Abd al-Halim. '*Nazariyyat al-Aqd*. Dār al-Ma rifah, Beirut. 1960),56

"jahalah" and *"gharar"* are minimized, the sale may be allowed where the items are non-existent at the time of sale.

The hadith of Prophet Mohammad that prohibits 'sale does not own' applies only to the sale of underlying assets in rem (*bay' 'al-a'ayans*), not to fungible goods. Further, Ibn Al-Qayyim (n.d) concluded "the *Hadith* is related to a specific item, not for described goods and also Ibn Al Qayyim (n.d) and Ibn Taymiyah (1398H) the *Hadith* is related to sale of what is not present and what the seller cannot deliver". Moreover, Kamali stated that "the *Hadith* that prohibit "sale does not own" applies only to sales that include specific objects and not to fungible goods, and the futures contracts normally proceed over fungible goods".[253]

Ibn Taymiyyah suggests that "agreed upon requirements between parties are binding to them based on the principle of the freedom of contractual requirement, thus in a forward contract, the parties can make requirements of the postponement for both the asset and its counter value".[254]

Jurists of the Hanbalī School like Ibn al-Qayyim and his teacher Ibn Taymiyyah, have permitted the sale of the items not existent at the time of the contract, subject to their availability and existence is known according to custom. They based their reasoning on the fact that no clear-cut prohibition is available in the Quran or Sunnah, and those *Ahādiths*

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[253] M. H. Kamali, *"Prospects for an Islamic Derivatives Market in Malaysia"*, Thunderbird International Business Review, 41(4/5) (1999): 523-540.

[254] (Ibn Taymiyyah, 1398, 20/529 and Al-Bājī, 1332 H., 1/399 quoted in Al Saati, Abdul Rahim A, '*Sharia Compatible Futures*, (Journal of King Abdulaziz University: Islamic Economics, Vol. 15, No. 1, 2002), 58, available at SSRN: https://ssrn.com/abstract= 3073926.

which prohibits the sales of nonexistent goods are describe the situations of excessive risk and uncertainty, where the object may not be deliverable.[255] So they find, in case where there is ignorance about the existence of the items in future, the sale of that item or object will be forbidden and if there is no ignorance regarding the future existence of the object that sale may be allowed. Thus, according to them, the prohibition is based on "excessive risk and uncertainty (*gharar*)", not on the 'lack of existence".

Khan (1996) suggests that "there are clear sayings of the Prophet (PBUH) that he who makes a *salaf* (forward sale) should do that for a specific quantity, specific weight, and for a specific period of time. Moreover, he states that the reason for accepting *salaf* is that the product is a public necessity and a payment is settled at the beginning of the contract. However, in the forward and futures markets, the payment is settled at the end of the contract. Thus, we argue that forward and futures violate the *Sharī'ah* rules."[256]

Zahraa and Mahmor also uphold the second approach and have opined that:

> *"Although a substantial majority of Muslim scholars stipulate that the subject matter must be in existence at the time the sale is concluded as an essential ingredient of the validity of the sale, however, the nonexistence of the subject matter does not necessarily invalidate the sale. The absence of uncertainty and doubt regarding the qualitative and quantitative description of the subject matter as well as the safe availability is the main*

[255] Ibid

[256] Nevi Danila, *'Derivatives: An Islamic Perspective'*, STIE School of Economics, Malang, Indonesia Agatha E. Jeffers, Montclair State University, New Jersey, USA,30

requirement, rather than existence of the subject matter, is the prime concern for the validity of the contract of sale".[257]

A similar approach has been taken by Kahf.[258] He does agree with the OIC Islamic Fiqh Academy decision that "the classical *fiqh* position prohibiting delay of both items in a sale contract would make futures impermissible". However, he adds reservation to the decision based on practical and real-life situation of the contracts, stating that:

> *"..Businesses require planning in advance. and all parties have to contract their products and their inputs in advance, regardless of the idea of financing (remember that salam is only a financing contract). The simplest example is the letter of credit. It always includes sale with postponement of both delivery and price and they are both effected in a future date at the same time. I believe that the evidence from the Sunnah against postponement of the two items is very weak, and there is no claimed „ ijma' on this issue, [which] I find one of the necessities of life, to the extent that it is impossible that our complete Sharī'ah would make it unlawful. Yet this is not to say that futures are permissible because I think only genuine trade with postponement of the two exchanged items (price*

[257] Mahdi Zahraa and Shafaai M. Mahmor, '*The validity of contracts when the goods are not yet in existence in Islamic Law of sale of goods*', (Arab Law Quarterly 17, no. 4 (2002), 397.
[258]M. Kahf, '*Islam's stance on commodities or futures market*', available at http://www.islamonline.net/servlet/Satellite?cid=1119503544954&pagename=IslamOnline_English-Ask_Scholar52FFatwaE%2FPrintFatwa, last accessed 10.11.2016).

and goods) is permissible, not the speculative practice on price change only, as it is normally in commodity futures".[259]

Therefore, Kahf is of the opinion that deferment of the two counter-values should be permissible, due to the necessities of life, and where no speculation and excessive ghara involved in transaction. However due to the "speculatory nature" of the futures transaction they should not be allowed. Kamali has mentioned that the nonexistence of the object in the futures or options contract will not be considered as *gharar* because of the function of the clearing house as a guarantors to both the counter parties, this function have been introduce for the purpose to prevent uncertainty and *gharar* over the fulfillment of the contract.[260] In this regard Kamali stated that "This is an unprecedented *gharar* prevention measure in the history of commerce is that the guarantee function we have here leaves nothing to chance, to the vagaries of climate, politics, or of the market-place".[261]

Finally, we may gave a practical example supporting the upholder of this approach that when the *Sharī'ah* Advisory Council of Malaysian Securities Commission, in its 11th meeting on 26 November, 1997, resolved that "a futures contract on crude palm oil is permissible", they have discussed in detail the issue of buying a nonexistent asset (*bay' madum*) and clarified that actually, the prohibition of *bay' madum* is due to the presence of uncertainty in relation to the delivery of the goods sold. They held that

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259 No page number can be provided for this quote because the legal opinion (fatwa) is taken from a web page: http://www.islamonline.net/servlet/Satellite?pagename=IslamOnline-English Ask_Scholar%2FFatwaE%2FFatwaEAskTheScholar&cid=1119503544954 accessed dated 12.10.2016

260 M.H Kamali, "Prospects for an Islamic derivative market in Malaysia," *Thunderbird International Business Review* 4, no. 5 (1999).

261 Ibid, 532.

"*Bay 'al-madum* is prohibited because of the element of *gharar* rather than the element of nonexistence".[262]

On the basis of the above mentioned discussion we may reach to the conclusion that, the nonexistence of the underlying asset may invalidate the contract in principle. However, it is clear from the fact that it is not the nonexistence of the asset per se, which invalidated the contract, but rather, the existence of excessive uncertainty and *gharar* that makes the contract invalid. If *gharar* can be removed, then the nonexistence of the subject matter at the time of the contract should not invalidate the contract, therefore, the approval may be given on case to case basis, after proper analyses by the advisors.

5.2.5. Selling prior to taking possession (Qabd)/ Offsetting sales and purchases

The word *Qabd* literally means and denotes holding something in one's hands.[263] In its technical application, as stated by Kamali, "*qabd*, refers to lawful custody and ownership in a proprietary capacity, even if it does not entail the material operation of holding".[264] The seller and buyer are both under obligations to bring the goods sold, and to pay the price. In conventional derivative transactions, majority of buyers and sellers reverse their positions before maturity or delivery the contract, which means that, futures derivatives transaction, physical delivery hardly ever takes place. In respect to taking "*qabz*"

[262] Securities Commission, '*Resolutions of the Securities Commission Advisory Council*', (Perpustakaan Negara Malaysia, 2006), 77-78.
[263] M.H. Kamali, '*Islamic Commercial Law: An analysis of futures*', *The American Journal of Islamic Social Sciences*, 13(2) (1996), 197-224.
[264] M.H. Kamali, '*Commodity Futures: An Islamic Legal Analysis*', *Thunderbird International Business Review*, 49(3) (2007): 309-339

possession before sale in futures contract, M.F.Khan has said "Futures contracts include selling items prior to taking possession".[265] Further, M.T.Usmani mentioned that "lack of real possession (sale prior to taking possession) making these contract not valid".[266]

The reasons behind this repeated sale of the same underlying asset in the chain without taking possession by the participants will add burden to the ultimate user and customers by adding the extra profit of the repeated sale to the commodities.

While differentiating the futures contract from *Salam* contract, International Islamic *Fiqh* Academy in 1992 session has stated that " futures contracts are different from *salam* contracts, where the price in futures contracts is deferred to expiration date, while in *salam* contracts the price paid during the contract session or can be delayed until three days further, ʿAlī El-Gārī, indicates that commodity futures contracts include selling prior to taking possession which is not the case in *salam* contract".[267]

The prevailing practice of the futures transactions is prohibited, as these kinds of contracts include "selling item prior to taking possession". The OIC Islamic *Fiqh* Academy, in its 7th session held in 1412H (9-14 May 1992), No. 63/1/7 opined as follows:

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265 M. F. Khan, *'Islamic Futures and Their Markets'*, *Islamic Research And Training Institute – IDB*, Research Paper No. 32 (1996),71

266 M. T. Usmani, *'Futures, options, swaps and equity investments'*, *Institute of Islamic Banking and Insurance, New Horizon*, (1996): 59.

267 Mohamed ʿAlī El-Gārī., '*Toward an Islamic Stock Market*' (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, Saudi Arabia, 1993), 1 -20.

"..the contract provides for the delivery of described and secured merchandise at some future date, and payment of its price on delivery. The contract, however, does not stipulate that it shall end with the actual delivery and receipt of the merchandise, and thus it may be terminated by an opposite contract. This type of contract is the most prevalent in the commodity markets. It is not at all permissible", moreover, "it is not permissible to sell a merchandise purchased under 'salam' terms with advance payment unless the merchandise has already been received".

All the leading classical Jurists agreed that selling of an item prior to taking possession is prohibited sale in *Sharī'ah* (Al-Shafei, 1321H; Al Sarkhasi, 1986).[268]

Al-Saati also has mentioned that "reverse trading in futures markets is contrary to the *Sharī'ah* ruling" as the purchaser cannot sell the goods purchased until he have taken it in his possession.[269]

While establishing this opinion, *Sharī'ah* scholars have based on the authority of the following *Hadiths*.

a. Hakim b. Hazzam narrates that he asked the Prophet (SAW): "A man comes to me and asks me to sell him something that I do not have. Should I sell it to him and then go and acquire it for him from the marketplace?" The Prophet (SAW)

[268] Quoted by S. Kunhibava & B. Shanmugam, *'Sharī ah and Conventional Law Objections to Derivatives: A Comparison'*, *Arab Law Quarterly* 24.4 (2010): 319.
[269] Al-Saati, Abdul Rahim A, *'Sharia Compatible Futures'*, (Journal of King Abdulaziz University: Islamic Economics, Vol. 15, No. 1, 2002), 51, available at SSRN: https://ssrn.com/abstract= 3073926.

replied: “Do not sell what you do not have”.[270]

b. Ibn Abbas narrated that the Messenger of Allah (SAW) said: “He who purchases food should not sell until he takes possession of it.” Ibn Abbas said: “Every sale is subjected to this condition.”

c. Abu Hurairah asked Marwan: “Have you legalized usury?” Marwan said: “No”. Then Abu Hurairah said: “You have legalized selling promissory notes whereas the Messenger of Allah (SAW) forbade selling foodstuff unless received by the seller.”_Marwan then addressed the people and forbade selling such notes. Sulaiman said: “I saw the guards taking them away from the hands of people.” In addition to the above mentioned *Ahādiths,* Al-Zuhaili has maintained that “the delivery of the item (underlying assets) in sales contracts is required, and if the seller is unable to deliver it, the transaction would entail *gharar*, gambling and risk”.[271]

5.2.6. Arguments against the criticism of salling prior to take possession or Arguments against the criticism of offsetting transaction

On the issue of ‘Selling prior to taking possession’, Scholars have different opinions, some are of the opinion that non-food items do not require the possession prior to sale, kamali quoted Ibn Rushd (n.d) stand, by stating that “selling non-food item before taking

[270] Quoted in S. Al-Suwailem, *‘Fatwa Archives Commerce and Employment’*; available at http://www.islamtoday.com/show_detail_section.cfm?q_id=737&main_cat_id=5, accessed 12.05.2015.
[271] Wahbah al-Zuhaili, ‘*Bay al-Dayn fi al-sharīah al-Islāmiyyah*’, (Dār al-Maktabi, Damascus, 1997), 80

possession is acceptable". Moreover, possession of real estate and non-weighted items, are also not necessary before to be sold out.[272]

The *ilah* (causality) of prohibition here is the '*gharar* (dispute) due to the seller's inability or failure to deliver underlying assets', if the delivery is ensured, then the existence or possession of the subject-matter is no more an issue, the oly thing which is prohibited is that of "inability to deliver".[273] Further, selling nonexistent items but whose existence is certain in future is permissible.[274] Hattab has also stated that, "there is clear sanctity of the sale of goods or financial securities before taking possession, for the presence of usury and *gharar* however, if there is no *riba* and *gharar*, it becomes permissible as in *salam* contract, but it is better to take possession on the commodities (financial securities) before the sale. Apart from that, the food is excluded from that, must be possessed before selling, but if the food is a preserved-type food, it can be sold before taking possession".[275]

5.2.7. Counter Arguments

In the matter of offsetting transaction, Kamali opined that "speculation causes the offsetting of transaction which adds burden to the customers is not true. Instead, it is

[272] M. H. Kamali, *'Fiqhī Issues in Commodity Futures'*, In Financial Engineering and Islamic Contracts, M. Iqbal, & T. Khan, ed. (New York: Palgrave Macmillan, 2005), 85.
[273] Al-Qaradāwi, *Bay al-Murābahah li al-Āmir bi al-Shirā Kamā Tujrīh al-Masārif al-Islāmiyyah Dirāsah fi Daw al-Nusūs wa al-Qawā id al-Shar iyyah*. (Maktabat Wahbah. Cairo, 1987), 23.
[274] M. T. Mansuri, *'Islamic Law of Contract and Business Transactions'* (Adam Publishers & Distributors, 2006) 3-16
[275] K. Hattab, *'Futures Commodity from the Perspective of Islamic'* (Working paper). International Conference of the Financial Markets and Stock Exchanges, (Makkah, Umm Al-Qura University, 2007),147

improper to assume that everyone in the chain of sale makes profit when in fact people can make profit and also can make losses, and also some people may need to resort to a reverse transaction before taking delivery on the same point. Apart from that, the validity of offsetting must be based on (*ibahah*) which means that the reverse trade must not include any contravention of Islamic law to be considered lawful".[276]

5.2.8. Futures Contracts are not a genuine sales

Futures contracts are generally considered as just paper transaction for the purpose of making speculative profit and not a genuine sale. According to al-Zarqa, " any contract that includes false contract (*suwari*) or fake does not intend to deliver item and price is void contract".[277]

This is in fact, fully applicable to conventional futures contracts, where no intention of taking delivery or making real possession or even real ownership is found and thus, these are not a genuine contract. Instead, these are considered a type of prohibited speculative activity with the aim to exploit price fluctuations to achieve maximum gains. In this respect, S. L. Gupta has mentioned that "The reason can be traced to leverage features in derivatives contract, where the buyer and the seller are required to deposit only a fraction of the contract value which enables them (speculators) to enter into more contracts than spot market. This causes the market to be more liquid, consequently

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[276] M. H. Kamali, *"Fiqhī Issues in Commodity Futures"*, In Financial Engineering and Islamic Contracts, M. Iqbal,& T. Khan, ed. (New York: Palgrave Macmillan, 2005): 20-57.

[277] Al-Zarqa as quoted in Ehab M. M. Injadat, *"Futures and forwards contracts from perspective of Islamic Law",Journal of economics and political economy* 1(2) (2014): 241-252.

increasing the speculative volume in derivatives market".[278]

In this connection Bacha (1999) has mentioned that "The trading volume of futures indicates an extensive amount of speculative behavior. He stated that the total trading volume is often much larger than the underlying volume. This huge divergence between underlying assets and trading volume has to do with risk dissipation. The extensive amount of speculative behavior is no doubt prohibited by *Sharī'ah* rules because it is similar to gambling".[279]

As result, the International Islamic *Fiqh* Academy (1992) and Islamic *Fiqh* Academy of Muslim World league (1984) identified that these contracts are forbidden in *Sharī'ah,* and the reason have been mentioned that the ultimate goal from these contracts are just to pay and receive price differences between sellers and buyers and thus are considered as gambling and are therefore impermissible.

5.2.9. The issue of underlying assets for Derivative Contract

Futures contracts when conducted on the prohibited underlying asset are absolutely considered as impermissible such as futures interest rate contracts, and when underlying asset are hypothetical such as futures and forward index, these are considered as a

[278] S. L. Gupta, '*Financial Derivatives: Theory, Concepts and Problems*' (New Delhi: Prentice-Hall of India Private Limited, 2006),23

[279] Obiyathullah I.B. '*Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration*' (International Journal of Islamic Financial Services Vol. 1 No.1.), 76.

form of gambling.[280] The prohibition occurs on these contracts Moreover, when the underlying asset is money (currencies) such as futures and forward currencies contracts are prohibited. In this regard Danila & Jeffers has mentioned that "since currencies are not considered as a commodity for selling and buying rather, it is a method for trading"[281]. Jobst & Sole, have also mentioned that "currencies must be traded on spot rather than on deferment basis so it is not accepted in futures and forward contracts. Currencies should only be traded hand to hand on spot basis, not on deferment basis".[282]Furthermore, International Islamic *Fiqh* Academy (1992) and Islamic *Fiqh* Academy of Muslim World league (1984) has considered deferment of currencies are invalid in Sharīʿah due to *ribā al-nasīaʾh* (*Riba* pertaining to loan contracts).[283]

5.2.10. The issue of Charging of Fees for the options right is not valid in *Sharīʿah*

As per practices, premium is required to be paid, to secure right to buy or sell the underlying asset in option transaction at a pre-determined exercise price.

According to Usmani, "an option is a promise, and such a promise is itself permissible and 'normally binding on the promisor'. However, charging and claim of fee for the same is not

[280] International Islamic Fiqh Academy. *Qararat al-Majma'*, Seventh Session, Resolution 1 Financial Markets. (Jeddah: International Islamic Fiqh Academy, 1992),73
[281] N. Danila & A. E.Jeffers, *'Derivatives: An Islamic Perspective'*, Journal of International Finance & Economics, 9 (3) (2009): 83-90.
[282] A. Jobst & J. Sole, *Operative Principles of Islamic Derivatives – Towards a Coherent Theory*. Paper presented at the meeting of International Monetary Fund (2012),16
[283] M. Obaidullah, 'Financial Contracting in Financial Market. An Islamic Evaluation', International Journal of Islamic Financial Services, 3(3) (2001),39

valid in *Sharī'ah*"[284]. This ruling, he opines, is applicable to all kinds of options whether they are call options or put options.

Here, the main issue is that to determine the nature and staus of option in Islamic Law. The upholder of this view, that options are rights and not tangible assets, therefore, cannot be the subject matter of the contract. As stated by the Organization of the Islamic Conference (OIC) Islamic Fiqh Academy in Resolution No. 63/1/7 in its 7th session in 1412 AH (9-14 May 1992) that

> *"Option contracts as currently applied in the world financial markets are a new type of contract which does not come under any one of the Sharī'ah-nominated contracts. Since the object of the contract is neither a sum of money nor a utility or a financial right which may be waived, then the contract is not permissible in the Sharī'ah"*[285].

This decision of the OIC Fiqh Academy has been endorsed by the European Council for Fatwa and Research.

Similar approach has been adopted by Alī El-Gārī, he stated that "Although Islamic law recognizes trading of intangibles such as service and usufruct (*manfaah*); however, a right given under an option may not be the same thing as usufruct. The rights under an option do not have a tangible or material quality. They are similar to a preemptive right, such as the

[284] Usmani M.T, '*Commodity Exchange and Stock Exchange in Islamic Economy*' (New Horizon, American Journal of Islamic Social Sciences, 1988), 6-7.
[285] Organization of the Islamic Conference (OIC) Islamic Fiqh Academy in Resolution No. 63/1/7 in its 7th session in 1412 AH, 9-14 May 1992.

rights of custody and guardianship, which are allowed in the *Sharī'ah*, but it does not allow to them to be sold for monetary compensation".[286]

Hasan has suggested that "options are prohibited since their maturity dates are beyond three days. Thus, they are similar to *Khiyār -al shart* (option of stipulation). Moreover, in these contracts, the buyer has many more benefits than the seller, in the sense that the seller has potentially unlimited risk and limited benefit. Further, the buyer has potentially unlimited benefits and limited risk. This is considered to be oppressive and unjust".

On the other hand, Kamali not agreed to the impermissibility of compensation on the right of options. He confirms that the concept of options, under the *Sharī'ah* concept of *ikhtiyarat* is valid under Islamic Law and accordingly entertainable. The origin of the same is traceable in the Sunnah, and further developed by the Islamic jurists in their writing through creativity and *Ijtihād*.[287] On the issue of 'options being a mere right and therefore not being amenable to sale and purchase', Kamali considered these rights to be similar type of intangibles as service and usufruct (*manfa'ah*). He observed that, the *Shaf 'ī* and *Hanbalī* schools included 'usufruct' under the definition of property and the *Hanafī* 's and *Malikī's* initially did not, however, *Hanafī* and *Malikī* jurists of the later periods came around to the *Shaf'ī* and *Hanbalī* view and did include 'usufruct' in the definition of property.

[286] Mohamed 'Alī El-Gārī., '*Toward an Islamic Stock Market*' (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, Saudi Arabia, 1993), 13.
[287] M.H. Kamali, *'Islamic Commercial Law: An analysis of futures'*, The American Journal of Islamic Social Sciences, 13(2) (1996), 221.

On the issue of compensation, whether it is allowed under the *Sharī'ah* or not, he stated that "the typical *ikhtiyar* that the *Sunnah* validates is the option of stipulation (*Khiyār al-shart*), which grants the buyer the option, within a time frame, to either ratify the contract or revoke it. Under such options, the *Sunnah* entitles the parties the freedom to insert stipulations that meet their legitimate needs and may be of benefit to them. Nevertheless, the liberty that is granted here is subject to the general condition that contractual stipulations may not overrule the clear injunctions of the *Sharī'ah* on *halal* and *haram*. Provided that this limitation is observed, in principle, there is no restriction on the nature and type of stipulation that the parties may wish to insert into a contract".[288]

On the basis of the argument of 'freedom to contract', Kamali holds that

> "*The freedom to insert stipulations in contracts is inclusive of a request for monetary compensation or a fee for granting an option or a privilege. If the seller is entitled to stipulate for a security or a pawn, then it is a mere expansion of the same logic that he may charge the buyer and impose a fee* or *compensation in respect of such options and stipulations that are to the latter's advantage*"[289].

Thus, Kamali concludes that the imposition of a fee on the other party for the right given through options is valid and permissible under the *Sharī'ah*. He further stated that "there is nothing; inherently objectionable in granting an option, exercising it over a period of time or charging a fee for it, and that options trading like other

[288] Ibid, p. 29.

[289] Ibid, p. 30.

varieties of trade is permissible mubah and as such, it is simply an extension of the basic liberty that the Quran has granted".[290]

Kamali's stance is strongly disputed by Obaidullah. He opined that validity of a sale cannot be disputed with the condition that is stipulation of an option (*Khiyār al-shart*) in. this case[291] Obaidullah further stated that "the contractual price is valid if it includes any compensation for the benefit provided by the seller if it places the seller at a disadvantage. However, in conventional options trading would imply separation of the compensation component and its up-front payment to the option writer or seller under a separate contract. A promise or obligation cannot be the object of sale, according to an overwhelming majority of scholars. In classical *Sharī'ah* law, before *daman* (guarantee) can operate one needs to show some illicit act (*taaddi*) or negligence (*tafrit*) by the party required to compensate. Kamali also fails to cite a single reference of the great *fuqaha* (an expert in *fiqh*) of the past on the use of *daman* in the *bay' wa shart* framework".[292]

To sum up the opinion of the Islamic Scholars regarding the status i.e. permissibility of derivatives or otherwise in Islamic finance, after these have been discussed in detail along with the arguments and counter arguments. These opinion have been broadly divided into to two types. 1st school of thought, is of the view that conventional derivatives i.e forwards, futures options and swaps in the present form are impermissible instruments from *Sharī'ah* point of view. While the 2nd group, which are in minority, pointed out that conventional

290 M.H. Kamali, (1995), *Islamic Commercial Law: An Analysis of Options*, Paper presented at The Conference On SPTF/Islamic Banking Products, Kuala Lumpur, Dec. 1995

291 M. Obaidullah, *'Financial engineering with Islamic options'*, *Islamic Economic Studies* 6, no.1 (1998), 43

292 Ibid, 80.

derivatives are not totally impermissible instruments in *Sharī'ah* and these could be used and sanctioned in Islamic finance with some adjustments as these are greatly needed in today's sophisticated business environment to enable Islamic finance to kept fulfilled needs of the public.

Sharī'ah scholars who objected to the permissibility of conventional derivatives have highlighted few objections in their critique. However, most of these objections have been rebutted by some modern scholars including Kamali and have mentioned various reason and justification. They said that apparently the upholders of these objections, have ignored the operational procedure of the futures and have premised on theoretical *Fiqhī* positions on conventional sale. Point wise elaboration of these objections along with their basis and counter counter-arguments and rationales can be summarized as:

The majority of Muslim jurists views that the futures and forwards contracts that are currently trading in the financial market are not permissible because futures sales, due to the deferment of both counter-values is a sale of one debt for another (*Bay' Al-kāli' bi al-kāli'*), which is forbidden in *Sharī'ah*, Moreover, Counter-values in Futures and Options Sales are Nonexistent at the time of the Contract and they involve high risk and *gharar* resulting from the sale of what is not with you or an asset not in the possession of the seller, debt by debt sale and gambling is prohibited.

On the other side, few modern scholars, have rejected the claim of common consensus on the prohibition of the exchange of debts, like Kamali argued against this objection. He stated that "the legal schools have recorded divergent rulings as to the definition of *bay'al-kāli' bi al-kāli'*". Moreover, he mentioned that this *Hadith* "only appears in some collections, and many prominent scholars consider it to be unreliable". Kamali further argued that no clear prohibition on the exchange of debts has been found, and a number of scholars have allowed it. Therefore, in the absence of a clear and definite prohibition on the sale of a debt, the principle of permissibility must be prevail, provided that it should be devoid of *riba* and *gharar*.

Further, they argued that keeping in view today's sophisticated nature of business and the nature of futures transactions in today's clearing house environment. It is an un-avoidable fact that as per practice, the clearing house acts as (guarantor) the seller for each buyer and the buyer for each seller in all futures transactions. So each transaction is guaranteed by the clearing house. There is no direct interaction of one trader with another trader. There is, therefore, no exchange of a debt for a debt, as each transaction ends with the exchange of buying or selling the futures contract.

On the basis of the above mentioned discussion we may reach to the conclusion that, the nonexistence of the underlying asset may invalidate the contract in principle. However, it is clear from the fact that it is not the nonexistence of the asset per se, which invalidated the contract, but rather, the existence of excessive uncertainty and *gharar* that makes the contract invalid. If *gharar* can be removed, then the nonexistence of the subject matter at the time of the contract should not invalidate the contract, therefore, the approval may be given on case to case basis, after proper analyses by the advisors.

CHAPTER NO.6

PROSPECTS OF ISLAMIC CONTRACTS AS ALTERNATIVES TO CONVENTIONAL DERIVATIVES

The analyses of *Sharī'ah* arguments on conventional derivatives clearly advocates the presence of flaws which render these instruments *Sharī'ah* non-compliant. Hence, can not be used in Islamic finance. Although, the use of conventional derivatives are relatively lesser in Islamic countries and it is a wise approach to reject and not to use conventional derivatives when conducting business in the Islamic environment. However, this have deprived the Islamic financial institutions (IFIs) and corporation of many advantages associated with derivatives as a suitable risk transfer mechanisms, as IFIs also have expanded their activities well beyond their original jurisdictions to almost all over the world. This global diversification of Islamic finance will definitely require new and more flexible updated instruments to manage the associated currency and other risks.[293] Due to today's un-avoidable international business requirement and considerable demand from the public, a *Sharī'ah* compliant instrument for management of risk and for the competitiveness of the Islamic financial institutions and corporations is essential.[294] As a complete code of life, *Sharī'ah* rules offer several risk management strategies which are compatible with the Islamic ethics and can simultaneously achieve the same goals as those provided by conventional derivative instruments.[295] Thus, in this chapter we will analyze in detail the closest alternatives instruments having derivatives like features that are available

[293] Heiko Hesse, Andreas A. Jobst and Juan Sole, *'Trends and Challenges in Islamic Finance'*, World Economics 175. (2008), 9.

[294] Andreas A. Jobst and Juan Sol'e. Jobst/sol' E, *'The Governance of Derivatives in Islamic Finance'* (J.I.B.L.R. (2009), 7.

[295] Syed Aun Raza Rizvi & Dr. Ahcene Lahsasna, *'Derivatives in Islamic Finance: The Need and Mechanisms Available for Islamic Financial Markets'*, 10-11

in Islamic finance as proposed by *Sharī'ah* scholars and practitioners such as the *Bay' Salam*, *Wa'ad* and *Murābahah* based arrangements, *Istijrār*, *Khiyār al-Shart*, *Bay' al-'Arbūn*. These available contracts in Islamic finance can be considered and used as the basis or building block for derivative contracts within an Islamic framework for further innovation of products as per industry requirement. So, in this chapter we will mention in detail a comprehensive jurisprudential concepts of these contracts, their definition, terms & conditions and then will discuss their industry usage as risk hedging instruments along with their application mechanism, process flow and procedure (modus operandi) and will recommend proper application and implementation of these instruments in Pakistani market so as to develop Islamic derivative market in Pakistan and to remove the prevailing unfavorable position for IFIs.

6.1. *Sharī'ah* Compliant Hedging Instruments: Introduction and Legitimacy

Sharī'ah Compliant hedging instruments are financial instruments which almost provides the similar benefits as conventional derivatives instruments through *Sharī'ah* compliant mechanism. As we have mentioned in detail earlier that all the *Sharī'ah* compliant transactions must be free at least from *riba, maysir, gharar* and *jahal*. These prohibitions are most relevant in the context of derivative instruments.

How can a derivative be *Sharī'ah* -compliant? Jobst has mentioned that derivatives may be in line with the *Sharī'ah* norms if they are "employed to address genuine hedging demand on asset performance associated with direct ownership interest, disavow mutual deferment without actual asset transfer, eschew avertable uncertainty (*gharar*) as prohibited sinful activity (*haram*) in a bid to create an equitable system of distributive justice in consideration of public interest (*maslahah*). Considering the above tenets, purposes of transactions and relative motivations of parties would also be significant along with structuring and return profile of a transaction for *Sharī'ah* scholars and financial engineers".[296]

6.2. Risk Hedging Islamic Financial Instruments: Theory and Practice

A number of instruments and contracts exist in Islamic finance that could be considered and used as the basis or building block for derivative contracts within an Islamic framework as proposed by Islamic scholars and practitioners such as *Bay'al-Salam, W'ad and Murābahah* based arrangements, *Istijrār*, Options like *Khiyār Al-Shart* and *Bay'al-'Arbūn* etc. A detailed discussion of these concepts and products have been made to understand the proper theoretical and jurisprudential concept of these contracts, their definition, terms & conditions and their industry usage as risk hedging instruments along with their application mechanism, process flow and procedure (modus operandi). These instruments can be used as Islamic alternative to short selling, FX Swaps, Cross Currency Swap, Profit Rate Swap and options etc as mentioned in detail below. All these innovations are hybrid products based on the combination of various Islamic concept and contracts as

[296] Andreas A. Jobst, '*Derivatives in Islamic finance*, available at http:// papers.ssrn.com/sol3/papers. *Derivatives increase liquidity*, available at http:// www.asx.com.au/profession- als/companies/derivatives increase_liquidity.htm, last accessed 10.05.2016.

designed by the *Sharīʿah* scholars and practitioners which pave the way of competition for the Islamic society in the relevant global financial market.

6.3. Bayʿal-Salam

6.3.1. Definition of Bayʿal-Salam

In Arabic, the word '*bay*' means sale, *salam* means delivery. However, *Salam* is defined as "a sale or purchase of a deferred commodity for the present price (*bayʿ ajilin bi ajil*)".[297] Another definition of the *Salam* is "A transaction where two parties agree to carry out a sale/purchase of an underlying asset at a predetermined future date but at a price determined and fully paid for today".[298] Thus while execution of the *salam* contract, the seller undertakes to deliver to the buyer some specific goods at a future date in exchange of an advance price fully paid at the time of contract. As per general rules of *Sharīʿah*, 'no sale can be affected unless the goods are in existence at the time of the bargain', however, *salam* sale is an exception to the general rules given by the Holy Prophet, provided the goods are specifically defined and the date of delivery is fixed.

6.3.2. Legitimacy of *Salam*

The legitimacy of *salam* is based on the sunnah of the Holy prophet (SAW), whereby the Prophet Muhammad (SAW) have observed the people paying in advance the 'price of dates' to be delivered within one, two or three years in Madina. At the time of payment or start of the contract, however, they did not specify the quality, measure or weight of the

[297] Ibn ʿĀbidin, *'Hāshiyat Rad al-Muhtār'*, (al-Bābī al-Halabī, Cairo, 1966), 209.
[298] Fahim Khan, *'Islamic Futures and Their Market'*, (Research Paper no. 32, Islamic Research and Training Institute), 14.

dates. The Prophet Muhammad ordained that: "Whoever pays money in advance (for fruits) (to be delivered later) should pay it for a known quality, specified measure and weight (of dates or fruit) along with the price and time of delivery"[299]

6.3.3. **Specification of Salam:**

Salam sale is almost similar to a conventional forward contract however, the big difference between *salam* and forward contract is that in a '*Salam* sale', the buyer pays the entire amount in full at the time the of the contract is initiated. It also stipulates that the payment should be made in cash form. The idea behind such an 'advance payment' requirement is that the main objective of *Bay' Salam* contract is to help and support the farmers and small businesses men who are in need of the working capital financing. *Salam* sale is clearly more beneficial to the seller due to the full prepayment in advance as compared to the buyer. However, 'the predetermined price is normally *lower* than the prevailing spot price. The lower *Salam* price as compared to the spot is the "compensation" by the seller to the buyer is considered a privilege given to the buyer. This price behavior in *salam* contract, certainly differentiate it from the conventional futures contracts prices. In future contracts the futures price is typically higher than the spot price by the amount of the carrying cost, which is not the case in *salam*.[300]

[299] Reported by Imam Bukhari, Muslim and others as quoted by http://islamicbankers. wordpress.com/focus/in-focus-bay'-salam(accessed dated 14.5.2016)

[300] Obiyathulla Ismath Bacha *"Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration,"* (Unpublished Paper, International Islamic University Malaysia, November, 1997), 21.

6.3.4. Conditions of Salam

As per Islamic law, *salam* contract has its own conditions, beside the general conditions of a regular sale in Islamic law. Following are the major conditions based on the classical sources and writing of the Muslim jurists also adopted by the Islamic Fiqh Academy (Jeddah) in its 9th session states that "A *salam* contract must fulfill the following important conditions:

a. It is necessary to precisely fix a period for the delivery of goods.

b. Quality, quantity, and place of delivery must be clearly enumerated.

a. A *salam* contract cannot be based on uniquely identified underlying assets. This means the underlying commodity cannot be based on a commodity from a particular farm/field.

c. Full payment should be made at the time of making the contract".[301]

Here if we compare the future contract with the *salam* on the basis of these conditions, it should be more clear that the current exchange traded futures has conform all these conditions with the exception of the fourth one which requires full advance payment by the buyer to the seller. However, the customized nature of *Bay' Salam* is more closely resemble to forwards rather than futures.

Moreover, the problems of the forwards; namely, double-coincidence, negotiated price and counterparty risk can also exist in the *Salam* contract. Though the counterparty risk would

[301] Ṣiddiq al-Darīr, '*al-Salam wa Tatbiqatuhu al-Muaṣirah*', *Majallat Majma' al-Fiqh al-Islami*, ninth session, 1996, no. 9, vol. 1, 379–383; Nazih Ḥammad, 'al-Salam wa tatḃiqatuhu al-Mu'aṣirah', *Majallat Majma' al-Fiqh al-Islami*, ninth session, 1996, no. 9 vol. 1, 553–555.

be, however, from one side, since the buyer has fully paid the price, so only the buyer who faces the default risk from the seller and not both ways as in the case of forwards and futures. In order to cover this potential risk of default on the part of the seller, the *Sharī'ah* allows for the buyer to obtain any security which may be the guarantee or mortgage etc.

The contract could also be beneficial for the financial institutions for the provision of working capital financing. As the *Salam* sale involves in the transaction of the 'underlying asset' and financial institutions may not be in favor of the transacting in the underlying asset, however, a number of alternatives available like entering into parallel contracts etc. Though all jurist are not agreed on its permissibility.[302]

6.3.5. Parallel with Seller

As a practical step, after conclusion of the original Salam Contract, the institution, for example bank, may enter into a parallel sale with the same seller to sell the underlying commodity after a time lapse fixed in the 1st contract. However, here in the 2nd contract the price of resale would be higher and considered to be justifiable since there has been a time lapse. Difference in prices of the two contract will be the bank's profit. Both of the sale or transaction would be independent from each other, and should not be subject to each other. The price in the 1st transaction should not have fixed with the intention that there will be a subsequent parallel Salam.

[302] Obiyathulla I.B. *'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration'*, (Unpublished Paper, International Islamic University Malaysia, November, 1997), 24.

6.3.6. **Offsetting Transaction with Third Party**

In the transaction with the 3rd party, here, the bank which had gone into an original *Salam* Contract may enters into another contract with the 3rd party promising to sell the commodity (which it will receive from 1st sale) to a third party on the delivery date. In this regard O.I. Bacha has stated that:

> *"In the first alternative the financial institutions after entering into the original contract, gets into a parallel Salam to sell the underlying commodity after a time lapse for the same maturity date to the original seller. Under the second alternative, the bank which had gone into an original contract enters into a contract promising to sell the commodity to the third party on the maturity date of that contract. Since this second transaction is not a contract the bank does not receive advance payment*"[303]

Since, here the Bank does not receive advance payment from 3rd party, it would be carried out or settled on maturity dated based on pre-determined price. So it is basically not a '*Salam* Contract' rather an offsetting transaction of the bank with the 3rd party that is why few scholars have objected to this nature of transaction.

Samuel Hayes, after detailed discussion on derivatives concludes that there are no effective derivate of Islamic debt contracts which replicate conventional risk-hedging and leveraging contracts such as swaps, futures, and options. Similarly, in the equity security sector, there are no risk-hedging or leveraging contracts in Islamic finance truly comparable to available

[303] Obiyathulla I. B, '*Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration*', (International Journal Of Islamic Financial Services, Vol. 1, No. 1, April – June 1999), 35

conventional derivatives. With respect to commodities and other goods, the *Salam* contract is an imperfect Islamic substitute for a conventional forward contract. The related *'Istisnā'*[304] contract for goods being manufactured for a buyer provides another partial Islamic proxy for a forward contract. It is also possible to construct an Islamic contract which partially replicates a conventional futures contract, via back-to-back *Salam* contracts.[305]

6.3.7. **Comparison of Salam with the Conventional derivative Instruments**

As mentioned earlier *Salam* contract is considered the closest to the conventional forward contract. Even few scholars have placed it as the Islamic alternative to the forward contract. Thus, Sudin Haron stated that forward markets do exist in Islamic financial system but only on a limited scale. Futures markets, however, have not been established in Islamic financial system. In case of forward markets for money there is a divergence of opinion pertaining to the legality of such transaction from the point of view of *Sharī'ah*. Forward markets for commodities are allowed by *Sharī'ah* under the principle of *bay' al-salam* (an advance purchase) and *istiṣna'* (a contract to manufacture).[306]

Another scholar Iqbal stated that *salam* contract is the closest substitute to the conventional forward contract. Further he acknowledged that the same is not in practiced in the market

[304] 'Istisnā' is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. It can be used for providing the facility of financing the manufacture or construction of houses, plants, projects, and building of bridges, roads and highways.
[305305] Ayub, Derivatives and Islamic Finance, Research paper available at www.sbp.org.pk/departments/ibd/derivatives_islamic.pdf, accessed dated 16.08.2016.
[306] Sudin Haron and Bala Shanmugan, '*Islamic Banking System Concept and Application*', (Pelanduk Publications, Kuala Lumpur, 1997), 180.

and have mentioned the two reasons: "first, as compared to the western forward contract, *bay' al-salam* requires full payment at the time of agreement. Second, since interest is incorporated in the determination of the forward contract price, it is synonymous with paying or receiving interest". Here the question is whether an increase in the price with the deferred delivery is justified or not and, does it result in dealing with interest (*riba*)? Zamir concluded that 'a forward contract may not incorporate the element of interest as it is prohibited by Islam'.[307] However, it should be noted here, that several institutional and individuals have ruled for the legality of increase in price with deferred delivery, so this question will not arise in the case of forward contract.[308]

However, to consider *bay'al-salam* as the exact Islamic alternative to the modern forward contract, the following major issue need to be resolved. The 1st outstanding issue is that in case of *bay' al-salam* full payment is required to be made at the time of agreement according to the majority of jurists, which is not the case in the forward contract. Thus to accommodate the conventional forward contract in Islamic finance this issue should be resolved. This study will attempt to elaborate on the matter. The second issue is that, the contract of *salam* is an exception to the general rules in Islamic law, it is not in accordance to the Islamic norms. Therefore, it can not be the bais of an analogy between *salam* and any new contract. This issue also needs to be resolved in connection with the accommodation of the forward contract in Islamic finance.

[307] See Zamir Iqbal, *'Financial Innovation in Islamic Banking'*, (*Journal of Islamic Banking and Finance*, the International Association of Islamic Banks, Karachi, Asian Region, vol. 15, no. 2), 12–13.
[308] See Islamic *Fiqh* Academy's resolution no. 2, 6th session, 1990.

6.3.7.1. The first issue is the full payment in advance at the time of agreement of *salam*

The condition of full payment in advance at the time of agreement of *salam* is not entirely agreed upon among the different schools of thoughts, and this condition has prevented salam from playing a parallel role in the market. According to the *Ḥanafis*, *Shaf ʿī* s and *Ḥanbalis* 'payment of the principal should not be delayed beyond the time the contract is signed'. They have based the justification on the delay of both commodity and principal is in fact 'a sale of debt for debt', which is prohibited in the *Sharī ʿah.* Moreover, 'the principal must be paid in advance if the very objective of *salam* is to be fulfilled'.[309] The *Malikīs*, on the other hand, disagree with this stand and said that delay of payment is allowed in *Sharī ʿah*, according to them,: "It is permissible to delay payment up to three days after the time of signing the contract, whether this is stipulated in the agreement between the two parties of the contract or not and whether the price is to be paid in cash or in kind". Further it is a point of concern that some *Malikīs* believe that delay for more than three days are also permissible without prior agreement. On the other hand, if the payment is in kind some accept delay in this case but for a short period. However, payment should not be delayed until the time of delivery. Another group believes that 'if such a long delay happens, the *salam* contract would still remain valid, but the act of making a long delay is *makrūh* (disliked)'.[310]

[309] See for instance Ibn al-Humām, *Sharḥ Fatḥ al-Qadir*, al-Matba'ah al-Amīriyyah, Egypt, 1937, vol. 5,337; Al-Nawawi, *al-Majmu*, vol. 9, 208. Ibn Ḥazm, *al-Muḥalla*, vol. 9,109.

[310] For more details about the *Mālikīs* opinion see al-Hattab, '*Mawāhīb al-Jalīl li-Sharh Mukhtasar Khalīl*', Mustaphā al-Halabī, vol. 4, 514–517; al-Khirshi, *Sharh al-Khirshī alā Mukhtasar Khalīl*, Dār Sādir, Beirūt, vol. 5, 202–203, and Ibn Rushd, *Bidāyat al- Mujtahid*, vol. 2, 202.

Based on the *Malikīs* opinion, al-Darīr has said that "there is no problem in deferring the price of *salam* as long as it is for a period not exceeding the time of delivery of the commodity itself". He argued that "the deferment by itself could not be the cause for *gharar* or prohibition but all these arguments are based on the assumption that the approval of *salam* in Islamic law was against the norms and not in line with *qiyās*"[311]

Furthermore, *Malikīs* also allow delay in the case of land leasing. According to Imām Malik, "it is permissible to lease on the condition that the lessor receives the leased property one year after the time of agreement while the second party can pay the price ten years later".[312] This is another case for the validity of deferment of both counter values in a contract.

It is also important to be noted here that the *Ḥanafīs* consider this condition for 'the continuation of the validity of the contract' (*baqa'uhu alā al-sihha*) and not as a condition for its effectiveness (*infādhihi*) nor its validity (*sihha*).[313] On the other hand, some Shaf'īs differentiate between the terms used in the contract. If the contract is concluded as 'a *salam* or *salaf* '(another name of *salam*), then the price must be paid. However, if the contact is concluded using the term 'sale rather than *salam* or *salaf*', then it is not necessary that the price should be paid immediately.[314] Muhammad al Bashir has mentioned that "despite the weakness of this differentiation, it does prove that the mere deferment of both counter

[311] Al-Darīr, '*Al-Gharar wa Atharuhu fi al-'Uqūd*', 461–462.
[312] Imām Mālik, '*al-Mudawwnah al-Kubrā*', (Dār al-Fikr Beirut vol. 3), 370.
[313] Ibn *Ābidīn, Rad al-Muhtār alā al-Dur al-Muqhtār*', (al-Bābī al-Halabī, Cairo, 1966), 288.
[314] Al-Shirāzī, '*al-Muhadhdhab*', (Maktab al-Bābi al-Halabi, Cairo, 1976, vol. 1), 392.

values is not *ḥaram* (prohibited)"[315]. The table show the summarize position of the opinion of the jurists on the conditions of *salam*.

6.3.7.2. **Opinion of the Major Schools on the Conditions of *Salam***

Schools	Delivery Period	Description	Type of commodity	Time of payment
Abu Hanifah	Must be precisely Fixed	Clearly enumerated	Not uniquely identified underlying asset	Full payment at the conclusion of the contract
Imam Malik	Must be precisely Fixed	Clearly enumerated	Not uniquely identified underlying asset	Could be deferred to three days or even more
Imam Al-Shaf'īe	Must be precisely Fixed	Clearly enumerated	Not uniquely identified underlying asset	Full payment at the conclusion of the contract
Imam Ahmad	Must be precisely Fixed	Clearly enumerated	Not uniquely identified underlying asset	Full payment at the conclusion of the contract

It can be concluded from the above discussion that the deferment of the price in *salam,* as per *Malikīs* opinion is neither involving *riba* nor *gharar*, which invalidate the contract. As stated by Muhammad Al-Bashir "all these arguments about the prohibition of the deferment of both counter values in a contract are based on the weak *hadith* about *bay' al-kali bi al-kali.* One may ask why the *Malikīs*, for instance, departed from the "general principles" and allowed deferment for three days. Some may argue that this is not in essence a departure from the "general principles," but just an application of the maxim *ma*

[315] Muhammad al-Bashir Muhammad al-Amine, '*Risk Management in Islamic Finance An Analysis of Derivatives Instruments in Commodity Markets*', Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), 269

qārab al-shai' yu'tā hukmahu, which means whenever a case is very close to another they could be given the same rule. Therefore, a deferment of just three days may not be considered a real deferment. However, if the deferment of the price in *salam* can really lead to *riba* or *gharar*, then could it be argued whether it is possible to allow it for one hour or one day and at best for three days? The answer is clear. *Ribā* or *gharar* cannot be allowed either for three days or more or less".[316]

It may be noted here that the view of Ibn Abbas in respect of *ayat al-Mudayanah* that this verse is concerned with *salam*, since at this time, *salam* means the deferment of one of the counter values, may be one of the sources of misconception of deferring both counter values is not legal. Since some scholars tried to confine the general meaning of the verse to the interpretation of Ibn Abbas. In this regard Kamali maintained that "the 'Ulama (*Shari'ah* scholars) have held different views with regard to their interpretation of the word *dayn.* While some have confined *dayn* (debt) to certain types of debt, others have applied it generally to all deferred liability transactions that can fall within its broad meaning. The Quran has evidently not specified the general meaning of *dayn* or *tadayantum* (debt or debt exchange) and there is no compelling evidence to warrant a departure from this position. The preferred view would thus appear to be that the general language of the text should convey its general and unqualified meaning. Even if we admit Ibn 'Abbas's interpretation, it may be said that it was based on the occasion of revelation (*sha'n al-nuzūl*) of the *ayah.* According to the general rules of *uṣūl al-fiqh*, the *sha'n al-nuzūl* (the occasion of

[316] Muhammad al-Bashir Muhammad al-Amine, *'Risk Management in Islamic Finance An Analysis of Derivatives Instruments in Commodity Markets',* Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), 125

revelation) of a text may be specific but that does not necessarily restrict the general purport and ruling of the text".Kamali concluded that even "if the text is revealed concerning *salam*, the language of the text is general and applies to all debts, which would imply the basic legality of deferred transactions in all its varieties in the *Sharī'ah*, provided, of course, that none of the principles of the Quran and sunnah on such other themes as usury, gambling, and *gharar* are violated."[317]

6.3.7.3. **The second issue is the possibility of drawing an analogy with *salam* if we consider it in line with *qiyās* (analogy) and not against it.**

The misconception here about the *salam* is the claim that it is against the *qiyās* and the norms of *Sharī'ah* and allowed as an exception to the general rules (because it is the sale of what one does not possess and the sale of the nonexistent.) and there is no specific *Hadith* about its legality.[318]

However, this claim is rejected by some classical jurists, such as Ibn Taymiyyah, Ibn Qayyim, and Ibn Ḥazm, and also by some prominent contemporary scholars. Before to proceed for the legal arguments it must be noted here to clarify that we discuss this issue because we are in need to extend the permissibility to the modern type of forward contract by way of *qiyās* or analogy and salam is the closest contract through which we can do that if we consider and prove that it is permitted by the explicit sunnah of the Prophet. However, such *qiyās* would be impossible if we consider *salam* as an exception and against

[317] M.H. Kamali, '*Islamic Commercial Law: An analysis of futures*', *The American Journal of Islamic Social Sciences*, 13(2) (1996), 255.

[318] Al-Aynī, Badr al-Dīn Mohammad Ibn Ahmad. *Umdat al-Qāri Sharh Sahīh al-Bukhārī'*, (Beirut. Dār al-Fikr, vol, 5), 561-63.

the norm of Islamic law. As for a valid analogy, according to the commonly agreed principle of Islamic jurisprudence, 'the *asl* or the principle should not be allowed by way of exception'.[319] Thus, an analogy with *salam*, in this regard will be considered violation of this principle.

While rebutting the above mentioned claim that *salam* is approved as an exception and against the norms of the *Sharī'ah* or against *qiyās*. Darīr, for instance, said:

> *"The right interpretation here is the one advocated by Ibn Taymiyyah and Ibn Qayyim. According to them, there is nothing in the Sharī'ah which is against qiyās. Moreover, everything which is supposed to be against qiyās is in fact inseparable from one of two things: either the qiyās or analogy itself is not valid, or there is no textual evidence to prove that the rule under discussion is from the Sharī'ah, because a genuine qiyās represents the justice for which Allah (s.w.t.) has sent His Messenger. Therefore, there is nothing in the Sharī'ah which contradicts a genuine qiyās."*

On the basis of this principle, al- Darīr concluded that *salam* is in line with a *qiyās*, and the *qiyās* upon which some scholars rely to declare *salam* to be against the norm is a *fasid* (imperfect) *qiyās*.[320] Then he quoted Ibn Qayyim's conclusion and said that "*salam* is in accordance with *qiyās*, public interest, and the most complete and just legal principles".[321] Ibn Ḥajar[322] and al- Izz Ibn Abd al-Salam[323] also expressed a similar opinion, and some

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[319] Ibid

[320] Ṣiddiq al-Darīr, '*al-Salam wa Tatbīqātuhu al-Mu āsiarah*', 379–383.

[321] Ibn Qayyim al-Jawziyyah. *I lām al-Muwaqqī n an Rab al-Ālamin*. (Beirut, Lebanon, Dār al-Kutub al-Ilmiyah,1991.),350

[322] Ibn Hajar al-Asqalānī, '*Fath al-Bārī*', (Maktabat al-Kulliyāt al-Azhariyyah, Cairo, 1978, vol. 9), 303

contemporary scholars such as Nazih Ḥammad[324] and Ajil Jasim al-Nashmi[325] also uphold the idea that *salam* is in line with *qiyās* and not against it.

On the basis of the above analyses and discussion, we can conclude that:

a. The condition about the price of *salam* to be piad in advance is not based on the fear of *riba* or *gharar* as express from the *Malikīs* attitude. Modren jurists have also endorsed this stands like al-Ḍarir, who maintained that "it is legal to defer the price for a short period (not necessarily three days) but it should be paid before the commodity is delivered".[326]

b. More importantly, Ibn Ḥajar in his definition of *salam* said "It is the sale of something prescribed in the *dhimmah*." Then, he added the phrase that "On condition that the price be paid at the spot is questionable because it is not an integral part of the nature of *salam* (*laisa dākhilan fi haqīqatihi.*)."[327]

c. The Islamic fiqh Academy also opted, in its resolution regarding *salam*, that the price of *salam* could be delayed for three days.

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323 Izz Al-Dīn Ibn Abd al-Salām, '*Qawā id al-Ahkām fi Masālīh al-Anām*', (Maktabat al-Kulliyāt al-Azhariyyah, Cairo, 1968, vol. 2 . 1968),111-112

324 Nazih Ḥammad, *'al-Salam wa Tatbīqātuhu al-Mu āsiarah'*, 553–555.

325 Majma al-Fiqh al-Islāmī, *Majallat Majma al-Fiqh al-Islāmī* (discussions about *salam*) ninth session, 1996, no. 9, vol. 1), 643..

326 al-Darīr, '*Al-Gharar wa Atharuhu fi al-'Uqūd'*, p. 461

327 Ibn Hajar al-Asqalānī. *Fath al-Bārī. bi Sharh Sahīh al-Bukhāri*, (Maktab al-Kulliyāt al-Azhāriyyah, Cairo, 1978 vol. 9), 303.

d. No explicit *hadith* (*naṣ*) about the price of *salam* to be paid at the formation of the *salam* contract was found. Moreover, the *ḥadith* of *bay' a al-kāli' bi al-kāli'* has been extended to *salam* through *Ijtihād* and is not directly connected to *salam*. Moreover, it is agreed among *Sharī'ah* scholars that the *ḥadīth bay'al-kāli' bi al-kāli'* is weak and, therefore, could not be the basis for a genuine reasoning.

e. Even the claim of *ijma* (consensus of Muslim scholars in specific issue) related to this issue is also disputed.

f. The assumption that *salam* is an exception and therefore, it involves *gharar*, is rejected by some early *Fuqaha* (*Sharī'ah* scholars) as well as modern scholars such Ibn Taymiyyah ibn Qayyim, al-Izz Ibn Abdal-Salam al- Darīr, Nazih Hammad, Ajil Jasim, Ahmad Ali Abdullah and others.Therefore, a standard *salam* contract, despite the deferment of the subject matter, does not involve *gharar* because it is allowed by the *Sharī'ah* as a standard rule, not an exception, and therefore there is no *gharar*.[328]

g. Muhammad al Bashir has rightly mentioned that "to follow the *Malikī* opinion is enough by itself to show that delay of both counter values in *salam* does not invalidate the contract regardless whether this delay is for three days or more or less if the economic conditions have changed. Yet, the limitation to three days is subjective. Therefore, if it is permissible to delay the price in *salam* for three days it will be permissible to delay it even for more than three days. In contrast, if the delay

[328] Ibn Qayyim al-Jawziyyah, *'I lām al-Muwaqqī n an Rab al-Ālamin'*, (Beirut, Lebanon, Dār al-Kutub al-Ilmiyah,1991.),350 Izz Al-Dīn Ibn Abd al-Salām, *'Qawā id al-Ahkām fi Masālīh al-Anām'*, (Maktabat al-Kulliyāt al-Azhariyyah, Cairo, 1968, vol. 2 . 1968),111-112

by itself invalidates the contract, and the length of the delay, even of one day or one hour will invalidate the contract as is the case with currency exchange or *ṣarf*. Moreover, if a delay for three days is permissible in *salam*, which is allowed not as an exception but as a principle, it will be permissible to delay longer than that with regard to the forward contract by way of analogy based on the argument followed in the present study that *salam* is in line with *qiyās* and not against it, and, therefore, it could be the basis for *qiyās*".[329]

h. In addition, to what has been explained by al-Darīr, Muslim scholars agree that "even if there is a *gharar* (not-excessive) in a specific contract and there is a real need for this contract this *gharar* would be tolerated and it will not invalidate the contract."[330]

After the above mentioned discussion we can say that *salam* is in line with *qiyās* and not against it, and it could be form the basis of *qiyās*, so we could say that the modern forward contract can be validated by way of analogy to *salam*. Further, how *salam* can be used as risk hedging instrument, the detail mechanism is discussed in the subsequent section.

6.3.8. The use of *Salam* as Risk Hedging Instrument

6.3.8.1. Application of *Salam* and Short Selling Transaction, Evidence from Malaysia

Since Malaysia claims offering short selling that complies with *Shari'ah* principles, we will discuss the short selling as applied in Malaysia along with its procedure and process

[329] Muhammad al-Bashir Muhammad al-Amine, '*Risk Management in Islamic Finance An Analysis of Derivatives Instruments in Commodity Markets*', Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), 238

[330] See *Majallat Majma al-Fiqh al-Isālmi*., no. 9, vol. 2, p. 325 & pp. 333–334; Ibn Qudāmah, *al-Mughni*, vol. 4, p. 326; Ibn Ābidīn,'*Rad al-Muhtār*, vol. 4, p. 284

flow and will examine its compliance with *Shari'ah* principles.

6.3.8.2. **Regulated Short Selling (RSS) in Bursa Malaysia**

In Bursa Malaysia, the short selling is regulated under the Regulated Short Selling (RSS) and Securities Borrowing and Lending (SBL) guidelines. Since the short sale is a sale of a security that the seller does not own then, in order to deliver the security to a purchaser, the short seller must first borrow the security. If one sells short without first borrowing the security to make delivery, then the naked short selling occurs. In Malaysia, naked or uncovered short is not allowed. RSS must be supported by a Securities Borrowing and Lending (SBL) agreement to ensure that the seller is able to fulfil his settlement obligations with respect to short selling. However, the opposite is not necessary and a SBL agreement can exist alone and be carried out for purposes other than RSS. In RSS, investors will have to borrow the stocks from the Central Lending Agency (CLA)[331], which charges fees of 2%, or over-the-counter, where fees are negotiated between the borrower and lender.[332]

In 2011, the index provider FTSE Group in Malaysia had upgraded the Malaysia market to "Advanced Emerging" from "Secondary Emerging". As per FTSE Group, the existence of short selling and Securities Borrowing and Lending (SBL) are among

[331]CLA is an agency managed by Bursa Clearing where all lending and borrowing take place. Investors cannot deal directly with the CLA; they have to go through an approved Participating Organization (PO) (also known as Stock Broker, which is licensed to trade in Bursa Malaysia) or an investment bank.
[332] International Business and Management, *'Shari'ah Issues in Short Selling and Its Potential Implementation in Qatar Stock Exchange*,(Vol. 11, No. 1, 2015, pp. 62-78,ISSN 1923-8428) available on www.cscanada.net, last accessed 12.08.2017.

criteria set for a "Developed" stock market. Malaysia is looking toward becoming a leading market in the ASEAN, hence, Bursa Malaysia has been providing investors with products such as Regulated Short Selling (RSS), which the Bursa claims is compliant with Shari'ah principles.

RSS and SBL was first allowed on Bursa Malaysia in September 1996, but it was then banned in September 1997 due to the Asian financial crisis. RSS and SBL were revived in January 2007, facilitated by the Central Agency model. In August 2009, over-the-counter market was introduced. The total trade value of RSS reached MYR293 million ($79 million) in June of 2013 from a zero base in March 2012, which reflects the market interest in this area. The SBL market was more active, where the total value of borrowing and lending reached MYR640 million ($174 million) in June 2013. This growth is anticipated to continue following the approval in July 2013 of the removal of the 100 stock cap. The Bursa increased the number of stocks available for RSS and SBL from 100 to 171.[333]

The *salam* based short selling is a simultaneous cash sale and *salam* purchase of a stock.[334] In the applicable structure, the owner sells his stocks to a short seller for cash. At the same time, the owner buys on *salam* the same amount of stocks from the short seller at an agreed price. Dividends and an amount equal to interest on proceeds of shorted stocks are included in credit purchase price. The ownership of the shares are

[333] Ibid

[334] Nejad, H. S. (2009). *Islamic view point on short selling.* Retrieved from http://www.rdis.ir/RDFiles/IslamicFin/ Binder13.pdf.Accessed 10.07.2017.

transferred to the short seller instead of paid cash, so he can now sell them to a third party at market price. Following is the stepwise procedure of the Salam based structure of the transaction:

6.3.9. Structure of the *Salam* based transaction along with Process flow:

Following *modus operandi* (transaction procedure along with process/cash flow) are used for Short-selling based on *Salam*:

a. A Company advises the "Broker" to sell the over-valued Shares in a particular entity at a specified price, for example, on Rs.100 per Share.

b. The "Broker" then sell the Shares, on Day 01, in the Market at Rs.100 per share as per advice of the company, and delivery to be made on day 10.

c. After the "Broker" has sold shares to the Buyer (with delivery to be made to the Buyer on Day 10) and received Rs.100 from the buyer. The "Broker" then enters into a Salam contract with the "Company" whereby the Broker pays Rs.98 on Day 1 (Rs.100 minus Broker's spread of Rs.2) and the Company undertakes to deliver Shares on Day 10 to the Broker.

Here in the present example, it is to mention that, the Company takes a "Short" Position on shares, however, the Company expects that the market value of Shares as on Day 10 will be less than on the Day 01.

d. On Day 10, the Company buys Shares from the market (Seller) on Rs.80 and delivers the same to the Broker as per Salam Arrangement.

This structure is basically to replicate the mechanics of conventional short-selling. Salam based short selling covers the aim of conventional short selling, namely, benefiting from a decrease in stock price. There are some differences, however, which can be summarized in the following points: i) short selling involves borrowing stocks at interest, while in salam there is a sale, so no borrowing involved, ii) the dividends during the borrowing period belongs to the lender in short selling, while in salam the dividends are estimated and included in the price. While commenting on the replication of conventional short-selling through Salam, Teilhard de Chardin, global head of prime brokerage at Newedge in London says: "Although different solutions seem more acceptable for different regions, many Saudi scholars prefer the Salam contract for equities, which is why we have taken this route."[335]

6.3.10. *Sharī'ah* analysis of the above mentioned structure:

To determine acceptability of the *Salam* based structure as *Shari'ah* compliant alternative, the core issues namely: (a) *'bay`ma`dum'*(i.e. selling what the seller does not own), (b)eligibility of stock as the subject matter of a loan contract and (c)benefiting from the loan contract needs to be resolved. In short selling, the owner

[335] Teilhard de Chardin, 'Meeting *all tastes-RISK,* September 2016 available at http://www.risk.net/public/showPage. html?.accessed dated 10.12.2016

does not own the stock he sell, which is violation of the sale contract as per views of majority of the jurists based on the *Hadith*, "Do not sell what you do not possess". However, according to Ibn Taymiah and Ibn Qaiyyem the rationale (*'illah*) for such prohibition is the occurrence of '*gharar*' due to the inability of seller to deliver the sold item, the *Hadith* is therefore means "Do not sell things you are not able to deliver". The *Hadith* prohibits the sales where the object is undeliverable, it may exist or not. The wisdom of the *Hadith* is the excessive risk and uncertainty (*gharar*) and not the existence of the object or lack thereof (Wahbah, 1984). As claimed by SSC, in RSS with the inclusion of SBL the fulfillment of the contract i.e delivery, settlement and payment is guaranteed and regulated by the exchange. As the seller, first borrows the stock before selling, through broker, is mostly capable to deliver the stocks at any time, which fulfill Ibn Taymiyah and Ibn Qayyim's condition. Thus, if the *ghara* could be eliminated in RSS, then the issue of '*bay'ma'dum*' is no longer be significant[336] in short selling transaction based on *fiqhi* maxim: "When an issue that impedes (the permissibility) is removed, then the activity which was initially forbidden becomes permissible" (Securities Commission 2006).

The second important issue is that whether stocks are eligible to be the subject matter of a loan contract. Juristic debate and ruling is based on how scholars look at the stock as fungible or non-fungible; as a financial value or looking into the company's assets and divides the same into cash, tangible assets, debts or combination of the three (cash, tangible assets, and debts). Majority of the jurists except *Hanafis* are of the opinion that all the goods whether fungible (*mithli*) or non-

[336] As resolved by SAC in its 69th meeting held on 18 April 2006.

fungible (*qimi*) eligible for forward sale (*Salam*) can be a subject matter of a loan contract (El-Gamal, 2006). *Hanafis* jurists also deem that stocks satisfy the homogeneity (*mithli*) properties which is an important criterion for objects to be eligible for lending. Though the stock originally represents is non-homogeneous properties (*mal qimi*), which breaches the *Hanafis*' conditions for the validity of lending stocks (Dusuki & Abdelazeem, 2008). The problem here is that whether the delivered stock is similar to the sold stock, as homogeneity means that the thing must be similar in terms of value or in shape. In short selling though the seller can not deliver the similar stock in value, as the value of the asset is changing, however, the borrower returns similar in shape. Moreover, SAC does not look into the assets of a company that represent the stock but consider the stock as fungible and eligible items to be lent. They further argue that as long as shares are available in the market, at the time of signing the *Salam* contract, it can be consider a *Salam* item and the RSS ensures the availability of the shares in the market which enable the seller to deliver the same to the buyer on the date of delivery as in the Regulated Short Selling, it is one of the mandatory requirement, to receive share availability confirmation, from the approved securities borrowing and lending agent that the share is available or ready to be borrowed. If for example, the shares (i.e *Salam* item) is not available in the market at delivery date for some reason, then the buyer has the option to terminate the contract or wait till the trading of shares is resumed.

So far as the third issue is concerned, even if we could adopt the opinion of some jurists like Ibn Taymiyah and Ibn Qayyim's and find out solutions to the problem of ownership of stocks in short selling and its validity as a subject matter of loan contract based on majority views, still there is another issue namely; getting benefits from the charges imposed by the stocks owner on the lending his stocks in short selling is against the *Shari'ah* principles which needs to be overcome before to fix the legality of the transaction. Therefore, the permissibility ruled by SSC on the regulated short selling needs reconsideration, and a careful standardized solution to the above-mentioned issues are required before to implement this product in other regions.

6.4. *Wa'ad* Based Arrangements as alternative to Forward contract: Theory and Application

6.4.1. The Concept of *Wa'ad*

The concept to *Wa'ad* is one of the most flexible and useful concept used in almost all products of Islamic Finance. *Wa'ad* has also been considered to be the possible version of the forward contract in Islamic finance as mentioned by the modern jurists, though, this concept is still under debate among the jurists. However, more financiers look to this concept with sympathy.

The term *Wa'ad* is a traditional concept and mentioned frequently in the Qur'an where it can mean "to promise", "to pledge" or "to firmly intend". It is generally acknowledged that in the context of commercial dealings, Wa'ad means a unilateral promise.[337]

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[337] Resolution numbers 2 and 3 of the Fifth Conference of the Islamic Fiqh Academy (Kuwait), as cited in Deutsche Bank Academic Paper, Pioneering Innovative *Shari'ah* Compliant Solutions, available at http://www.db.com/presse/en/down- load/White_Paper.pdf.(excess dated 17.2.2017)

This unilateral promise (*Wa'ad*) refers to "a commitment made by one person to another to undertake a certain action or verbal disposal beneficial to the other party"[338]. In West's Encyclopedia of American Law (2008) has defined "the unilateral promise as a contract in which only one party makes an expressed promise, or undertakes a performance without first securing a reciprocal agreement from the other party". According to Akram "*Wa'ad* is a promise which affirms the positive meaning and negative meaning. But if the promise is to do something evil, then it is not obligatory to fulfil it"[339].

This unilateral nature makes the *Wa'ad* very useful and flexible tool to be used for the *Sharī'ah* compliant structuring of the transactions. According to the ruling issued by the Islamic Fiqh Academy (the IFA) in its 5th Conference held in Kuwait (1988-1989), "a Wa'ad, in the context of a classic Murābahah sale is morally binding, and additionally, its fulfilment may be enforceable at court, if: (a) the promise is a unilateral promise binding only one of the parties to the Murābahah; and (b) the promise has caused the promise to incur some liabilities".[340] This view has been supported by various Islamic scholars.[341] Though, it is however debatable, that whether the fatwa issued by IFA is extendable to other products than Murābahah or not. However, the Accounting and Auditing

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338 Lehman, J & Phelps, S. 2005. *West's Encyclopedia of American Law.* 2nd ed. Detroit: Thomson /Gale Publication (2008), 356.

339 Mohamad Akram Laldin, *'The concept of promise and bilateral promise in financial contracts: a Fiqhī perspective.* International Sharī'ah Research Academy for Islamic Finance (ISRA) Research Paper No. 4 (2009), 148.

340 Resolution numbers 2 and 3 of the Fifth Conference of the Islamic Fiqh Academy (Kuwait), as cited in Deutsche Bank Academic Paper, Pioneering Innovative *Shari'ah* Compliant Solutions, available at http://www.db.com/presse/en/down- load/White_Paper.pdf, accessed dated 15.08.2016)

341 Liau Y-Sing, W'ad is legally binding for compensations scholar, 1 April 2009, available at http://www.forexpros.com/news/general-news/interview-W'ad-is-legally-binding-for-compensation-scholar-41406, accessed dated 26.06.2016)

Organization of Islamic Financial Institutions (AAOIFI) has endorsed that the ruling of the IFA may be extended to the currency exchange transactions within an Islamic framework.[342] So, they have suggested, thereby, that the application of *Wa'ad* may not be confined to the *Murābahah* model only. However, some scholars have criticized such extension of the IFA's fatwa to other products.[343]

It is however not necessary for the *Wa'ad,* being a unilateral promise to fulfil the requirements of a bilateral contract (aq'd) under *Shari'ah* (i.e. (i) knowledge of the price and (ii) possession or ownership of the subject matter of the contract etc.). Due to this inherent flexibility of the Wa'ad, has rendered it to be more helpful in development of other *Shari'ah* compliant innovative structures and various structure being used based on *W'ad* such as an Foreign Currency Exchange, FX option FX swap, cross currency swap and profit rate swap etc. as mentioned in detail below.

6.4.2. Difference between '*Wa'ad*' and '*Muwa'adah*' and Juristic Opinion

The definition of a *muw'ada* is where two parties performing two unilateral promises on the same subject. For example, Mr. "A" promises to sell the car at Rs.100,000 to Mr. 'B", and Mr. "B" also promises to buy the car from Mr. "A" at Rs. 100,000 in one year time.[344]

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[342] Muhammad Al Bashir Al Amine, Risk Management in Islamic Finance: *An analysis of derivatives instruments in commodity markets',* (Brill's Arab & Islamic Laws series (2008), 251.

[343] Frank E. Vogel and Samuel L. Hayes, 'Islamic *Law and Finance: Religion, Risk, and Return',* (Arab and Islamic Laws, Vol. 16) (Arab and Islamic Laws Series); *the journey towards absolute return,* The Banker, 10 March 2009, available at http://www. The banker.com/news/full- story.php/aid/6467, last accessed dated 12.05.2016

[344] Syed Aun Raza Rizvi1 & Dr. Ahcene Lahsasna, '*Derivatives in Islamic Finance: The Need and Mechanisms Available for Islamic Financial Markets.* 10-11

Most Islamic jurists look less favorably at *Muw'ada*, compared to *Wa'ad.* We can summarise the two main schools of thought as per below.[345]

Majority of the jurists is of the view including AAIOFI and Islamic Fiqh Academy that '*Muw'ada* is only permissible when it can be validly executed. And in the case of forward contracts *Muw'ada* is frowned upon, with the premise that mutual *w'ad* which is *muw'ada* leads to binding contract, and with the principle of not allowing sale in future that it is not allowed'. However, Hanafī jurists upheld that 'Forward contracts can be based on the *Muw'ada* principle, as long as there are no other prohibitions' (such as excessive *gharar* and short selling).

Based on these difference of opinion Mohamad who is part of a Malaysian central *Shari'ah* advisory body has stated that "The issue is one of differing interpretations, whether muw'adah is a contract. My view is that it is not a sale and purchase contract because specific words must be used to enter into a contract in Islam."[346]

While differentiating *Wa'ad* from *muwa'dah*, Abu Ghuddah (2006) mentioned that "*muwa'dah* which is also known as bilateral promise refers to two reciprocal promises in which two parties agreed to do the same acts". The Fiqh Academy of Jeddah in its resolution No.157, (2006) has decided that "bilateral promise, if binding on both parties are not allowed".[347] While defining *muwa'dah*, AAOIFI (2008) ruled that "binding *muwa'dah*

[345] http:// -law www.islamicbanker.com/islamic-contract.html, retrieved on March 25, 2011 at 1230hrs

[346] http://www.arabianbusiness.com/muwa-adah-valid-for-forward-forex-contracts-scholar-342721.html retrieved on March 21, 2016.

[347] Fiqh Academy of Jeddah. 2006. Resolution no. 157. 24-28 July 2006. Amman, Jordan. http://www.isra.my/fatwas/organisation/oic-fiqh-academy.html (visit dated 12 November 2011).

is regarded as contract".[348] Although *muwa'dah* is claimed to be similar to the contract, but Shamsiah & Rusnah (2009) opined that "*muwa'dah* should not be deemed as a contract but it is only a bilateral promise to execute an agreement on future date".[349] Almost all the scholars agree that *wa'd* is different from contract, as in contract, both of the contracting parties are bound to do or to deliver something to each other.

6.4.3. **The Status of *Wa'ad* (Promise) in Islam**

Promise in *Sharī'ah* is one of the essential characteristics of a true believer (muslim) and a person who breaches his promise is termed as 'munafiq', as stated in the Hadith of the Holy Prophet (SAW) "Four qualities denote the hypocrite: when he talks he lies; his promise he does not keep; his covenant he betrays; and when he argues he exceeds the limit. Allah S.W.T. has mentioned the word '*Wa'ad*' more than 150 times in Qur'an to show its significance.[350]. Allah SWT said: Meaning: "O you who believe, fulfil you promise" (al-Qur'an, al-Maidah: 1). this verse orders for the fulfilment of the promise. Although, high emphasize for the fulfilling of promise has been given by the *Sharī'ah*, However, difference among the jurists has been found on whether the *Wa'ad* (promise) is legally binding or not. There seems three positions in this regard. (1) fulfilling promise is praiseworthy but not obligatory; (2) fulfilling promise is always obligatory; (3) fulfilling

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[348] AAOIFI. Ahmad Suhaimi Yahya, '*Shari'ah* Standards for Islamic Financial Institutions, Manama, 1429H-2008.
[349] Shamsiah Mohamad & Rusnah Muhamad, Finance and Banking Conference. (.2010. Produk perbendaharaan Islam: isuyariah.) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1260110. (Visit dated 17 July 2009).
[350] Qurrah Daghi, Ali Muhyiddin, '*Buhūth fi al-Iqtisad al-Islāmi*' (Beirut: Darul Bashar al- Islamiyyah, 2002), 35

promise is basically obligatory but with conditions and exceptions [351]. Hence, as a general principle, since *Wa'ad* creates only moral obligation so must be fulfilled for religious reasons only but it cannot be enforced by the courts of law. However, if any losses incur to the promise due to the breach of promise by the promisor it is mandatory on the promisor to compensate the promise for which he may be compelled by the courts.

6.4.4. The Practice of *Wa'ad* in Islamic Financial Institution

At the early ages, the use and application of *Wa'ad* in Islamic financial industry was limited only to *Murābahah* to the purchase orderer (*Murābahah lil amr bi al-shira'*). Later on, its application of Wa'ad was extended to the other Islamic product of investment facilities such as sale (*bay'*), leasing (*ijarah*) and partnership (*shirkah*). According to Nurdianawati "The purpose of using *Wa'ad* in those contracts is mainly to ensure continuous *Sharī'ah* compliancy in every stage of the transaction, particularly to avoid the formation of two contracts in one or conditional contract which is impermissible in Islam"[352]. In the documents of Islamic financing structure, *Wa'ad* has been applied as a supplementary document to the master agreement which is commonly known as 'purchase undertaking'.

According to Parker "the concept of Wa'ad has gained prominence over the last few years as Islamic financial industry has sought to innovate derivative products and in the context

[351] Mohamad Akram Laldin, *'the concept of promise and bilateral promise in financial contracts: a Fiqhī perspective', International* Sharī'ah Research Academy for Islamic Finance (ISRA) Research Paper No. 4. (2009)

[352] Nurdianawati Irwani Abdullah, *'The status of promise (Wa'ad) and its implication in contemporary Islamic banking'.* (Paper presented at the ISRA Islamic Finance Seminar (IIFS), Kuala Lumpur, November 11, 2008).

of proliferation of the global sukuk market as it is very useful and is a flexible tool in structuring *Shari'ah* compliant transactions"[353].

6.4.5. The Role of '*Wa'ad Mulzim*' in Islamic Products

The concept of Wa'ad mulzim has been applied in Islamic products and it plays most important role in the implementation of such products, as Wa'ad needs the parties to fulfill the commitments to complete the transaction according to their ultimate intentions. '*Wa'ad* mulzim ' known as binding unilateral promise has been embedded in various Islamic products which are based on sale, leasing and partnership contracts to protect the interest of financial institutions.

For example, in the transaction of *Murābahah* to the purchase order, the customer will have to purchase the asset from the bank which the bank has purchased from the supplier as per his request. The *Wa'ad* has been separately executed through signing of order form prior to the execution of sale Deed or Murābahah contract. During the purchase of assets, definitely the bank will have to incur some costs, as ordered by the customer. If the customer do not fulfil his *Wa'ad*, then he is liable to pay the actual expense paid by the bank for the acquisition of the assets, this may recovered through court of law.

[353]Parker, M. 2010. BNM says no fee for Wa'd currency hedging. Arab News, Jeddah. arabnews.com/economy/islamicfinance/article135853, accessed dated16 November 2016).

Moreover, the concept of *Wa'ad* also used in the contract of *ijarah muntahia bi-tamleek* 'whereby the bank or customer make a promise with the other party to sell or purchase the asset at the end of the lease period or transfer the ownership to the customer through gift (hibah) or sale of the leased asset'[354]. Further, 'the ownership of the leased asset shall be transferred to the lessee upon execution of a sale contract of the leased asset as stated in *Wa'ad* by the lessor at a mutually agreed consideration to be executed at the end of the lease period or at any time during the lease period. The *Wa'ad* by the lessee to lease the asset from the bank upon the latter's acquisition of the asset shall be binding on the lessee and shall be separately executed prior to the execution of *ijarah* contract. The bank may require the customer to pay a security deposit as a guarantee which protects the bank from the risk of the customer not fulfilling the unilateral Wa'ad to lease the asset upon; purchase by bank. If the customer breaks the *Wa'ad*, the bank may set-off the actual loss from the amount of security deposit. In a situation where there is no breach of promise, the security deposit may become part of the rental payment of the leased asset'[355].

All of the above-mentioned instance prove the usefulness of *Wa'ad* in the financing contracts, due to this significance role, in almost all Islamic financing product, Wa'ad mulzim has been used to facilitate their operations. However, there is ongoing debate on the acceptability and usage of derivatives in Islamic finance for hedging purposes. Although the need for hedging itself is not disputed. As it is of the most important

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[354] Muhammad Ayub, '*Understanding Islamic Finance*'. New York: John & Wiley (2007),211
[355] Ibid

objectives of *Shari'ah* (popularly known as *Maqāsid al-Shari'ah*). It is in fact the way and mechanism which must not violate any Shari'ah ruling.[356].

So hedging mechanism in Islamic finance must be developed in such a way that must mitigate risk effectively and at the same time preserve *Maqāsid al-shari'ah* and not violate any of the basic principles of *Sharī'ah.* In this regard Suhaimi (2008) states that "the challenges faced by the industry is to provide a hedging mechanism that have value added and will give positive impact to the economy". However, these instrument must be in line with the *Sharī'ah.* Hence, instead of using conventional products for hedging purposes, Islamic finance could look deeper and develop its own contracts. Therefore, after deeper thinking, we are of the view that, on the basis of *Wa'ad* (promise) the most recent and viable concept, which is also known as 'unilateral undertaking' or 'unilateral promise' can be used as a tool for hedging and will serve the same purpose as that of conventional instrument and at the same time will also be in conformity with the Islamic principles. So, *Wa'ad* is the most recent and viable concept to be applied in Islamic finance. Although *Wa'ad* is still criticized from a conceptual perspective, but in reality it can become a contractual promise as it offers great flexibility to Islamic financial industry.

[356] Ashraf wajdi Dusuki 2010, 'Islamic Perspectives on Islamic FX Forward. New Horizon'http://www.newhorizonislamicbanking.com/index.cfm?section=academicarticles&action=10734. Accessed dated 31 Mac 2011.

6.4.6. **Application of *Wa'ad* in Islamic Hedging Mechanism**

Nowadays, *Wa'ad* is widely adopted and used in Islamic financial markets. Although, there is still criticism on the framework based on *Wa'ad* as mentioned earlier, however, in practice this instrument being a promise it offers great flexibility. Therefore, it can also be used as a risk hedging tool to mitigate undesired risks such as 'price risk' and 'exchange rate risk' etc.

Sharī'ah does not allow the market participants to enter into a foreign currency contract in which both the counter values do not take place simultaneously. Thus, *Wa'ad* based principle can be adopted for import and export trading activities which is in line with the *Sharī'ah* and will edge the currency fluctuation risk effectively. As the importers and exporter are needed to hedge their foreign exchange risk, but as per Islamic law they are not allowed to enter into forward contracts of gold, silver or any monetary units as they are prohibited. However, they can hedge against risk using *Wa'ad* arrangement without involving the element of riba. As stated by Muhammad Ayub "the importers can take foreign currency forward cover for genuine business activities on the basis of *Wa'ad* and simultaneously exchange of the currencies at the agreed time".[357]

[357] Muhammad Ayub, Use of W'ad and Tawarruq for swaps in the frame work of Islamic Finance, Research Paper, available at www.iefpedia.com/english/wpcontent/uploads/2011/12/Muhammad-Ayub.pdf, accessed dated 15.2.2017.

6.4.7. **How does *Wa'ad* Works for Foreign Currency Exchange Hedging**

Wa'ad can be used to hedge the risk associated with the foreign currency appreciation or depreciation which may result loses to the concerned party i.e. exporter or importer. Thus, the party can enter into Islamic FX forward, which refers to a *Wa'ad* arrangement, where a party make a *Wa'ad* to buy or sell a particular currency at a particular rate (rate agreed upfront) at a future date particular amount of currency against another currency on a predetermined date and at a predetermined rate.

This arrangement is much important because, for example, if an importer; is under obligation to make a payment in foreign currency at a future date. Thus, he is exposed to risks that the foreign currency might appreciate, compelling him to pay extra in local currency. Similarly, an exporter who has foreign currency receivables at a future date, he has the risks of losses if in future, the foreign currency depreciates, he would have to receive less in export revenue in local currency.

6.4.8. **The Concept of FX Forward and the use of *Wa'ad***

FX Forward is an agreement to exchange one currency for another currency at a specified rate of exchange at a predetermined future date. The settlement of the exchange on the predetermined future date can either be a specific date (closed forward) or a window of time up to a maturity date (open forward). FX Forwards are tools of financial markets that are used to manage the volatility of global currencies. This is particularly useful for clients who are involved in cross border trade and exposed to foreign currencies either in their payment of imports or in their receivables on exports of goods.[358]

Let us demonstrate the usefulness of an FX Forward contract with the help of the following example (still within a conventional structure).

Consider Muslim Insaf (MI) a hypothetical national infrastructure company is planning to buy a fleet of environmentally friendly natural gas powered buses from a Korean manufacturer. The prices are quoted in US Dollars. MI is buying these buses at a cost of US$ 10million, Current quotes on US Dollars (USD) against Pak Rupees (PKR) from a local bank show the following rates:

<u>(USD/PKR)</u>

Spot:	2.998
30-day Forward:	3.015
60-day Forward:	3.020
90-day Forward:	3.050

The buses will be delivered in a month's time (30 days) and MI will have to make payments upon delivery. MI decides to enter into a 30-day forward contract to buy US$10million at the exchange rate of PKR=3.015/USD. The counterparty is a local financial institution which will exchange with MI US$10million at a pre-agreed future date in exchange for Rs.30,150,000. On the value date of the exchange, which is one month

[358] Syed Awi Mohammad Sultan and Dr. Aznan Hasan "*A mini Guide to Islamic Derivatives: A Primer to Islamic FX Forwards, Profit Rate Swaps and Options*", Center for Research and Training, p. 21.

later, MI will receive US$10million from the local financial institution, which will be used to pay the Korean manufacturer. MI, in turn, will make a payment of Rs. 30,150,000 to the local financial institution as consideration for the exchange. Both these exchanges will happen only in 30 days' time.

Suppose that the spot rate on the value date of the exchange (one month's time) is PKR 3.050, and assume MI did not have a FX Forward arrangement, MI would have had to fork out Rs 30,500,000, which is a Rs. 350,000 opportunity loss, in exchange for US$10million to pay the Korean manufacturer. By entering into the FX Forward and locked down the exchange rate, has benefited from the rising trend of the US Dollar currency and has removed all the foreign exchange risk from this transaction.

The above example is designed to demonstrate the benefit of entering into an FX Forward contract and locking down exchange rates ahead of the actual need of such foreign currency to remove any volatility risk of the foreign currency.

Of course, an argument can be made that had the foreign currency moved counter to what MI had anticipated, say the spot rate on value date was Rs. 2.998/USD (in which case MI would have incurred an opportunity loss of Rs. 170,000), the FX Forward contract would have been detrimental to the company. However, the benefits of locking a foreign currency exchange rate and removing the foreign exchange risk will allow companies to fix their profit margins upfront and provide them with the ability to project revenues and profits despite market conditions. Certainly, companies will have to gauge the market conditions and enter into such contracts to hedge against certain risks. A good read of market conditions including the volatility of currency exchanges combined with a clear risk management policy on hedging financial exposures is absolutely important before entering into any financial risk management solutions, FX Forwards included.[359]

6.4.9. *Sharī'ah* Issues with FX Forward

The above example has demonstrated the need for companies to rely on financial instruments such as the FX Forward and how it becomes applicable in managing their risks. However, the above solution is not considered Sharī'ah compliant.

This is because the FX Forward is a binding agreement made on the present date to exchange two sets of currencies on a deferred date. This triggers a basic prohibition in Islamic financial dealing known as *Riba' an-Nasee'ah.* In modern day foreign exchange transactions, the prohibition of *Riba' an-Nasee'ah* will be triggered when a pair of currencies i.e. USD and Rupees; are exchanged at an agreed upon exchange rate but the delivery of either currency or both are deferred to a future date. It is a prerequisite based on the Prophet's hadith that in an exchange of currencies, the delivery or the exchange of the currencies between the counterparties must be done on spot. One of the hadith is shown below:

Narrated by Abu Al-Minhal: I used to practice money exchange, and I asked Zaid bin Arqam about it, and he narrated what the Prophet (pbuh) said in the following : Abu Al-Minhal said, "I asked Al-Bara' bin Azib and Zaid bin 'Arqam about practicing

[359] Ibid

money exchange. They replied! We are traders in the time of Allah's Apostle (pbuh) and I asked Allah's Apostle (pbuh) about money exchange. He replied, "If it is from hand to hand, there is no harm in it; Otherwise it is not permissible".[360]

Separately, in *AAOIFI's Sharī'ah Standard No. 1* -Trading in Currencies, Clause 2 mentions that it is permissible to trade in currencies provided that it is done in compliance with a set of conditions, including the condition that both parties must take possession of the counter values upon concluding the contract.[361]

Therefore, a contract of exchanging currencies can only be *Sharī'ah* compliant if such exchange is transacted on spot with both currencies being exchanged without any deferment. Any deferment to any one of the counter value will result in *Riba' An-Nasee'ah*, hence invalidating the exchange entirely.

In summary, when we decompose the FX Forward contract we can identify the following *Sharī'ah* issues:

a) In a conventional FX Forward, both the counter values are deferred to the future date while the contract is binding at the present date. In *Sharī'ah*, a contract of exchange where both counter values are deferred to a future date is prohibited.

b) As the conventional EX Forward is an exchange of two different currencies, the rule of *Bay'al-Sarf is* breached whereby currencies can only be exchanged at spot, without any delay as to the exchange of the currencies.

[360] *Sahih Al-Bukhari* Vol.3, P.157

[361] *AAOIFI Shari 'ah 2004-5/1425-6H,* Shari'a Standard,1 of "*Trading in Currencies*" Clause 2

Now that the *Sharī'ah* issues of an FX Forward are outlined quite clearly, let us identify the alternative structuring mechanics and contracts available within the *Sharī'ah* framework that can be used to structure a *Sharī'ah* compliant version of an FX Forward solution.

6.4.10. **Islamic FX Forward Structures**

Since in conventional FX forward contract, both the price and delivery are deferred to a future date which is not allowed in *Sharī'ah*, thus *Wa'ad* arrangements is adopted in Islamic FX forward arrangement. To explain the Islamic FX Forward structures as an alternative in the Islamic finance market, let us demonstrate the same with the help of the following case study which will highlight the stepwise procedure for all the three alternative options mentioned below. Moreover, this example mentioned will be used as reference for all the three options shown below:

Consider a Pakistan-based automobile manufacturer Muslim Insaf Motors (MI Motors) - which is involved in exporting vehicles to the international market. For the sake of the example, let us say MI Motors recently made a shipment to their clients in Turkey for a sales invoice of US$20million with a 30-day credit term. The prevailing exchange rate USD/PKR is 3.000. Therefore, at the rate of 3.000, MI Motors is expecting to record a revenue of Rs. 60million (US$20million x Rs.3.000) after conversion into Rupees.

The market outlook is for the Rupees to strengthen against the US Dollar. Hence, they decided to enter into a FX Forward contract with a foreign Islamic bank in Pakistan (Islamic bank) to exchange US$20million at the rate of 3.000 in 30 days' time.

6.4.10.1. Option 1, Single Wa'ad Combined with a Spot Exchange

In this structure, MI Motors undertakes and promises to purchase Rs.60million on the basis of *Wa'ad*, from the Islamic Bank in 30 days' time (value date). MI Motors will also agree to pay to the Islamic bank an agreed price of USD20million on the maturity date. In essence this is a *Wa'ad* that ends with a *Bay'al-Sarf*..

Transaction Steps:

Assumptions:

Promise Date/Deal Date: 01 June 2018 &

Value Date/ Maturity Date: 30 June 2018)

Step 1, Promise to Purchase (On deal date-01 June 2018)

MI Motors promises to purchase RM60million from the Islamic bank on 30 June 2018 (value date), MI Motors signs the Promise to Purchase note (akin to a promissory note) that contains the undertaking to purchase Rs.60million and acknowledges that the Islamic bank will make arrangements to deliver Rs.60million. It is to be noted here that, the Islamic bank does not provide any undertaking or promise to MI Motors on the exchange.

Step 2, Offer to Purchase (2 days before Maturity date-28 June 2011)

MI Motors will deliver an offer to Purchase to the Islamic bank, stating that their offer to purchase Rs.60million for a consideration of US$20million,, The Islamic bank will acknowledge and accept the Offer. This effectively concludes the exchange of the currencies (*Bay' as-Sarf*). The reason for the two days' gap between the contract date and the maturity date is a norm in treasury operations. This is known as spot date. This practice is also allowed by *AAOIFI* standard where it clearly recognizes "a delay in making the transfer consistent with the practice according to prevailing business practice in currency markets".[362]

It has to be noted at this juncture that if the Client (MI Motors) fails to deliver the Offer to Purchase (based on the earlier undertaking given), the Islamic Bank can recover actual loss suffered from this failure to fulfill the promise which is tantamount to a default. In some instances, Islamic banks may also seek security from the client as collateral against potential defaults. In such situations, the collateral can be used to recover the losses of the Islamic bank. Any excess amounts remaining from the security shall be refunded back to the client.

[362] *AAOIFI Shari'ah 2004-5/1425-6H,* Shari'a Standard,1 of "*Trading in Currencies*" Clause 2/6/5.

Step 3, Settlement (Maturity date -June 30, 2018)

On this day, the settlement of the currency exchange takes place. MI Motors will deliver to the Islamic Bank US$20million, while the Islamic Bank will deliver to MI Motors Rs. 60million.

6.4.10.2. Sharīʿah analysis of the above mentioned structure

Let us study the composition of the structure above and identify how *Sharīʿah* elements have been incorporated to bring together a *Sharīʿah* compliant FX Forward structure.

i. The first item to analysis the promise by a single party to purchase a specific currency for a specific amount at a specified date in the future. It is important to ensure that there is no binding contractual agreement at this stage because that triggers the *Nasee'ah* prohibition. That explains the single party promise.

Various *Sharīʿah* juristic views can be found with regards to whether a promise is considered binding or not. The view widely adopted by modern jurists including by the *Sharīʿah* Standard of AAOIFI is that if the promisor (party giving the promise to undertake certain acts) had caused the promisee to incur certain expenses as a result of the promise given, the promise becomes binding on the promisor, hence termed as *alwa'd al-mulzim min tarafwahid* (a unilateral binding promise given by one party). [363]

[363] Dr. Aznan Hasan, *Islamic Structured and Cha//enges*, Muzakarah Penasihat Syariah Kt"tvangem 008, CERT.

In the above example, the promisor is the Client (MI Motors), The Islamic Bank (as promisee) makes arrangements to deliver the Rr.60million based on the promise given by MI Motors, hence effectively binding MI Motors to honour the promise, come maturity date.

ii. The next feature of the transaction structure above is the exchange of two currencies on spot. This is to satisfy the "*hand to hand*" rule as specified in the Prophet's hadith.

The actual exchange occurs on spot basis. In treasury practice, spot date is recognized as two business days prior to the value date or maturity date. The reason for this is to facilitate cross border transfer of foreign currencies taking into account timing differences and effort to source the exchanged foreign currencies across markets prior to settlement. The *AAOIFI Sharīʿah Standard* 1 Clause 2/6/5 mentioned above is evidence that such market practice is acceptable to the *Sharīʿah* scholars.

Therefore, combining the *Wa'ad* on deal date and a spot exchange on maturity date enables the formation of a modified Islamic FX Forward solution, within the parameters of *Sharīʿah* compliance.

The *Sharīʿah* Resolution by Central Bank of Malaysia's *Sharīʿah* Advisory Council (SAC) about the FX Forward was deliberated in their meeting in April 2005 and it was resolved as follows[364]:

[364] Syed Alwi Mohammad Sultan and Dr. Aznan Hasan "*A mini Guide to Islamic Derivatives: A Primer to Islamic FX Forwards, Profit Rate Swaps and Options*", Center for Research and Training, p. 31.

a) The exchange of currencies at a future date based on a single party's promise to purchase (*Wa'ad mulzim*) that binds only the promisor to fulfil the promise is allowed.

b) The promisee is allowed to claim costs and expenses as a result of non-fulfilment of the promise by the promisor.

c) Such transactions are allowed to be undertaken by Islamic financial institutions (IFI) with other IFIs or with their corporate clients or with conventional financial institutions.

d) The permissibility of the above is based on present views of the jurists that a single party promise is merely a promise and not a binding contractual relationship between the parties promisor and promisee.

e) However, any form of forward currency exchange where both parties enter into binding promises by each other *(Muwa'ad Mulzimah)* is impermissible according to the views of the majority of jurists, as it resembles a binding sale contract.

f) *Muwada Mulzimah* in a currency exchange is also impermissible because it results in a contract of exchange if debt for another debt *"bey' al-kali' bil ka,"*.

6.4.11. Option 2, Dual *Wa'ad* (*Wadaan*) Combined with Spot Exchange

One of the arguments of the structure shown m Option 1-the single party *Wa'ad*- is that it does not hold the promisee responsible in fulfilling its part of the deal. Though that was done to satisfy a *Sharī'ah* requirement of avoiding a bilateral contract, which a promise by both parties may legally result in, critics still argue that such imbalance in responsibilities may result in fraud.

Using the same example above, wherein MI Motors (promisor) undertakes and promises to purchase Rs.60million on the basis of Wa'ad, from the Islamic bank (promisee) in 30 days' time (value date), the promise is only binding on MI Motors. If MI Motors delivers its promise to pay to the Islamic bank the agreed price of USD20million on the maturity date and finds out that the Islamic bank fails to fulfil its part of the deal, the promisor ends up unable to claim any damages from the promisee. Though such action by the Islamic bank will result serious reputation risk and possible reprimand from the central bank, this is seen as an unfair arrangement by some practitioners.

Therefore, the idea mooted as an alternative structure was to create a structure that allows both parties to have commercial obligations and liabilities to the transaction, without compromising on approved *Sharī'ah* principles. In finding the solution towards this end, the dual *Wa'ad (Wa'daan*) structure finds its genesis.

6.4.11.1. Dual *Wa'ad(Wa'daan*) Structure

In this structure, both parties the Islamic financial institution and the counterparty-will provide a promise to each other. Each promise is independent and unrelated upon each other. More importantly; the two promises (*Wa'daan*) consist of two sets of unilateral promises, where both parties promise to purchase two different currencies.

For sake of consistency, let's adopt the similar example as used in the single party *Wa'ad* above whereby MI Motors undertakes and promises to purchase Rs.60million and agrees to pay to the Islamic Bank an agreed price of US$20million on the maturity date.

The transactions steps for the dual *Wa'ad* are shown below.

Assumptions:

Promise Date/Deal Date: 1 June 2018

Value Date/Maturity Date: 30 June 2018,

USD/PKR 30-day Forward Rate: 3.00

Step 1-A: Promise to Purchase (on deal date 01 June 2018)

MI Motors promises to purchase Rs.60 million from Islamic Bank on 30 June 2018.MI Motors signs the Promise to Purchase note (akin to a promissory note) that contains the undertaking to purchase Rs.60million (Customer Undertaking) and acknowledges that the Islamic Bank will make arrangements to deliver Rs.60million.

This undertaking to purchase by the promisor (MI Motors) will also state that it will be triggered by the promisee (Islamic bank) upon a specific exchange rate scenario. In this case, the scenario would be if the prevailing exchange rate on trade date (which is 2 business days prior to maturity date) shows the US Dollar trading at any rate above Rs3.00 (US$1.00 > RM3.00).[365]

[365] Note 1: The logic behind the method of determining which Promise will be triggered is that the party which is 'in the money' will always be allowed to trigger the undertaking of the counterparty. Therefore, in a situation where US Dollar trades above Rs.3.00, the Islamic Bank is 'in the money'" (because USD has appreciated against Rupees), hence the Islamic Bank will call upon the Customer's Undertaking.

Step 1-B: Promise to purchase on deal date (01 June 2018)

Islamic Bank promises to purchase US$20mil lion from MI Motors on 30 June 2018. Islamic Bank signs the Promise to Purchase note (Islamic Bank's Undertaking) that contains the undertaking to purchase US$20million and acknowledges that MI Motors will make arrangements to deliver US$20million.

This undertaking to purchase by the promisor (Islamic Bank) will also state that it will be triggered by the promisee (MI Motors) upon a specific exchange rate scenario. In this case, the scenario would be if the prevailing exchange rate on trade date (which is 2 business days prior to maturity date) shows the US Dollar trading at any rate below Rs3.00 (US$I.00 < Rs3.00).[366]

Step 02: Offer to purchase (2 days before maturity date i.e 28 June 2011)

The parties will identify the prevailing exchange rate in the market based on agreed norms. Two scenarios may take place:

Scenario 1: US$I.00 > Rs.3.00

In this situation, the US Dollar trades above Rupees, hence the Islamic Bank will be 'in the money'. The Customer's Undertaking will be triggered by the Islamic bank, and the Islamic

[366] Note 2: following on from Note 1, in a situation where US Dollar trades below Rs.3.00, the Customer is 'in the money' (because USD has depreciated against Rupees), hence the Customer will call upon the Islamic Bank's Undertaking.

Bank's Undertaking will be waived and cancelled, To that effect, the Islamic Bank will request MI Motors to fulfil its promise to purchase Rs.60million from the Islamic Bank. Hence, MI Motors will deliver an Offer to Purchase to the Islamic Bank, stating that their offer to purchase Rs.60million for a consideration of US$20million. The Islamic Bank will acknowledge and accept the Offer. This effectively concludes the exchange of the currencies at an exchange rate of USD/PKR of 3.00.

Scenario 2: US$I.00< Rs. 3.00

In this situation, the US Dollar trades below Rupees, hence the client will be 'in the money'. The Islamic Bank's Undertaking will be triggered by the client, and the client's undertaking will be waived and cancelled. To that effect, the Client will request the Islamic Bank to fulfil its promise or undertaking to purchase US$20million from MI Motors at the rate of US$1.OO= Rs.3.00.

Hence, the Islamic Bank will deliver an Offer to Purchase to MI Motors stating their offer to purchaseUS$20million in exchange of Rs.160million, effectively providing MI Motors with an exchange rate of USD/ PKR of 3.00.[367]

Step 03: (On Maturity Date)

On this day, the settlement of the currency exchange takes place. MI Motors will deliver to the Islamic Bank US$20million, while the Islamic Bank will deliver to MI Motors Rs.60million.

[367] Note 3: The parties will agree upfront which undertaking will be effected if the exchange rate is exactly US$1.00=Rs.3.00.

6.4.11.2. ***Sharī'ah* analysis of the above mentioned structure**

Let us now study the composition of the structure above from a *Sharī'ah* viewpoint:

1. The most glaring feature that requires serious deliberation is the *dual- Wa'ad* deployed in the structure above. It is a unanimous prohibition of scholars that two inverse sets of promises by the counter-parties on the same matter would be tantamount to a bilateral contract, Further, a bilateral contract of exchange which defers both the payment and the underlying asset of exchange is prohibited.[368]

   However, the structure shown above has carefully designed the *Wa'ad* to be unilateral promises of the same kind and unrelated to each other. For example, notice that both the parties make a promise to purchase, instead of one party promising to purchase and the other party promising to sell. Hence, the structure above has avoided from triggering the prohibition on engaging in a bilateral contract of exchange for future delivery.

2. The main reason why scholars have resorted to requiring both counter parties to provide a promise is to ensure both parties are equally responsible that their respective promises are fulfilled and not provide either party with a tilted edge to the entire transaction. This is mainly based on the legal maxim "*harm must be eliminated*" (*"Al-darar uzaal"*). This legal

[368] *AAOIFI Shari 'ah 2004-5/1425-6H, Shari'a Standard of Commodities in Organized Markets;* Clause 3/2/2

maxim is derived from the renown hadith *("la darara wa laa diraar")* "let there be no infliction of harm nor its reciprocation"[369]

3. To ensure that the above structure is executed appropriately, the following conditions must be fulfilled:
   a) Each promise is independent and unrelated and not conditional upon each other.
   b) The two promises *(Wa'daan)* consist of two sets of unilateral promises, where both parties provide promises on two different conditions.[370]
   c) On the maturity date, only one of the promises or *Wa'ad* will be effected and the other promise will be waived and cancelled by mutual consent.
   d) It is paramount that the dual Wa'ad is not a *"two-way" Wa'ad* where one party promises to buy certain currencies and the other party promises to sell the same currencies. This "two-way" Wa'ad is what has been deemed impermissible by the jurists and also by the resolution of BNM shown above because it effectively creates a binding contractual relationship.

Therefore, having two sets of unilateral promises *(Wa'daan)* by each party on deal date and a spot exchange on maturity date (by exercising one of the promises and waiving the other), has enabled the formation of an alternative Islamic FX Forward solution, within the parameters of *Sharī'ah* compliance.

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369 Kamali, Mohammad Hashim, *Introduction to Sharī'ah*, Ilmiah Publishers, 2006, p.133

370 The two promises with different conditions are as follows; MI Motors promises to purchase Rs.60million if the exchange rate is USSI.00>Rs.3.00. Meanwhile, the Islamic bank promiscs to purchase US$20million if the exchange rate is USSI.00<Rs.3.00

6.4.12. **Option 3: Dual *Wa'ad* (*Wa'daan* but with a variation to the Promise).**

The third option to be shown here is quite simply a slight variation from Option 2 shown above, In Option 2, both parties will provide a unilateral promise to purchase two different currencies. Therefore, both parties promise to enter into *Bay' al-sarf.*

Option 3, on the other hand, will witness one party providing a promise to enter into a *Bay'al-Sarf* while the other party will promise to enter into a Commodity Murahctha transaction to buy commodities. Hence, the issue of whether the two promises may amalgamate to become a binding contract is further detached because the promises are entirely on two separate unrelated matters.

This structure is part of the *Sharī'ah* Resolution of Bank Negara Malaysia (BNM) (2010-2011) and was approved by the Sharī'ah Advisory Council of BNM during their 113th meeting on 23 June 2011.

For sake of consistency, let's as used in the two options shown above. Is-MI Motors undertakes and promises Rs.60million and agrees to pay to agreed price ofUS$20million.

The transactions steps are shown below.

Assumptions:

Promise Date/Deal Date: 1 June 2011

Value Date/Maturity Date: 30 June 2011,

USD/PKR 30-day Forward Rate: 3.00

Step 1-A: Promise to Purchase (On deal date 01, June 2018)

MI Motors promises to purchase Rs. 60million from Islamic Bank on 30 June 2018. MI Motors Promise to Purchase note (akin that contains the undertaking to purchase (Customer's Undertaking).

This undertaking to purchase by the will also state that it will only be (Islamic bank) upon a specific exchange rate scenario. In this case, the scenario would be that of the prevailing exchange rate on trade date (which is 2 business days prior to maturity date) showing the US Dollar trading at any rate above Rs.3.00 (US$I.00>Rs.3.00).

Step 1-B: Promise to Purchase (on deal date 01 June 2018)

Separately, the Islamic Bank promises to purchase a set of commodities at a selling price (which includes cost and profit margin) worth Rs.60million from MI Motors on 30 June 2018, Islamic Bank signs the Promise to Purchase note (Islamic Bank's Undertaking) to that effect.

This undertaking to purchase by the promisor (Islamic Bank) will also state that it will be triggered by the promisee (MI Motors) upon a specific exchange rate scenario. In this case, the scenario would be if the prevailing exchange rate on trade date (which is 2 business clays prior to maturity date) shows the US Dollar trading at any rate below Rs.3.00 (US$I.00<Rs.3.00).

Step 2: Offer to Purchase (2 days before maturity date 28 June 2018)

The parties will identify the prevailing exchange rate in the market based on agreed norms. Two scenarios may take place:

Scenario 1: US$1.00 > Rs.3.00

In this situation, the Customer's Undertaking will be triggered by the Islamic bank, and the Islamic Bank's Undertaking will be waived and cancelled. To that effect, the Islamic Bank will request MI Motors to fulfil its promise to purchase Rs.60million from the Islamic Bank. Hence, MI Motors will deliver an Offer to Purchase to the Islamic Bank, stating that their offer to purchase Rs.60million for a consideration of US$20million, The Islamic Bank will acknowledge and accept the Offer. This effectively concludes the exchange of the currencies at an exchange rate of USD/PKR of Rs.3.00.

Scenario 2: US$1.00<Rs3.00

In this situation, the Islamic Bank's Undertaking will be triggered by the client, and the client's undertaking will be waived and cancelled. To that effect, the Client will request the Islamic Bank to fulfil its promise or undertaking to purchase a set of commodities using the Commodity Murābahah structure.

Hence, the Islamic Bank will deliver an Offer to Purchase to MI Motors stating their offer to purchase a set of commodities at the prevailing cost price and a profit margin which in total will bring the selling price to Rs.60million.

MI Motors on the other hand will source for the commodities (following the receipt of the Offer to Purchase from the Islamic Bank) and appoint the Islamic bank as their purchasing agent and deliver US$20million to the purchasing agent to source for the commodities. This effectively results in an economic exchange rate of USD/PKR of Rs.3.00.[371]

Step 3: (On maturity (30 June 2018)

On this day, the settlement of the currency exchange takes place. MI Motors will deliver to the Islamic Bank US$20million, while the Islamic Bank will deliver to MI Motors Rs.60million.

6.4.12.1. *Sharī'ah* analysis of the above mentioned structure

The same *Sharī'ah* justifications used for Option 2 above shall apply here. However, from a commercial point of view, the use of Commodity Murābahah will incur additional costs, such as the brokerage cost of the commodities. Therefore, the parties to the contract may mutually agree that at all times only the Islamic Bank's Undertaking would be effected such that the Commodity Murābahah transaction will not take place at all.

As mentioned earlier, according to *Sharī'ah* Advisory Council (SAC) of Bank Negara Malaysia (2010), Islamic financial institutions are allowed to enter into a forward foreign currency transaction for hedging purposes based on *Wa'ad mulzim* which is

[371] Note: The parties will agree upfront which undertaking will be effected if the exchange rate is exactly US$1.00 = Rs.3.00.

binding on the promissory and the compensation for breaching of promise could be implemented. Nevertheless, no fee is allowed to be charged on the promisee because the upfront cash payment for forward currency transaction would lead to a bilateral *Wa'ad* which is not allowed by *Sharīʿah.* In Islam, the bilateral *Wa'ad* is not allowed to be used in forward currency exchange since it is akin to contract, thus *riba* will occur. However, binding unilateral promise does not violate any basic tenet of *Sharīʿah.* Hence, the importers or exporters can use *Wa'ad* in the contract of forward involving currencies.

This is in line with the view of the majority of jurists who opines that unilateral binding *Wa'ad* without any consideration is permissible in a forward currency transaction (Bank Negara Malaysia 2010). In 2004, a fatwa was obtained from a prominent Saudi cleric to allow the application of *Wa'ad* on foreign exchange (currency option), but only for hedging purposes. Meaning that, the importers of exporters can take foreign currency forward to cover for genuine business activities on the basis of *Wa'ad* and simultaneous exchange of the currencies at the agreed time, so the forward exchange contract which is commonly practiced in conventional financial institution for the purpose of hedging is not allowed in Islam since both price and delivery are deferred to a future date. Therefore, Islamic financial institution has adopted *Wa'ad* principles which makes the transaction of FX forward comply with *shari'ah.*

6.4.13. A glance on the application of *Wa'ad* in Islamic Banks

In April 2006, Standard Chartered first in South East Asia, had launched a comprehensive Islamic derivatives solution based on a globally acceptable Islamic concept to ensure that customers have access to hedge profit rates risks while enhancing their balance sheet management. The Islamic derivatives solution comprises Islamic Profit Rate Swap, Islamic Cross Currency Swap and Islamic Forward Rate Agreement.

In July 2006, Standard Charted Bank Malaysia Berhad executed US$10 million Islamic Cross Currency Swap with Bank Muamalat Malaysia Berhad, the first Islamic cross currency swap in Malaysia and probably in the world. The currency swap allows Bank Muamalat to hedge the currency and interest rate risks of its investment in foreign currency denominated assets. The facility allows the parties involved to exchange a series of profit- principled payments in one currency for another denominated in a different currency, based on a notional principal amount over an agreed period.

In February 2009, 'the Gulf Finance House (GFH) announced a partnership with Deutsche Bank in a first-of- its-kind foreign exchange hedging deal worth over Euro 30 million (US$ 39.4 million). The deal utilizes a *Sharī'ah* compliant FX-option developed by Deutsche Bank and approved (for the purposes of the above deal) by the Secretary General and member of GFH *Sharī'ah* Board, Dr. Fareed Hadi. Commenting on the deal, Mr. Abdul Rahman Al Jasmi, Deputy Chief Executive Officer, GFH said: "We are proud to be the first bank to utilize the Islamic FX Option provided by Deutsche Bank. This pioneering product will help GFH to eliminate foreign exchange risks and as such we are pleased to be able to add this type of promissory note or option to our inventory of risk management *tools".*[372]

Although Islamic FX option is not widely offered by Islamic financial institutions, but some Islamic banks such as CIMB had offered it for risk management and investment purposes. In 2007, the CIMB Islamic Bank Berhad launched the Islamic Foreign Exchange with *Sharī'ah* -Compliant Option or FXOP, Cross Currencies Profit Rate Swap (CCPRS) and Islamic Profit Rate Swap (PRS) that allow customers to hedge their foreign exchange risk.

The FXOP by way of *Wa'ad* enables customers to lock in a foreign exchange rate in advance by engaging in a *Sharī'ah*-compliant financial transaction with CIMB Islamic. The net proceeds from this transaction which is similar to the premium paid for option instruments in conventional finance grants customers the right, but not the obligation, to exercise the option at the agreed rate on the maturity date. Hence, customers can protect the value of their future foreign currency proceeds, fix their hedging cost at the equivalent of the option 'premium' and even earn a profit if foreign exchange rates move in their favor. This is done to replicate option.[373]

The CIMB Islamic Profit Rate Swap has been recognized as the world's first Islamic derivative product. In recognition for this innovation, the CIMB's Islamic Profit Rate

[372] GFH partners with Deutsche Bank with Historic *Sharī'ah* Compliant 'Islamic FX Option, available at http:// tyo.ca/islambank.community/ modules.php?op=modload& name=News&file=article&s id=2471, accessed dated 12.05.2017.

[373] http://www.cimbislamic.com/index.php?tpt=islamic, accessed dated 02 01, 2016.

Swap has been conferred the Islamic Finance Product of the year in 2005 by Euro money. The product is basically an agreement to exchange profit rates between a fixed rate party and a floating party or vice versa implemented through the execution of a series of underlying contracts to trade certain assets under the *Sharīʿah* contracts. (Azmi & Associates 2008).

State Bank of Pakistan have also allowed *Wa'ad* based structure and various banks used *Wa'ad* based structure for FX Transactions.

Kuwait Finance House (M) Berhad has also applied Promissory FX Contract containing an unconditional promise to enter into an agreed foreign exchange contract with another party at a specified future date in order to mitigate the uncertainty and provide flexibility in managing foreign exchange open positions. KFHMB's Promissory FX Contract is a long awaited product that offers a hedging mechanism to protect customers against fluctuations in foreign exchange rates and utilizing the concept of *Wa'ad.* In the transaction, the bank enters into a foreign exchange contract for delivery on a specific future date as determined by the customer. The introduction of KFH Promissory FX Contract-by KFHMB is a major step forward in Islamic banking, as for the first time, corporations like Air Asia have the option to hedge their foreign currency exposure by using *Sharīʿah* compliant solutions.[374]

The other Islamic bank that has adopted the principle of *Wa'ad* is Bank Muamalat Malaysia Berhad, whereby the customers promise to enter into the contract aware of

[374] http://www.kfhonline.com.my/kfhmb/ accessed dated 27 12 2016.

their obligations. Bank Muamalat has applied forward foreign exchange, that is a *Wa'ad* on trade date followed by *aqad* on the value date. The pricing to be negotiated with the dealers and the bank has the right to claim for mark to market (MTM) losses on the extension or cancellation of forward. Meaning that, banks has the right to claim for actual losses on MTM on termination date.

Bank Islam Malaysia Berhad also has their own innovative *Shari'ah* compliant hedging solution based on *Wa'ad* concept. Among the products offered by Bank Islam is Wiqa' Profit Rate Swap which is an agreement to exchange profit rates between two counterparties (normally consist of a Fixed Rate Party and a Floating Rate Party). The other product is Wiqa' Cross Currency Swap (WCCS) which is an arrangement between two parties to exchange a series of profit and/or principal payments denominated in one currency, for another series of profit and/or principal payments denominated in another currency, based on a notional principal amount over agreed period. The last hedging product offered by BIMB is Islamic Option (Commodity Undertaking) which provides the option buyer the right but not an obligation to enter into an underlying contract of exchange on a future date.[375]

RHB Islamic Bank Berhad had also approved Islamic Promissory Forward Currency contract based on *Wa'ad mulzim*. In this contract, the customer will promise to buy foreign currency in specific agreed period based on agreed rate. Later, the bank will arrange *Murābahah* contract (*tawarruq*) with third party based on currency needed by

[375] (http://www.bimb.com.my, accessed dated 24.12.2016.

the customer to do mismatch arrangement (Ahmad Suhaimi 2008). The other hedging products using *Wa'ad* principle offered by RHB Islamic are Islamic FX forward, Islamic Profit Rate Swap and Islamic Cross Currency Swap.[376]

Deutche Bank (Malaysia) Berhad has also adopted *Wa'ad* principle in structuring Islamic hedging mechanism. In the *Wa'ad* structure, the Islamic account gives *Wa'ad* to DB (*Wa'ad* 1) to sell a number of shares selected from a basket at a predefined price while DB gives *Wa'ad* to the Islamic account (*Wa'ad* 2) to buy the relevant shares at the settlement price. The purpose of these *Wa'ad* is to enable the exchange, upon settlement of the securities, of the relevant shares for the cash amounts required to be paid to investors in respect of the securities at such time. These *Wa'ad* 1 and *Wa'ad* 2 are mutually exclusive and independent to each other. Following receipt of the relevant notice to perform the obligations of either *Wa'ad* 1 or *Wa'ad* 2, the Islamic account and DB shall be deemed to enter into an agreement on the terms of the form of either the *Wa'ad* Share Sale Agreement or the *Wa'ad* Share Purchase Agreement [377]

In Malaysia, most Islamic banks that have developed Islamic derivatives have also adopted the principle of *Wa'ad,* for example in forward FX instruments as a mechanism to hedge against foreign currency exposure. This instrument is vital to provide certainty in terms of price and foreign exchange transactions to the parties involved. In practice, only the customer (which may be an importer / exporter) will

[376] (http://www.rhb.com.my/islamic_banking/main/main.html accessed 27.12.2016.

[377] (http://www.db.com/malaysia/ 25 December 2010).

give *Wa'ad* to the bank to sell/ buy foreign currency to/ from the bank to set rates for the date specified in the foreseeable future. At maturity, the contract is carried out based on the principle of *Bay'al-Sarf* (Shamsiah & Rusnah 2010). Islamic banks such as CIMB Islamic, BIMB and Bank Muamalat have made available spot trading and Islamic FX forward trading which uses the concept of *Wa'ad*, that is *Wa'ad* on the trading date and *Wa'ad* on the value date.

The table below summarizes the instances, of hedging products based on *Wa'ad* structure by Islamic banks in Malaysia:

6.4.14. Hedging Products based on *Wa'ad* Structure offered by Malaysian Islamic Banks[378]

Islamic Bank	Hedging product based on Wa'ad
Bank Islam Malaysia Berhad (BIMB)	a. *Wiqa'* Forward Rate Agreement b. *Wiqa'* profit Rate Swap c. *Wiqa'* Cross Currency Swap (WCCS) d. Islamic Option (Commodity Undertaking-i)
Bank Malaysia Berhad Muamalat	a. Forward Foreign Exchange
CIMB Islamic Bank Berhad	a. Cross currency profit rate swap (CCPRS-i) b. Cross currency swap (CCS-i) c. Islamic Profit Rate Swap (PRS-i) d. Islamic Foreign Exchange with Shari'a Compliant e. Option Features (FXOP-i)
RHB Islamic Bank Berhad	a. Islamic Promissory Forward Currency contract b. Islamic FX forward c. Islamic Profit Rate Swap

[378] Innovative Islamic Hedging Products: application of wa'd in Malaysian Banks, Research Center for Islamic Economics and Finance (The National University of Malaysia),43600 UKM Bangi, Selangor, Malaysia, available at http://www.mfa.com.my/wp-content/uploads/2015/11/volume-19-2011-pg-33-51.pdf

	d. Islamic Cross Currency Swap
Kuwait Finance House (M) Berhad	a. Promissory FX contract-i b. Ijarah Rental Swap-i
Standard Chartered Saadiq Bank Berhad	a. Islamic FX Forward b. Islamic Cross Currency Swap c. Islamic Forward Rate Agreement. d. Islamic Profit Rate Swap

To sum up the above mentioned discussion on *Wa'ad*, we say that '*Wa'ad* is a unilateral promise made by one party which is known as a promisor to do certain acts in the future. The basic purpose of binding promise is to gain assurance that the promisor will fulfil his responsibilities, as stated in the promise, hence, the promisor is legally binding to fulfil it. Since the procedural aspects of conventional forward contract is not correct according to *Sharī'ah* due to deferment of both counter values, *Wa'ad* is seen as the most suitable principle to be adopted in the forward contract. Hence, forward foreign exchange transaction may be done on a promise basis instead of a contract. Under *Wa'ad* structure, only one party promise to buy/ sell certain asset or currency in the future and he is bound by that promise. While the other party will proceed with the promise undertaken by the promissory. Even though *Wa'ad* is binding upon the promissory, but it is not deemed as contract under Islamic law. This is because contract will bind both parties'. While entering into forward foreign currency transactions based on *Wa'ad* but no fee is to be charged on the promise by Islamic financial institutions due to the fact that upfront cash payment for "forward currency transaction" would lead to a bilateral Wa'ad which is not allowed in *Sharī'ah*. This is based on the majority jurists' view.

6.5. *Murābahah* as a building Block for Derivatives

Murābahah is a sale transaction (also known as cost-plus financing) and commonly used as Shari'a compliant financing technique, on the asset side of the bank's balance sheet. In *Murābahah* transactionthe the bank buys the asset from the supplier and and sells it to the customer at a profit margin. Almost 70% of the transactions are carried out through Murābahah in the Islamic institutions. Furthermore, Murābahah also become the building block for Islamic derivative instrument and can play a vital role in the derivative market and serve the same purpose as conventional derivatives.

6.5.1. Structure of the Sample *Murābahah* Transaction:

In the Murābahah structure, the bank (B) (i) purchases commodities from a third party broker, Broker 1 (T) at a particular price (X) (Step 1) and (ii) sells these commodities to the counterparty (C) at a price which includes B's cost price (X) and some profit / mark-up (Δ), which B discloses to C. Thus, C's cost price is equal to X plus Δ (Y) (Step 2).Typically, Y is payable by C in instalments, but it can also be paid as a one-time bullet payment on a specified date in the future (similar to the 'sale and deferred payment' model in conventional financing) (Step 3). Having purchased the commodities from B, C on-sells these to another third-party broker, Broker 2 (P) at a price equal to X (Step 4).

6.5.2. Step by Step *Murābahah* cost plus financing Procedure

- Step.1. "B" Bank, buys Assets from Broker "1", for Rs. X (100)
- Step.2. "B" Bank then, sells assets to "C" Counter party for Rs. (X(100)+profit(5)=105), where the Rs.'5' is the free agreed profit element
- Step.3. Counter Party pay the profit "Y" to the "B" Bank in lump sum or in Installment.
- Step.4. Counter party sells the assets to another 3rd party Broker"2" for Rs. X

The above mentioned structure is *Sharī'ah* compliant because of the following reason

(i) No interest is being charged by B (Bank), rather, B (Bank) is making a profit, which is justifiable since B (Bank) bears the risk (though for a short a period), of not being able to on-sell the commodities to C); and

(ii) The financial transaction is backed by underlying transactions in tangible goods. It is important to maintain the severance between the following three parts of a Murābahah as separate transactions: (a) the purchase of goods by B (Bank) from T (Broker-1); (b) the sale of goods by B to C; and (c) the sale of goods by C to P (Broker-2).

6.5.3. Application of *Murābaha* as Risk Hedging Mechanism

Murābahah is particularly popular and frequently used as Islamic financing technique in the realms of consumer finance and asset finance. Much of the Islamic "derivatives" that are available today are derived from their more traditional counterparts where mainstream derivatives are, to a certain extent, reverse-engineered to fit *Sharīʿah*-compliance regulations. Many of these Islamic "derivatives" involve the use of multiple Murābahah (cost-plus financing) and *Wa'ad* (promise) contracts. *Murābahah* contracts, as the translation suggests, is a permitted form of Islamic financing where the lender (e.g. bank) buys commodities from a broker and sells this on to the borrower at a markup, who is then able to sell this on to another broker. This is one of the most popular forms of Islamic financing and is the foundation of over 70% of Islamic derivatives (Wilson, 2007). Thus, *Murābahah* can be used in a *Sharīʿah* compliant profit rate swap and/or a cross-currency swap etc. as we will discuss the detail mechanism of using Murābahah as risk hedging instrument in the subsequent sections.

6.5.3.1. The Concept of Profit Rate Swap and the use of *Murābahah*

In the conventional financial world, this derivative instrument is known as Interest Rate Swaps (IRS). An IRS is an agreement between two parties to exchange streams of cash flows of two sets of interest-based payment obligations for a period of time. In other words, two parties come together and agree to exchange or transfer the debt payment streams of each other-without transferring the underlying debt.

The most common application of the IRS is when one party pays fixed rate payments at periodic intervals to the counterparty, who in exchange will make payments on a floating rate basis pegged to a pre-agreed benchmark, also at similar periodic intervals. Certainly, there has to be coincidence of wants between the parties. Evidently, the two parties will have different credit ratings, because there is no arbitrage opportunity between two similar credit profile counterparties. Also, both parties would have the intention of reducing their interest cost and have different expectations on future movement of the market interest rate. Finally, both parties who wish to form this partnership to swap the respective interest based payment obligations will have to agree to a common nominal value. The following practical scenario and example will help in better understanding of the Profit Rate Swap.[379]

BerasCorp is the national paddy and rice producer of a certain country. They are involved in the entire supply chain process of cultivating, harvesting, producing and distributing rice from the paddy field to the rice bowl at every home in that country. As part of their funding structure, they issued a Sukuk for RM500million with a tenor of 5 years paying a fixed coupon rate semi annually of 5% per annum. Shortly after issuance, Ms. Syefa, the Head of Finance of BerasCorp takes a view that the market interest rate will continue to fall and thus swapping from a fixed payment obligation to a floating rate will provide them with possible cost savings. They engaged Pakbank, a reputable investment bank to provide them with an interest rate Swap solution.

Pakbank prepared the following credit analysis:

a) Notional Amount to hedge: Rs.500million.
b) BerasCorp receives at every 6 months: 5% p.a on notional amount.
c) BerasCorp pays at every 6 months: Prevailing 6 month-KIBOR plus margin of 1.5%.

[379]Taken from the discussion of Syed Alwi Mohammad Sultan and Dr. Aznan Hasan on derivatives in a *"A mini Guide to Islamic Derivatives: A Primer to Islamic FX Forwards, Profit Rate Swaps and Options'*, Center for Research and Training, p.52.

BerasCorp makes a series of payments to Pakbank on a floating rate basis at the margin of 1.50% benchmarked against the 6 month KIBOR rate. A standard mechanism of determining the KIBOR rate and fixing the interest payment shall be agreed by the parties in the legal Documentation.

The following table provides a scenario analysis on the cash flow payments that BerasCorp will be facing depending on the movement of the 6M-KIBOR rates.

Note that BerasCorp will only benefit from the swap if their total interest cost is lower than 5% which is their obligation to pay the Sukuk holders.

Expected 6M-KIBOR	Margin	Total Interest Rate	Savings or Loss
3.00%	1.50%	4.50%	+ 0.50%
3.25%	1.50%	4.75%	+ 0.25%
3.50%	1.50%	5.00%	Breakeven
3.75%	1.50%	5.25%	0.250/6
4.00%	1.50%	5.50%	

Rates are for illustrative purposes only,

Assume that the 6 month KIBOR rate is 3.00% at any point during the swap trade, these are the cash flows that BerasCorp will be paying and receiving:

BerasCorp will receive (from Pakbank):

Rs. 500million x 5% x6/12=Rs.12.5 million

BerasCorp will pay (to Pakbank):

Rs. 500x(3.00%+1.5%)x6/12=11.25million

BerasCorp saving is thus Rs.1.25million from the BerasCorps saving swap trade for that particular period of 6 months.

Let us recap some of the key takeaways from the example above:

a) Firstly, the example was meant to demonstrate how BerasCorp, which has a payment obligation of 5% per annum (with semi annual periodic payment) over a 5 year period wishes to exchange their payment obligation with Pakbank and in exchange pay Pakbank a floating rate interest payment benchmarked against KIBOR.

b) Notice that there are no principal amounts being exchanged neither at the beginning nor at the maturity of the entire trade. This is precisely how the interest rate swap works because in essence it is an exchange of streams of cash flows but not the obligation on the underlying debt.

BerasCorp has taken a view that the market interest rates will decline hence decided to convert their fixed rate payment obligation to a floating rate payment. Assuming the market rates hover at a rate less than 3.50% during the tenor of the swap, BerasCorp will stand to gain from the swap trade that they entered into. On the other hand, if the market rates were to rise above 3.50%, they will be incurring a loss as they will end up paying more than the 5% per annum.

The above example of the interest rate swap has demonstrated how a conventional structure works in a simplified manner. This is obviously not *Sharī'ah* compliant despite the fact that the underlying debt is arising from a Sukuk transaction. The reason why this is not Sharī'ah compliant is because:

a) The fixed rate payment from Pakbank to BerasCorp is on the basis of a synthetic loan provided by BerasCorp at the notional amount of Rs.500million to Pakbank at the fixed rate of 5% p.a. This is purely a *Riba'* based transaction.

b) The floating rate payment from BerasCorp to Pakbank is also on the basis of a synthetic loan provided by Pakbank at the notional amount of Rs.500million at the rate which is tied to the KIBOR cost of funds plus a margin of 1.50% p.a."*This is also a Ripa'* based transaction.

Now, let's study how the Islamic alternative to the interest rate swap is structured and executed.

6.6. Islamic Profit Rate Swap Structures

6.6.1. Option No.1: Islamic Profit Rate Swap based on Combining Commodity *Murābahah, Wakalah and Wa'ad.*

The previous section clearly highlighted that a conventional swap agreement exchanges interest payments through two sets of synthetic loan agreements, which is disallowed from a Sharī'ah viewpoint. To structure an Islamic swap, this payment exchange misfit should be resolved by way of ensuring that the cash flows are exchanged based on a permissible

Sharī'ah structure. The best proxy that has been identified to plug this gap is by using the Commodity Murābahah structure.[380]

6.6.1.1. How the *Commodity Murābahah* structure works for Profit Rate Swap?

The Commodity Murābahah based structure involving a financing extended by the Bank to the Client, Step 1 involves the Bank purchasing the underlying commodities from Commodity Broker A. At Step 2, the Bank sells the underlying commodities to the Client, acting through the Bank as their agent, will sell the underlying commodities to Commodity Broker B for immediate cash payment, which represent the financing amount. On deferred basic, the Client makes the instalment payment the Bank.

Following is the detail stepwise procedure for Islamic Profit Rate Swap:

Step I: Appointment of Bank as Agent

As part of the entire documentation to set up a derivative trade between the counterparties, Client will appoint the Bank as their agent to perform the task of purchasing the underlying commodities from the brokers when the client is involved in selling the commodities to the Bank, and also to perform the task of selling the commodities to the brokers when the client has purchased the commodities from the Bank. This is a one-off agreement signed between the parties that can be used for all the derivative deals undertaken between the client and

[380] Richard Tredgett and Priya Uberoi, *Islamic Derivatives case study: a Cross Currency Swap*, Derivatives Week, 16 June 2008.

the Bank. This is an important leg of the entire structure because this facilitates the client's purchase and sale of the commodities without the hassle and operational risk of directly dealing with the commodity brokers.

Step 2-A: Customer Undertaking

In this step, the Customer or BerasCorp irrevocably undertakes that it shall purchase the underlying commodities and pay the relevant deferred sale price at every occasion that Pakbank sells them the underlying commodities, This undertaking is done on the basis of *Wa'ad* The reason for this undertaking is to ensure that the customer is committed to enter into a series of exchanges of cash flows throughout the tenor of the swap trade.

At every transaction date or the date when the cash flows are to be exchanged, Pakbank would send BerasCorp a sale notice that contains the detailed information on the Commodity Murābahah sale including information on the underlying assets and the price, which shall be at a floating rate of KIBOR plus sale notice would be sent by Pakbank to purchasing the commodities from the commodity brokers.

By executing the sale notice, effectively BerasCorp has accepted the purchase of the underlying commodities for the deferred sale price which consists of the notional principal of Rs.500million plus the profit which was derived from the floating rate. The notional principal will shortly be set-off against the notional principal from the fixed leg of the transaction (to be explained below), hence resulting in BerasCorp to make the settlement of the profit amount only. With this, BerasCorp fulfils its liability to pay the floating rate profit amount. The next leg shows how they will receive the fixed rate profit payment that will be used to pay the *Sukak* holders' coupon payment.

Step 2-B: Bank's Undertaking

Similar to the Customer Undertaking, at the signing of the facility agreements the Bank will provide a Bank Undertaking which irrevocably undertakes that it shall purchase the underlying commodities and pay the relevant deferred sale price at each series of the cash flow payments. This undertaking commits the Bank to enter into a series of exchanges of cash flows throughout the tenor of the swap trade.

At every transaction date, the Bank sends a purchase notice to BerasCorp, whereby the Bank confirms their obligation to purchase the underlying commodities from BerasCorp. Once this purchase notice is received, BerasCorp will purchase the underlying commodities (via the purchasing agent, pursuant to signing the Agency Agreement as shown in Step I above) and immediately sell the underlying commodities to Pakbank.

The deferred selling price shall be the notional principal amount of RM500million plus the profit rate which is derived using the fixed rate of 5% p.a. The principal amount is set-off against the principal amount due from the floating leg (as stated above), hence leaving only the fixed profit amount payable by the Bank to BerasCorp. With this, BerasCorp receives the fixed rate of 5% on the notional amount of Rs.500million, which will be used to settle their liability to pay the *Sukuk* holders.

Summary of the Transaction and Cash flows

In summary, the Islamic Profit Rate Swap consists of the following features:

a) Two separate and distinct Commodity Murābahah transactions are executed by the counterparties.

b) In one of the Commodity Murābahah transaction, BerasCorp purchases the commodities from the commodity brokers and sells them to Pakbank for a price that is based on a fixed profit rate. This ensures that BerasCorp receives the fixed profit rate payment from to Pakbank. The purchase of the commodities is done via the purchasing agent pursuant to the Agency Agreement signed between BerasCorp appointing the bank as its agent.

c) In the other Commodity Murābahah transaction, BerasCorp purchases the commodities from to Pakbank for a price that is based on a rate that is benchmarked against a floating rate benchmark. BerasCorp will act through the Bank as their agent to on-sell the underlying commodities to the commodity brokers.

d) The notional principal amount payable by both parties is set off to the effect that the only cash flows that are transferred are the profit amounts.

6.6.2. Option 2: Islamic Profit Rate Swap (With Single Commodity Murābahah)

In the stepwise procedure shown above, we have demonstrated that for an Islamic Profit Rate Swap to take effect, two distinct Commodity Murābahah transactions are entered into by the parties to the agreement. One Commodity Murahaha transaction will produce the payment from a fixed rate benchmark while the other Commodity Murahaha will yield the payment from a floating rate benchmark.

However, in an effort to improve the efficiency of the documentation and operational process flow, an improved structure has been designed that allows for only one commodity Murābahah transaction to be effected at each settlement date by way of netting off the two cash flows. This will allow for only the netted amount (profit amount under a single commodity Murābahah) to be paid by the party which is "out of the money".

Two key changes are required to build a mechanism in the Master Agreements to allow for only one undertaking to be effected at each settlement date-defining the two rates as Rate A and Rate B (as shown below); and building in a formula for the profit amount at each settlement date.

Using the same example as above, let us define Rate A as Floating rate of KIBOR plus 1.5%; and Rate is Fixed rate of 5%. The formula which shall be stated in the Master Agreement shall be as follows:

If Rate A > Rate B; Customer Undertaking is triggered

If Rate B > Rate A; Bank Undertaking is triggered.

Separately, the settlement amount or Netting Formula will be defined as follows;

If the Customer Undertaking is exercised, the profit amount payable shall be:

Notional Amount [(Rate A- Rate B)*Number of Days in the period]

If the Bank Undertaking is exercised, the profit amount payable shall be:

Notional Amount (Rate B- Rate A) Number of Days in the period]

Transaction Steps:

Step 1: Appointment of Bank as Agent

The process here is similar to how it is done under option 1 shown above

Step 2-A: Customer Undertaking

In this step, the customer or BerasCorp irrevocably undertakes that it shall purchase the underlying commodities and pay the relevant deferred sale price at every occasion that Pakbank sells them the underlying commodities. The price will be based on the Netting Formula shown above.

The process here is similar to that explained under Option 1 shown above.

Step 2-B: Bank's Undertaking

Similar to the Customer Undertaking, at the signing of the facility agreements the Bank will provide a Bank Undertaking which irrevocably undertakes that it shall purchase the underlying commodities and pay the relevant deferred sale price at every occasion that BerasCorp sells them the underlying commodities. The price will be based on the Netting Formula shown above.

The process here is similar to that explained under option 1 shown above.

Step 3: (On each settlement date)

An appointed calculation agent will compute Rate A and Rate B the calculation agent will determine which undertaking shall be exercised. Depending on which undertaking is exercised, the Netting Formula will be used to compute the Selling Price for the Commodity Murahaha transaction.

Example 1

Rate A = 6% (whereby 6M KIBOR is 4.5% and margin is 1.5%

Rate B= 5%

Profit Amount = 1%

As Rate A > Rate B, the Customer Undertaking will be exercised, whereby BerasCorp undertakes to buy commodities from the Bank. Based on the Netting Formula, the profit amount will be the difference between Rate A and. Rate B for the number of days during that period. Only one Commodity Murābahah will be exercised resulting in BerasCorp paying only 1%* of the Notional Amount (multiplied by the number of days during the period) to Pakbank.

Example 2

Rate A 3.5% (whereby 6MKlibor is 2% and margin is 1.5%)

Rate B 5%

Profit Amount = 1.5 %

As Rate B > Rate A, the Bank Undertaking will be exercised, Whereby Pakbank undertakes to buy commodities from the Customer. Based on the Netting Formula, the profit amount will be the difference between Rate B and Rate A for the number of days during that period. Only one Commodity Murābahah will be exercised resulting in Pakbank paying only of the Notional Amount (multiplied by the number of days during the period) to BerasCorp.

6.6.3. Structuring Islamic Cross Currency Swap

The Islamic Profit Rate Swap explained in the section above is a single-currency swap where both legs of the swap are denominated in the same currency. Therefore, the notional amount of the swap is not exchanged as it is used only as a computational abstraction nothing is gained by the contracting parties by exchanging the exact same notional amount. A Cross Currency Swap (CCS), in the conventional financial sense, involves an exchange of interest liabilities in two different currencies and consists of three stages:

a) a spot exchange of principal of the two currencies (spot settlement is two business days after the rate fixing)
b) a continuing exchange of interest payments during the swap's life
c) a re-exchange of principal at the maturity of the contract normally at the same spot rates used at the start.[381]

The key practical difference then, between a cross currency swap and a non-currency swap has to do with the notional amount[382]. This is because in a CCS, the foreign exchange risk

[381] Paul C. *Harding; 'Mastering The ISIDA Master Agreements*, 3rd Edition, FT-Prentice Hall, 2010, p 5.

becomes a consideration. Therefore, the notional amounts are exchange at the start and at the end to remove the exchange rate uncertainty from the equation.

CCS is a financial engineering tool that is useful for both borrowers and investors. For corporate clients, the CCS is typically used to take advantage of advantageous borrowing opportunities in different credit markets, particularly where the client faces differences in funding costs or credit pricing across markets. Therefore, the CCS allows the client to lower their cost of funds while at the same time diversify their investor base, obviously, this is typically possible for clients with significant name recognition in the global credit market. The CCS is also a useful tool for investors or fund managers as it allows the diversification of currency exposure under a portfolio management.

To demonstrate that how the ICCS works and to prove that Islamic finance industry also have its alternative mechanism to allow for an Islamic cross currency swap (ICCS). The example below, taken from the Alvi and Aznan work, provides a case study along with stepwise procedure on the use of the ICCS.[383]

As part of their strategy to diversify their sources of funding, International Middle-east Arab Nur Bank (IMAN Bank), a Middle East based Islamic bank with an international network, decides to establish an Islamic MTN programme in Malaysia for a programme size of RM3 billion. They appoint Bank Muamalat Malaysia as their arranger and swap

[382] Michael Durbin; '*AllAbout Derivatives*',2nd Edition, McGrawHill, p 35.
[383] Syed Awi Mohammad Sultan and Dr. Aznan Hasan "*A mini Guide to Islamic Derivatives: A Primer to Islamic FX Forwards, Profit Rate Swaps and Options*", Center for Research and Training, p. 68

provider. Following the establishment of the programme, 1MAN Bank issues its first *Sukuk* off the programme for a size of RM 500million. The tenor of the Sukuk is 5 years, priced at 5% p.a, with semi annual payments of the coupon. Bank Muamalat Malaysia as the swap provider quotes the following terms of the currency swap:

Essential Information of Terms Sheet	
MYR National	RM 500 million
USD National	US$ 166.67 million (exchange rate ofUSS
Initial Date	2 Syptember,2012
Maturity Date	2 September, 2017
Party A	Bank Muamalat Malaysia
Party B	IMAM Bank
Party A Initial Exchange	US$ 166.67 million
Party A Pays	p.a. on RIM 500 million, S.A.
Party A Final Exchange	RM 500 million
Party B Intial Exchange	RM 500 million
Party B pays	6 Months Libor 100bps on US$ 166.67 million, S.A.
Party B Final Exchange	US$ 166.67 million

The table on the left captures the essential information that would be contained in a term sheet for a transaction of this nature. The substance of the entire transaction is that IMAN Bank intends to swap the RM500mil1ion Sukuk proceeds received from the issuance of their Sukuk to US Dollars. The exchange rate quoted by the swap provider is assumed to be US$I.00 = RM3.00, which effectively translates RM500million into US$166.67million.

Transaction Steps

In essence, the transaction steps are the same as the steps for Islamic Profit Rate Swap (IPRS) explained in the previous section. The key difference between an ICCS and an IPRS are as follows:[384]

a) In an ICCS, the principal amount in the respective currencies are exchanged at the start and re-exchanged at the maturity of the tenor.

b) During the life of the swap, there will be two sets of cash flow streams being exchanged in the two respective currencies between the parties.

The three steps mentioned at the start of this section are thus transacted using the following Sharī'ah compliant analyses and mechanisms:

Step 1: Analysis of the spot exchange of principal of the two currencies:

a) Upon the completion of the Sukuk issuance, IMAN Bank will receive the Sukuk proceeds of RM 500million. As they do not have a Malaysian operation where the Ringgit can be deployed, they intend to Swap the RM500million into US Dollar equivalents.

b) Based on the assumption that the exchange rate is US$1.00=RM3.00, the swapped amount shall be US$166.67million.

c) The two undertakings, Bank Undertaking and Client Undertaking (or Customer Undertaking) follows the same method and logic as explained in the previous section on

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[384] Syed Awi Mohammad Sultan and Dr. Aznan Hasan "*A mini Guide to Islamic Derivatives: A Primer to Islamic FX Forwards, Profit Rate Swaps and Options*", Center for Research and Training, p 69.

Islamic Profit Rate Swap. This is signed one-off upfront as part of the master agreement between the two parties.

d) Upon receiving the Sukuk proceeds (subject to the business days convention), IMAN Bank will enter into a spot exchange with Bank Muamalat on the basis of *Bay'al-Sarf*, whereby IMAN Bank exchanges RM500million for US$166.67million. This concludes the initial exchange of the principal amounts of the two different currencies, which is a distinctive feature of the cross currency swap.

Step 2: Analysis of the continuing exchange of profit payments during swap's life

a) In this example, the tenor of the swap is 5 years and each settlement date is 6 month intervals.

b) At each settlement date, both undertakings i.e. Bank Undertaking and Client Undertaking (or Customer Undertaking), is exercised. To that effect, two separate and distinct Commodity Murābahah transactions will be effected for the respective undertakings.

c) Under the Bank Undertaking, IMAN Bank will buy commodities worth RM500million and sell the commodities to Bank Muamalat at a profit rate of 5%p.a. This will result in Bank Muamalat paying IMAN Bank the profit of 5% p.a. on the notional amount of RM500million at every 6 month interval. (The principal amount that Bank Muamalat owes to IMAN Bank as a result ofthe Murābahah contract is setoff against what IMAN Bank owes Bank Muamalat, as their agent to purchase the commodities, hence resulting in only the profit amount being exchanged).

d) IMAN Bank will basically use the profit amount paid by Bank Muamalat to pay the Sukuk profits to the Sukuk holders.

e) Under the Client Undertaking, Bank Muamalat will buy commodities worth US$ 166.67million and sell the commodities to IMAN Bank at a profit rate of 6 Month LIBOR plus 100bps (rate to be fixed according to the agreed rate fixing convention) at every 6 month interval. Similar to the explanation above, only the profit amount is exchanged from TMAN Bank to Bank Muamalat.

f) Hence, the cash flows are exchanged using the combination of Commodity Murābahah and Waka/ah (for the Agency Agreement) by triggering the *Wa'ad* based undertaking provided by each party at the onset.

Step 3: Analysis of the Re-Exchange of Principal at Maturity

a) The example only shows the re-exchange of the principal amounts. In actual fact, the final payment of the respective parties will also include the final profit amounts.

b) The re-exchange of the principals can be effected either through another set of *Bay'al Saf* for through the final Commodity Murābahah transaction (only this time the full selling Price is paid, the principal plus profit amounts),

c) If the *Bay' al-Sarf* is used, this will only be for the re-exchange of the principal amounts, thus assuming the final profit is settled separately through the Commodity Murābahah mechanism as explained under Step 2 above.

d) If the Commodity Murābahah is used at maturity for the final settlement, another two sets of Commodity Murābahah will be exercised, only this time the full selling price of the respective Murābahah contracts will be paid in full by the parties. This will ensure that the principal amounts are re-exchanged.

e) Upon receiving the RM500million principal amount -from Bank Muamalat, IMAN Bank will use this amount to settle off their Sukuk Obligation and cancel the Sukuk accordingly:

Final Analysis:

The above example has demonstrated how an Islamic Cross Currency Swap is effected using a combination of *Wa'ad, Bay' al-Sarf, Wakalah* and *Murābahah*. The periodic exchange of cash flows use the same mechanism as explained under the Islamic Profit Rate Swap, with the only difference under the Islamic Cross Currency Swap is the exchange of the principal or notional amounts in the two currencies at the start and end of the contract. Depending on how the provider are drafted, this exchange of the notional amounts can be effected through a *Bay al- Sarf* contract or even through a Commodity Murābahah mechanism.

6.6.4. Sharī'ah Issues with Swap Contracts

As mentioned earlier, that the purpose of swap contracts is to exchange cash flows arising from one form of underlying liability with another form of underlying liability between two willing parties within a certain period of time. It does not, however, exchange the obligation of the debt itself. The underlying asset could be currencies- hence, a cross currency swap-where the parties exchange cash flow obligations of one currency for another combined with the exchange of the nominal value of the currencies upfront and reversed at maturity. On the other hand, a commodity swap involves the parties exchanging cash flows based on a predetermined price benchmark against market price of the underlying commodity.

Issue 1: Deferment of Counter values

As with the forward contract mentioned in the previous chapter, a conventional interest rate swap also involves the deferment of the exchange of the counter values to a series of future date at fixed intervals, which is known as reset periods. This is clearly not permissible from a *Sharī'ah* viewpoint However, this issue is addressed by way of the undertaking on the basis of *Wa'ad* provided by both parties to continue to enter into the transaction at the reset periods throughout the tenor of the facility, To that effect, the counter values are always exchanged on spot basis-hence, no deferment occurs - through the Commodity Murābahah transactions, while the commitment of the parties to continue to enter into the series of exchanges is managed through the Wa'ad undertaking by the respective parties.

Issue 2: Use of Separate Commodities

Assuming that two sets of Commodity Murābahah transactions are required, it has also been noted that some jurists would insist that the commodities for the respective

Commodity Murābahah transactions are dissimilar. This is to ensure that the unconditional and distinctiveness of the two Commodity Murābahah transactions are established very clearly.

Obviously, the above requirement may pose an additional operational risk to be adhered to by the parties to the contract. Among others, the parties will have to make sure that for each reset period there are sufficient commodities of two separate kinds i.e. aluminium and copper, palladium and platinum, CPO and coffee etc., that are available for the amount that is being exchanged. Naturally, Commodity *Murabaha* platforms that only provide one set of commodities as the underlying asset will also be disadvantaged with this requirement.

Issue 3: Premature Termination and Mark to Market

Finally, the issue of premature termination of the trade is worth mentioning here. It is common for any derivative deal to be terminated prematurely if the assumptions on the market upon which the original derivative trade proves false and the trade does not bring any economic benefit for at least one of the party in the agreement. For example, if BerasCorp's assumption on sustained decline in KIBOR benchmark rates proves misguided and suddenly KIBOR rises the extent that BerasCorp ends up paying much higher rates than the 5% fixed on its Sukuk, obviously BerasCorp will prefer unwinding the derivative contract quickly rather than end up paying more than the Tahawuut Master Agreement

(TMA) developed by ISDA and IIFM (see capsule above) outlines the following steps in dealing with early termination events.[385]

a) Upon Early Termination, an Index must be calculated.
b) Each party shall provide another set of undertaking, upfront at the initiation of the facility agreements, on the basis of *Wa'ad* to enter into a *Musawamma* contract if called upon to do so following calculation of the Index.
c) The Index measures the replacement cost (or gain) of entering into replacement transactions.
d) Calculation of the Index would follow pre-agreed conventions that would be clear to both parties.

Upon the calculation of the Index, the party which is "out of the money" will be required to make a final settlement to the other party. The undertaking of the party "out of the money" will be triggered, upon calculation of the Index, to the effect that the party which is "out of the money will be required to purchase from the party "in the money" a set of commodities at the deferred sale price which will include the outstanding payable amount which includes the amount calculated by the Index. This final settlement shall be done by way of a one-off Commodity *Murābahah* but on the basis of a *Masawarnah* contract.

The reason for the use of *Musawamah* contract for the final settlement is that jurists have opined that in a breach of promise to enter into a contract, the only compensation that can

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385 Ijlal Alvi, '*Tahawout, Master Agreement, Introduction; IIMF,Seminar on Hedging and Liquidity Management in Islamic Finance*; Nov 22, 2010, Bahrain.

be claimed by the party that has been disadvantaged by the premature termination is up to the actual lass as a result of the breach. However, in a premature termination of derivatives, the actual cost of the termination, due to the mark to market convention of computing the present value of all future cash flows, may be different from the actual loss of a breach.

Hence the use of *Musawamah* contract, to give effect the payment of an amount which may be other than the actual loss. With a *Musawamah* contract, the parties can enter into a trade on any amount that is mutually agreed upon.

The developments on the above structures continue as this mini-guide is being developed. This is natural for an industry that is still evolving and in particular due to the early days on the Islamic treasury solutions. It is encouraging to see that several bodies such as AAOIFI and 11FM are debating these issues and hopefully will soon set acceptable industry standards on the above solutions.

6.6.5. Case Study

In October 2006, 'Citigroup designed a currency swap for the Dubai Investment Group (DIB) based on *Murābahah* to hedge the currency risk on DIB's RM 828 million (approximately £119 million) investment in Bank Islam Malaysia.[386]Standard Chartered

[386] Mark Bendeich, Islamic Commodities: what would Mohammed do?, December 8, 2006, available at http://www.gata.org/node/4587, accessed dated 10.08.2016.

Saadiq, Al Hilal Bank and Calyon also market products based on *Shari'ah*-compliant Cross- Currency Swaps.[387]

6.7. Istijrār Contract

6.7.1. The Concept of Istijrār Contract

Istijrār is an agreement between the buyer and the seller, where a buyer purchases a particular asset on different intervals on an on-going basis from the seller; there in no need of bargain or offer or acceptance each time. All the terms and conditions upon which Istijrār to be executed are confirmed in a master agreement. Bacha described Istijrār contract as the most complicated among the Islamic contracts which is based on the complex combination of the options, average prices and Murābahah agreement (cost plus profit mode).

Under Islamic jurisprudence "*Istijrār* is an agreement under which a buyer purchases something at different time intervals. Each time there is no offer or acceptance or bargain for the contract. Instead there is one master agreement where all terms and conditions are finalized".[388]

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[387] http://www.standard- chartered.com.my/islamic- banking/wholesale-banking/ treasury products/en/:http://www.calyon.com/ business-lines/calyon-at-the- heart-of-the-development- of-islamic-banking.htm; http://www.alhilalbank.ae/ web/?page=treasury unit, accessed dated 12.04.2017.

[388] Dr. Muhammad Imran Ashraf Usmani, *'Meezan Bank's Guide to Islamic Banking,* (2002), 35

6.7.2. Parties to the Istijrār Contract

This contract revolved around two parties, (1) The buyer, which in normal practice, is usually a company looking for financing to purchase an underlying asset, and (2) an Islamic financial institution which will be the bank as per common practice.[389]

6.7.3. Types of Istijrār Contract

There are two main types of *Istijrār*:

The first, where after completion of all the transactions of purchases, the selling price is determined. In this kind of Istijrār where the purchas price is not known there may be a general acceptance between the buyer and the seller that whatever the price may be at the time of possession, it would be acceptable to the buyer.

In the second type of *Istijrār*, the selling price is fixed and determined in advance but the purchases are executed from time to time as on ongoing basis.[390]

In this type of Istijrār, the price of the goods is discloses by the seller at the time of each purchase and after the buyer takes the possession the sale becomes valid. Sale and purchase take place regularly. On the completion of all the transactions the amount is paid. It is not necessary that each and every time, the price of the subject matter is to be disclose by the

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[389] Obiyathulla I. Bacha, *'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration'*, International Journal Of Islamic Financial Services, (Vol. 1, No. 1, April – June -1999)

[390]Dr. Muhammad Imran Ashraf Usmani, *'Meezan Bank's Guide to Islamic Banking,* (2002), 135

seller, if the other party knows that it is being sold on market value. The upper and lower range around the cost price P0 is determined in the Master agreement. Which may be linked to a benchmark such as 'LIBOR+ margin'. Hence it would change when the benchmark shifts.

6.7.4. Practice of Istijrār in Islamic Banks

6.7.4.1. Transaction Flow and Price determination of Istijrār:

The concept of Istijrar is under discussion, however, yet not implement by the banks due to its fresh innovation and nature of complexity. However, it is involved in various activities based on Murābahah, Musharaka, Mudaraba and Ijara.[391] For Example in the case of Murābahah, the Bank involve with the suplier of the borrower on the basis of Istijrār. In this case, the Islamic bank, after entering into Murābahah with the supplier purchases the assets from supplier at a market price and sell it onwards to the customer (it may be new) on the basis of Murābahah. The customer, then purchase the assets from the bank, an ongoing basis in tranches rather than at once and on the completion of the whole purchases within the within the specified time period on an agreed mode of payment to be determined in advance or at the conclusion of the transaction as agreed by the parties in the agreement.

An illustrative example for the implementation of a typical Istijrār, as per the structure approved, we may state that, "a car production company seeking short term working capital

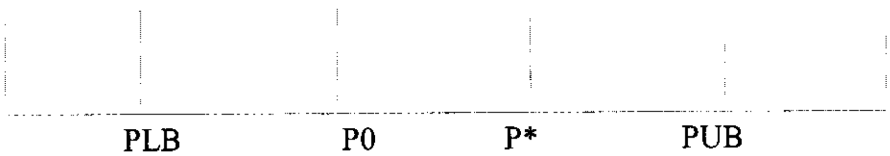
[391] Dr. Muhammad Imran Ashraf Usmani, *'Meezan Bank's Guide to Islamic Banking*, (chapter *19-Istijrar,* 2002), 78.

financing, approaches an Islamic bank to finance the purchase of a commodity such as air-conditioning units. The bank purchases the units at the current price (P0), and resells it to the factory for payment to be made (for example in 3 months) at a mutually agreed date in the future. The price at which settlement will occurs on maturity is contingent on the air-conditioning units price movement from the day the contract was initiated to the maturity (e.g. price movement from t0 to t90' where t0 is the day the contract was initiated and t90 is the 90th day which would be the maturity day).

Unlike a *Murābahah* contract, where the settlement price would simply be a predetermined price; P* where P* P0 (I + r), with 'r' being the bank's required return learning. 'The price of the Istijrār can be settled at any time before contract maturity, both parties can agree (in the contract) on the price at which Istijrār will be settled it could either be the predetermined *Murābahah* price 'P*' or an average price over the period (P) of the commodity between the period t0 to t90. As to which of the two prices will be used for settlement will depend on how prices have behaved and which party chooses to 'fix' the settlement price. The embedded option is the right to chooses to fix the price at which settlement will occur at any time before contract maturity. At the initiation of the contract; t0 both parties agree on the following two items (i) in the predetermined Murābahahh price; P* and (ii) an upper and lower bound around the P0. (bank's purchase price at t0).

Normally, the financial institution (Bank) continuesly deliver the specified units to the client at the price already known to the client, and the client repay the installment on a monthly basis or as agreed between the parties. So, for every consignment (unit), separate offer and acceptance is needed from the client to the bank.

For better clarification, the different prices (from the start till end) are shown below in a continuum, on which one op the party may exercise its right of option for the settlement of the transaction, however, within the bounds.



Where P0 = The price that bank pays to purchase underlying commodity.

P* = Murābahah price; P* = P0 (l+r)

PLB = The Lower bound price

PUB = The upper bound price

6.7.4.2. How the settlement price is determined?

The settlement price (PS) at t90 would be one of the following:

▪ PS = P (Avg price of asset during T0-T90); if the underlying asset price remained within the bounds.

▪ PS= Pt = Spot price of underlying commodity of day t

▪ (PS = P*; if the underlying asset exceeds the bounds and one of the parties chooses to exercise its options and use P* as the price at which to settle at maturity.(Exercise price fixed by either party after the market price of asset during time T0-T90 has gone out of the price range. This exercise price may be the *Murābahah* price P* or some other price fixed by either bank or customer)

To exercise the option by either party, the 'spot price' must have exceeded the bounds at any time during contract. As to which party would exercise its option is totally depends on the direction of the spot price movement.[392] Bacha has described this through an example, he stated that "if the spot price at any time breaks through the upper bound the buyer would get worried. But whether he will exercise or not would depend on his expectations of the spot price over the remaining period of the contract. If he believes that the price is likely to keep increasing thereby causing p at which settlement will occur to be greater than P*, it will be in his interest to 'exercise' by fixing the settlement price now at P*. Essentially, he would notify the bank that he is exercising his option and that the settlement would be P*. Should spot prices be falling such that it breaks the lower bound, the seller, in this case the bank would have the option to fix the settlement price at P*.[393]

Bacha has rightly said that "analyzing the Istijrār contract entirely from an options viewpoint is complicated since it has two different exercise styles rolled in one. Such an instrument would be highly unusual in conventional finance. Still for our purpose here, the embedded options in the Istijrār can simply be thought of as follows. The fact that buyer get to fix the buying price at P* when the price goes higher implies that he has a call option at an exercise price of P* while the bank a put option at the same exercise price. What the Istijrār contract attempts to do is to allow for the impact for price changes but to cap the benefits that accrue, as a result. By definition, since changes are allowed only within a band, the advantage to one party and the disadvantage to the other is capped. The

392 Obiyathullah I.B. *'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration'*, (International Journal of Islamic Financial Services Vol. 1 No.1), 22

393 Ibid

maximum potential gain or loss is limited. Such a contract fulfills the need to avoid a fixed return on risk less asset which would be considered *riba* and also avoids *gharar* in that both parties know up front, p* and the range of other possible prices (by definition between the upper and lower bounds).

6.7.5. Documentation involved in th Mechanism of *Istijrār* Contract[394]:

Step No. 1

▪ Like Master Murabah Finance Agreement (MMFA) an *Istijrār* Agreement to be signed between the cutomer and Islamic financial institution, various Sub-*Murābahah*s may be executed on the basis of the Master Agreemnt.(Master Murābahah Agrement/Istijrār agreement is signed at time=T0.

Step No. 2

- Agency agreement will be signed with the customer (if required) at T0.

Step No. 3

- When the bank purchases the commodity the Declaration (Sub Murābahah) is signed at T90.

Step No.4

- Ps-the Settlement Price (Contract Price) is paid on the Settlement Date=TS
- T90= When Declaration is signed -- Offer and Acceptance between Customer and Islamic financial institution to sell the asset back to customer, the sale is executed.[395]

[394] The process flow has been taken from Obaidullah (1997) and Bacha (1999).

6.8. Alternative to Options

We have discussed in detail the concept of conventional options. They are treated as independent contracts under the umbrella of financial contracts, and the jurists are almost have consensus on the impermissibility of charging fee for it. However, as Obiadullah has highlighted that "options can however be used as an embedded option in contracts. The Islamic law of contracts does keep the window of embedded options in contracts of exchange under the umbrella of *al Khiyār* ".[396]

As per *Sharī'ah,* options have the following main kinds, namely: *Khiyār al-shart* (option by stipulation); *Khiyār al ta'yin* (option of determination); *Khiyār al-ayb* (option for defect); *Khiyār al-ruyat* (option after inspection); and *Khiyār al-majlis* (option of session). These and other different types of options along with their importance have been identified in Islamic law.[397]

However, some modern jurists have highlighted the possibility that, out of these various kinds, '*Khiyār al shart*' can be utilized by banks for designing new financial instrument to manage their exposures and protect them from unnecessary risk. Moreover, Ibn Qayyim has also suggested the mechanisms how to utilize *Khiyār al shart* in the Murābahah contract to mitigate risk.[398] For instance in *Murābahah* contract, the bank purchases the goods from

[395] Syed Aun Raza Rizvi1 & Dr. Ahcene Lahsasna, *'Derivatives in Islamic Finance: The Need and Mechanisms Available for Islamic Financial Markets'*. 19-20

[396] Obaidullah, *'Financial Engineering with Islamic Options'*, *Islamic Economic Studies*, vol. 6, no. 1, (2005), 80

[397]See Abu Ghuddah, *'Al-Khiyār wa Atharuhu fi al-'Uqud'*, (Dallah al-Barakah, Jeddah,n.d). 71

[398] Ibn Qayyim al-Jawziyyah, *I'lām al-Muwaqqi'īn 'an Rab al-'Ālamin*, (Beirut, Lebanon, Dār al-Kutub al-'Ilmiyah, 1991) 310.

the supplier and sell to the customer on profit margin. However, this exposes the bank to the subsequent risk that the customer may not purchase the goods from the bank. To manage this risk, Islamic bank can retain an option (*Khiyār al shart*) for itself from the original supplier that, subsequently if the bank's customer fails to buy the asset from the bank, the bank can return the assets to the supplier. In the realistic sense, as said by bacaha "the Islamic bank would have to settle for a lesser profit since the original supplier may charge a higher price for as sale with return option as compare to a binding sale without option". So the original supplier may increase in the price which he will consider as the cost of the option that he gives to the buyer, which means that the value of the option is embedded in the price that the bank pays.

We have tried in this section to look deeply into the above mentioned highlighted possibility along with their various dimension, the legal aspect of these contracts and the possibility of using them as an alternative to the conventional options.

The modern jurist, those who are of the view that options could be accommodated in Islamic law through *Khiyār al-shart* and its subdivision namely *Khiyār al-naqd* (the option of paying the price) contract and have drawn an analogy between the two concepts among these are Kamali,[399] Ali Abd al-Qadir,[400] Shahhat al-Jundi,[401] and

[399]M.H. Kamali, "Islamic Commercial Law: An analysis of futures", *The American Journal of Islamic Social Sciences*, 13(2) (1996), 191

[400] Ali Abd al-Qadir, 'Taqib ala Rai al-Tashr al-Islmi fi Masail al-Bursah', *al-Mawsua al-Ilmiyyahwa al-Amaliyyah li bunuk al-Islmiyyah*, Cairo, al-Ittihad al-Dawli lil-Bunukal-Islamiyyah, 1982, vol. 5, 438–443.

[401] Shahhat al-Jundi,*Mu amalat al-Bursah fi al-shari ah al-Islamiyyah*, Cairo, Dar al-Nahdah, 1988,143

Obaidullah.[402]

On the other hand, some scholars, although they have made an analogy between the two concepts, have concluded that option can not be legalized by making an analogy to *Khiyār al-shart* or option of stipulation. However, the Islamic law in the theory of contract, has discussed the concept of option within the context of giving the right to the contracting parties either to confirm the contract within the determined period or to cancel it.

6.8.1. Risk management through options-*Khiyār Al-Shart*

6.8.1.1. The Concept of *Khiyār Al-Shart*

Khiyār al-Shart or option of stipulation, introduced by the modern jurists as 1st Islamic alternative to conventional options. Generally, it is an option in the nature of a condition in a contract either to cancel or confirm a contract within the specific time period. Thus, it is not based on mutual consent of the parties rather based on equity of the transaction,

As mentioned by al-Jizari "it provides a right to either of the parties, or both or even to a third party to confirm or to cancel the contract within a stipulated period of time".[403] This specific right is allowed by Sharī'ah in the exchange contract with the purpose to help reduce *gharar* or bring it within islamically acceptable limits.

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[402]Obaidulla, I.B., 'Financial Engineering with Islamic Options', *Islamic Economic Studies*, vol. 6, no. 1, November 1998, 73–103.

[403] Abd al-Rahman al-Jizari, '*Al-Fiqh ala al-Madhāhib al-Arbah*, Dar al-Rayyan li al-Turath, Cairo, n.d., vol. 3, 155.

6.8.1.2. Authority or Legality of the *Khiyār Al-Shart*

The legality of this concept is based on the authority of various *Ahādith* of the Holy Prophet (SAW). Such as the Hadith narrated by Abdullah Ibn Umar to the effect tht "the parties to a contract of sale have a right of option as long as they are not separated except in a sale that is subject to option".[404] In another *Hadith* it is reported that a compliant was made about frequently cheating in a sale by Hibban Ibn Munqidh to the Prophet (SAW). He responded, "When you concluded a sale, you may say there must be no fraud and you reserve for yourself an option lasting for three days".[405] One general *hadith* is also quoted in this regard. "Muslims are bound by their_stipulation unless it be a stipulation which declares unlawful what is lawful or permits what is unlawful".

Apart from the above mentioned *Ahādith s*, an *Ijma* to the effect of the validity of *Khiyār al-shart* has been reported by some jurists. For example Al-Nawawi, said in this regard "The strongest basis for *Khiyār al-shart* is *ijma* . and it is enough".[406] A similar statement has been recorded by Ibn al-Humam.[407] Although, disagreement of the al-Thawri, Ibn Shubrumah and some of the Zahiri school especially Ibn Hazm has been reported by Ibn Rushed. However, a little disagreement was there among the scholars at the beginning on *Khiyār al-shart* but has been accepted by *ijma*. It is to mention that the validity of *khiyār al-shart* is not a point of disagreement among Muslim jurists nowadays. It is worth noting, as mentioned by Muhammad al-Bashir that "option of stipulation is only valid with regard

[404] *Sahih Al-Bukhari with Fath al-Bari*, vol. 4, p. 326.
[405] *Sahih Al-Bukhari with Fath al-Bari*, vol. 4, p. 337; *Sahih Muslim with Sharh al-*Nawawi, vol. 10, p. 177.
[406] Al-Nawawi, *al-Majmu Sharh al-Muhazzab*, vol. 9, p. 225.
[407] Ibn al-Humam, *Fath al-Qadir*, vol. 5, p. 111.

to non-usurious sales. *Khiyār al-shart* is not applicable to *salam*, and any option would make the contract of *salam* null and void according to the majority. He further mentioned that "as for usurious items such as currencies and barter sale of foodstuffs, they must be concluded on the spot without delay. Therefore, *Khiyār al-shart* is not applicable to currency trading".[408]

6.8.1.3. *Juristic* opinion on the duration and terms of *Khiyār Al-Shart* in a contract

Islamic Jurists have divergence opinions on the terms of *Khiyār Al-Shart* in contract. However, these may be devided into three main classes:

(1)Abu Hanifah, Shaf'ī and Zufar are of the view the *kiyar* or option in the contract should not exceed more than three days as specified in the *hadith*, and secondly *Khiyār al-shart* is contrary to the norms of *qiyās* as it is allowed as an exception. In other words, *Khiyār al-shart* is originally against the objective of the sale contract, because as per Islamic Law, Sale contract should be binding immediately after its conclusion. However, t is allowed on the basis of necessity. Therefore, it should remained it its minimum possible period as three three days.[409]

(2) Malikīs are of the opinion that the *hadith* mentions three days in for understanding purpose merely to convey the concept in an illustrated manner. The actual duration may

[408] Muhammad al-Bashir Muhammad al-Amine, '*Risk Management in Islamic Finance An Analysis of Derivatives Instruments in Commodity Markets*', Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), 156.

[409] Al-Kasani, *Badai al-Sanai*, vol. 5, 157; Ibn 'Ābidin, *Radd al-Muhtar*, vol. 4, 565. Al-Nawawi, *al-Majmu Sharh al-Muhazzab*, vol. 9, 190.

be linked with the subject matter of the sale to achieve the objective of the option. For example, in the case of sale of cloth three days may be enough, however, in the case of purchasing a house it may be extended.[410]

(3) The third and more flexible opinion is that of the disciples of Abu Hanifah, namely Abu Yousuf and Muhammad Ibn al-Hasan al-Shaibani and Hanbalī School. They held that, length of time in the option is totally depends on the agreement between the and there is no maximum permissible period.[411]

However, the main hindrance for the innovation the new instruments based on *Khiyār al-shart* is the issue of its legality that it is approved as an exception and therefore, it is not possible to make it the basis of an analogy. This issue has already discussed in detail in the legality of *salam*. However, some modern writers preferred the opinion that "the period of *khiyār al-shart* should not exceed three days as it is stated in the *hadīth* because it has been legalized by way of exception and not in line with the general principles. Therefore, it should not be used as an alternative to the conventional options, which are generally for one month to twelve months. Moreover, it is claimed that the period of option in the conventional system is generally used for speculative purposes and therefore, there is no need therefore, for it in the Islamic financial system. Hence, the period of option should not exceed three days and there is no need to change this rule, which has in any case been validated by way of exception".[412]

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[410]Ibn Rushd, *Bidayat al-Mujtahid*, vol. 2, 208.
[411] Ibn Qudamah, *al-Mughni*, vol. 3, 585; Ibn Ābidin, *Radd al-Muhtar*, vol. 4, 565.
[412] Sāmi r Ridwan, *Aswaq al-Awraq al-Maliyyah*, 367.

However, Muhammad Al Bashir rightly stated that "it could be argued that, to stick to the literal meaning of the *hadith* without any effort to analyze its purpose is not the best approach of genuine Islamic research especially in the area of *muamalat* and when we are addressing new types of contracts unknown to early Muslim jurists. Moreover, the majority of these scholars have opted for the extension of this period according to the commodity sold or according to the need of the contracting parties as it is explained above. It seems that there is a tendency among certain writers to judge any new transaction, as illegal, as it is the best way of a valuable piece of research or the only indication of the genuine Islamisity of a study and the *taqwā* or God fearing of the writer. Moreover, in order to reach this negative conclusion, no effort would is required made to analyze each part of the problem separately but all the issues that could be and could not be accommodated in Islamic law, and those which, are mixed in order to give a negative impression.[413] Moreover, Sufyan al-Thawri has that in this regard that "the genuine *fiqh* interpretation is that which is done by a reliable jurist to prove the legality of an uneasy alternative without contravening the principles of the *shai ah* while the strictness (by prohibiting everything) could be done by everyone".[414]

Thus, on the basis of the above mentioned discussion we are of the openion that openion of Malikīe and especially that of later Hanafīes and Hanbalī are more in line with the objectives of Sharī'ah, therefore, preference will be given to these second and third opinions.,

[413] Muhammad al-Bashir Muhammad al-Amine, '*Risk Management in Islamic Finance An Analysis of Derivatives Instruments in Commodity Markets*', Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), 213.

[414] Al-Qaradāwi, *Bay al-Murābahah li al-Āmir bi al-Shirā Kamā Tujrīh al-Masārif al-Islāmiyyah Dirāsah fi Daw al-Nusūs wa al-Qawā id al-Shar iyyah*, (Maktabat Wahbah, Cairo, 1987), 53.

6.8.1.4. Management of Price Risk with *Khiyār al-Shart*

As we have mentioned earlier in start of this section that how risk could be managed through *Khiyār al-Shart* in *Murābahah* contract and have explained the same with the help of an example. Now, we will explain another important factor of *Khiyār al-Shart* which could significantly contributes to manage price volatilityrisk. So, *Khiyār al-shart* could be used as a tool for managing business risk and specifically price risk in the context of commodity markets.[415]

Similarly, *Khiyār al-shart* could be used as useful tool for managing risk in the financial_market, such as the stock market which is characterized by volatile prices. While using conventional option, the economic rationale is that, it is used as a risk hedging or risk management device. For example, "individual A plans to buy or sell stock X after a time period of three months. He may be adversely affected if the price moves up or down during this time period. The risk due to price movement could be hedged by purchasing a call (put) with a given exercise price of, say, $50. The price paid for the option; say $5 is in the nature of insuring against adverse price fluctuations. At the end of three months even if the price moves up to $60 (down to $40), individual A is not affected since he can buy or sell at the exercise price of $50. While this is true, the fact remains that this contract can be used for speculation".[416]

[415] See, Obaidullah, *"Financial Engineering with Islamic Options"*, *Islamic Economic Studies*, vol. 6, no. 1, November 1998, 90–91.

[416] Muhammad al-Bashir Muhammad al-Amine, *'Risk Management in Islamic Finance An Analysis of Derivatives Instruments in Commodity Markets'*, Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), 224.

An alternative scenario can be achieved through *Khiyār al-shart as highlighted* by Obaidullah "An Individual A can now enter into a purchase or sale contract and stipulate a condition of option for himself for a period of three months. At the end of the three months, if the price of stock X moves up or down, it can confirm the contract of purchase or sale at the known contractual price and thus be immune to price risk. However, if the price of stock X moves down or up then individual A can rescind the contract and purchase (sell) in the market, thereby not losing the profit potential. Thus, *khiyār al-shart* may benefit the party holding the option at the cost of the_counterparty. However, the disadvantage caused to the counterparty can be compensated in the form of a higher contractual price and need not be paid separately upfront to the counterparty. It is this feature that provides an effective curb to speculation on price differences and thus, differentiates Islamic options from conventional ones".[417]

While commenting on this alternative, Muhammad Bashir stated that "Despite the fact that the above alternative could be considered as a genuine Islamic way of risk management, to consider it immune from price differential and, by consequence free from the possibility of being used for speculation is not totally true. The individual, who is buying stock, as it is mentioned in the above example, is looking at the up or down trend of the stock he has bought or sold. He is neither looking to avoid possible cheating in the price from his counterpart nor a possible defect in the commodity or stock he bought or sold. At the same time, he is not asking for an option because he has no sufficient knowledge of the subject matter he has agreed to buy. He is buying these stocks with a

[417]M. Obaidullah, *'Financial Engineering with Islamic Options'*, 91–92.

view of seeing if the later price is in his favor in which case he will exercise the option in order to benefit from price differential and if the opposite situation happens he will leave the option to expire with- out exercising it. Yet, we are not arguing that since the use of *Khiyār al-shart* as it is in the above example is not immune from being used for price differential gain, therefore, it should be declared illegal. On the contrary, we would like to say the issue of_price differential should not be used as ground to ban certain transactions. Otherwise even the use of *Khiyār al-shart* here would be the center of controversy since it is not free from the intention of gaining from price differentials"[418].

Although *Khiyār al-shart,* as an option, can be a useful and effective risk hedging instrument even without charging fee or any monetary compensation in exchange for giving the right to cancel or confirm the contract. However, some modern jurists are of the opinion that there is no Sharī'ah issue for charging a fee or premium for the option in *Khiyār al-shart.* So in this case it will be similar and match to the conventional option. Kamali has thus, maintained that "the validity of charging a fee for options is a matter that falls under the general subject of contractual stipulation, a subject that invoked different responses from the schools of Islamic law notwithstanding the affirmative nature of the source of evidence on it. In principle, the contractual stipulation by the parties should not be allowed to circumvent and override the given mandate of the *Sharīah* in contract. In other words, the parties are not at total liberty to stipulate what they please. The liberty given by the general theory of freedom of contract in Islamic law is subject to the condition that stipulation

[418] Muhammad al-Bashir Muhammad al-Amine, '*Risk Management in Islamic Finance An Analysis of Derivatives Instruments in Commodity Markets*', Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), 227

should not overrule the clear injunctions of Islamic law. Provided that this limitation is observed, there is in principle no restriction on the nature and types of stipulations that the parties may wish to insert into a contract".[419] He further quoted the various schools opinion on the liberty of the parties and states that "According to *Hanafīs* and *Shafīs'* point of view stipulations are valid when they are in line with the essence of the contract. Thus, a condition to provide a guarantor or a surety in the form of mortgage or pawn is legal provided that both parties agree upon it. The *Malikīs* are even more explicit in validating stipulations having financial value, as for example a buyer's stipulation for transporting the goods to a certain locality. The *Hanbalīs* are the most liberal. They maintain that stipulations which fulfill a legitimate objective and realize a benefit and convenience, or which may help to remove hardship and facilitate the easy flow of commercial transactions are generally valid as a matter of principle".[420]

Thus, after discussion and elaboration on the opinion of the different schools on the liberty of the parties involved in a contract to insert the conditions they wish, Kamali concluded that "this analysis is not only affirmative of the parties' freedom to insert stipulations in contracts but also that compensation or a fee may be asked by one who grants an option or privilege to the other. If the seller is entitled to stipulate a security deposit or pawn, then, it is a mere extension of the same logic that he may charge the buyer and impose a fee for compensation in respect of such options

[419] M.H. Kamali, "Islamic Commercial Law: An analysis of futures", *The American Journal of Islamic Social Sciences*, 13(2) (1996),220-225

[420] Ibid

and stipulations that are to the latter's advantage. When the buyer, for example, stipulates that he will ratify or revoke the con- tract within a week or a month, this may well prove to be costly to the seller and he may, therefore, charge a fee/compensation for granting the option. We thus conclude that options may carry a premium and there should basically be no objection to this".[421]

A similar stance has been taken by other modern jurists, such as, Shahhat al-Jundi, Yousuf Sulaimān and 'Ali Abd al-Qadir. Yousuf Sulaiman, for instance, concluded: "the money taken by the seller as premium could not be returned to the buyer (if he fails to ratify the contract within the agreed period) because Allāh says, "Oh you who believe fulfill your obligations". In addition according to the reported *hadīth* of the Prophet "*Sulh* among Muslim is permissible unless it transforms what is *halāl* into *haram* or what is *haram* into *halal* and, Muslims are bound by their stipulations unless it be a stipulation, which declares unlawful what is permissible or permits what is unlawful".[422] As stated by Abdal qadar "Since the second party has the same right, then he could sell it as well given that the time period of the option is determined. On the other hand, it is possible that one of the parties donated the premium to the other as a gift.[423] Similarly, 'Ali Abd al-Qadir[424] and Shahhat al-Jundi[425] endorsed the above opinion.

[421] Ibid. 356–357.
[422] Al-Bukhari, '*Sahih al-Bukhari with Fath al-Bari*', Book of conditions (Shurut), v. 5, 354.
[423] See, Youssuf Sulaiman, 'Rai al-Tashri al-Islami fi Maail al-Bursah', *al-Mawsuahal-Ilmiyyah wa al-Amaliyyah lil bunuk al-Islamiyyah*, vol. 5, 425.
[424] See, 'Taqib ala Rai al-Tashri' al-Islami fi Masail al-Bursah', *al-Mawsuahal-Ilmiyyah wa al-Amaliyyah lil bunuk al-Islamiyyah*, vol. 5,. 441.
[425] See, *Muamalat al-Bursah*, 151.

In contrast, Ahmad Muhyi al-Din and Samir Ridwan have taken a negative position and totally opposed any adoption of conventional options through *Khiyār al-shart*. One of their main arguments is that *Khiyār al-shart* or the option of stipulation is anomalous to norms and principle of Islamic law. It is merely tolerated by way of exception. It is not allowed to give an opportunity to look if the price movement is in one's favor.[426] We have already demonstrated the weakness of this argument while mentioning the legality of *salam*. Similarly, Ibn Taymiyyah and Ibn Qayyim vigorously refuted this claim with *Khiyār al-shart* and maintained that it is allowed as a matter of principle and not against the norms or *qiyās*. Yet, it could be argued that it is wise to prefer the opinion of the majority rather than to follow the opinion of a few scholars.

Moreover, Muhammad Al-Bashir has stated that "the Hanafī s themselves have departed from the principles that they have established with regard to this theory in general and about *Khiyār al-shart* in particular by legalizing *Khiyār al-naqd* by way of analogy to *Khiyār al-shart*. Yet, if *Khiyār al-shart* is allowed by way of exception as it is claimed and, if the alleged theory, that, what has been allowed by way of exception should not be the basis of analogy (*ma thabata alā khilāf al-qiyās la yuqāsu alaihi*), is true, then *Khiyār al-naqd* should be declared illegal in the Hanafī school. But this was not the case. Thus, we do believe that *Khiyār al-shart* is in line with the norms of *qiyās* and it is legal to base an analogy on it".

[426] Ahmad Muhyi al-Din Hassan, *Amal Sharikat al-Istithmar*, pp. 268–271; Sāmi r Ridwan, *Suq al Awraq al-Maliyyah*, 361.

Another critic objected to option on the grounds that "it is an unfair transaction and works for the advantage of one party to the total detriment of the other, and therefore, it is a kind of oppression and injustice".[427]

However, while refuting this argument, Kamali said: "This analysis is somewhat unfounded and superfluous as it is based on wrong foundation. For one thing, it should be obvious that the option holder does not always make profits, as Hassan tends to suggest, but may make a loss and lose his premium as a result. It is not as if the option holder has locked himself in a no lose situation and Hassan has not acknowledged this. The other point is that the option holder may well be acting as a hedger who wishes to protect himself against exorbitant losses and buying options merely tries to minimize the prospect of a bigger loss. And then the issue of oppression and injustice is rather an exaggeration simply because the parties enter an agreement and the option buyer pays for the advantage he is granted. The price that he pays is also determined not by him or his agent, but by the exchange authorities and the question of manipulation and unfair advantage is basically not relevant".[428]

At the end of this discussion, it is clear that *Khiyār al-shart,* as a tool of risk hedging could serve and fulfill the benefits of conventional options. Moreover, while considering the legality of charging a fee for giving the option, will bring the *Khiyār al-shart* in a similar position to the conventional option as a tool of risk management. Although some jurists have

[427] Ahmad Muhyi al-Din Hassan, '*Amaal Sharikat al-Istithmar*, 268–271; Sāmi r Ridwan, *Suq al-Awraq al-Maliyyah*, 361.
[428] M.H. Kamali, "Islamic Commercial Law: An analysis of futures", *The American Journal of Islamic Social Sciences*, 13(2) (1996), 260.

objection to such a proposition on the grounds that the subject matter in such a transaction will be a pure right, which is not eligible to be the subject matter of a contract. However, the others have rebutted the same as we have mentioned the same in detail the legality of option. I personally will prefer the use of *Khiyār al shart* without charging fee for it.

6.9. *Bay'Al-'Arbūn* as Alternative to Option:

Some jurists are of the opinion that on the basis of 'Arbūn ' a *Sharī'ah* compliant instrument may be developed like option contract by which one party (the buyer)will buy the right to purchase from the other party (the seller) identified assets for a determined price on a certain date.[429] The "purchaser" pays to the "seller" at the inception on the contract a deposit, and the purchaser has right to revoke his commitment at any moment.

6.9.1. Concept and Definition of "*Bay' Al-'Arbūn* "

The word '*Urbun'* is an Arabic word, literally it means and translating into "earnest money". It is basically a nonrefundable deposits paid by a buyer for retaining a right to confirm or cancel the sale. This advance payment is made with the condition that "If the buyer continues with the contract within the stipulated time period, the earnest money becomes a part of the price negotiated already. In the case the buyer decides to cancel the

[429] Frank, E. Vogel and Samuel Hayes, '*Islamic Law and Finance, Religion, Risk, and Return'* (The Hague: Kluwer Law International, 1998), 156

transaction or decide not to go ahead with the sale, the earnest money is forfeited by the buyer. The deposit money can be kept by the seller".[430]

'Arbūn refers to a sale in which the buyer deposits earnest money with the seller as part payment of the price in advance, but agrees that if he fails to ratify the contract, he will forfeit the deposit money, which the seller can keep".[431] It is also defined as "a transaction whereby the buyer pays only a small part of the price of a commodity (for instance two *dirhams*), on the understanding that the seller will retain this amount if the sale is not finally concluded due to withdrawal of the buyer".[432]

A more general definition of '*'Arbūn* ' is given by Imam Malik. It holds "when a person buys or rents an animal and says to the seller or the owner of the animal, i will give you one *dinar* or one *dirham* or more or less and if I ratify the sale or the rent contract, the amount I gave will be part of the total price. And if I cancel the deal, then what I gave will be for you without any exchange".[433] This definition further widen the scope of *'Arbūn* , and shows that apart from sale, *'Arbūn* can also be possible in lease or rent contract. However, there is disagreement among the classical schools of Islamic law about the legality of *'Arbūn* . Majority of the *madhabs* have declared 'Arbūn is an invalid contract, 'since it makes a gift (the initial deposit) conditional upon a sale, and therefore allegedly offends the Sharī'ah principle of non-

[430] Syed Aun Raza Rizvi1 & Dr. Ahcene Lahsasna, 'Derivatives in Islamic Finance: The Need and Mechanisms Available for Islamic Financial Markets', -17

[431] M.H. Kamali, "Islamic Commercial Law: An analysis of futures", *The American Journal of Islamic Social Sciences*, 13(2) (1996), 197-224.365.

[432] Mohamed 'Alī El-Gārī., '*Toward an Islamic Stock Market*' (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, Saudi Arabia, 1993), 14.

[433] Al- Bājī, '*Al-Muntaqā Sharh Muwattā al-Imām Mālik*. (Beirut: Dar al-Gharb al-Islami, 1991), 158.

combination of gratuitous contracts with onerous ones'. But the Hanbalī School declared the 'Arbūn as a valid form of contract in Sharī'ah.[434] The OIC Academy has also endorsed the legality of 'Arbūn subject to the condition that the time limit must be specified for exercising the option.[435]

Islamic Fiqh Academy (2000), in its resolution no 72/3/8 resolved that "*al-urbun* contract is permissible if the time frame of the contract is set, and the down payment is considered as part of the selling price if the purchase is carried through, and is the property of the seller if the buyer desists. Similar to conventional FX option, Islamic FX option contract also requires a buyer to pay a premium to seller in order to get a right to buy currency on a specified rate based on the mutually agreed rate". A simple example may be illustrated as in an 'Arbūn contract, "the buyer (B) concludes a purchase and makes an advance of some sum (X) which is less than the purchase price (Y) to the seller (S). The contract stipulates that if B decides to proceed with the transaction, he will pay S the purchase price minus the initial deposit (Y minus X = Z). If B decides not to proceed with the transaction, he forfeits the deposit in favour of S".

6.9.2. Legality of 'Arbūn and Juristic debate

There is disagreement among the four classical school of thoughts on the validity of *'Arbūn.* According to the Majority (Hanafī es, Malikīes and Shaf 'ī es) "*'Arbūn* is an invalid contract and considered it to be akin to misappropriating the property of

[434] Frank, E. Vogel and Samuel Hayes, '*Islamic Law and Finance, Religion, Risk, and Return*' (The Hague: Kluwer Law International, 1998), 110.
[435] OIC Academy, eighth session (1994), Fiqh Academy Journal 1:794.

others. Moreover, it involves an unknown option or condition, which amounts to *gharar*".[436]

However, he Hanbalī school, on the other hand, of the openio that "it as a legal contract. 'Umar, the second caliph, and his son Abd Allah Ibn Umar held a similar position. Among the followers certain prominent jurists including Mujahīd, Said Ibn al-Musayyib, Ibn Sirin, Nafi Ibn al-Harith, and Zaid Ibn Aslam also held that *'Arbūn* is a lawful and acceptable contract".[437]

The difference arises due to the the authenticity of two *Ahādith* reported in relation to the issues which seem in contradictions to each other. Therefore, the majority based their openion on the *hadith* reported by Imam Malik in al-Muwattā' and reported by by Imam Ahmad, Nasai, Abu Dawud and Ibn Majah to the effect that the Prophet (PBUH) prohibited the sale of *'Arbūn* . But the *hadith* is considered to be a weak (*munqati*').[438]

So far as the minority (Hanbalī School) opinion are concerned they have relied on the *hadith* reported by Abd al-Razzak to the effect that the Prophet was asked about *'Arbūn* contract and He declared it permissible. However, this *hadith* is also declared to be weak (*mursal*). In addition to that, the Hanbalīs also have relied on the report of Nafīs Ibn al-

[436] See for instance, Ibn Rushd, *Bidāyat al Mujtahid*, vol. 2, p. 161. Al-Dirdir, *al-Sharhal-Kabir*, vol. 3, p. 63; Al-Nawawi, *Mugni al-Muhtaj*, vol. 2, p. 39; Ibn Qudama
, *al-Mughni*, vol. 4, p. 224.

[437] See, for instance, Ibn Qudama, *al-Mughni*, vol. 4, 234; al-Qurtubi, *Ahkam al-Qur'an*, vol. 5, 150 and Ibn Qayyim al-Jawziyyah, *I'lām al-Muwaqqīn 'an Rab al-'Ālamin*. (Beirut, Lebanon, Dār al-Kutub al-'Ilmiyah, 1991), 389.

[438] See, for instance Ibn Hajar, *Talkhis al-Habīr*, vol. 3, p. 17; al-Sanani, *Subul al-Salam*,vol. 3, 17 and al-Shawkani, *Nayl al-Awtar*, vol. 5,153.

Harith, the officer of the caliph Umar in Makkah to the effect that 'he bought from Safwan Ibn Umayyah a prison house for the caliph Umar for four thousand *dirham* on condition that if the caliph approved of it, the deal would be final, otherwise Safwan would be given four hundred *dirhams*'[439].

On the legality of *'Arbūn*, further evidences may be presenred in its support such as the *hadith*: "Muslims are bound by their stipulations unless it be a stipulation which declares unlawful what is permissible or permits what is unlawful".[440] Also it is reported in al-Bukhari and narrated by Ibn Sirin that "a man said to a hirer of animals, 'prepare your travelling animals and if I do not go with you on such and such a day, I shall pay you a hundred *dirhams*'. But he did not go on that day. Shuraih said: If anyone puts a condition on himself of his own free will without being under duress, he has to abide by it. Also it is narrated by Ayub from Ibn Sirin that "A man sold food, and the buyer told the seller that if he did not come to him on Wednesday, his deal would be cancelled, and he did not turn up on that day". Shuraih said to the buyer "You have broken your promise" and gave the verdict against him. Ibn Hajar said, Sayid Ibn Mansur has completed this transmission by the chain of Sufyan from Ayub". The conclusion is that in both of the above mentioned cases, Shuriah had given decision against the person who makes the condition against himself without duress.[441]

It is much important here to mention that, many modern Muslim jurists have accepted

[439] See for instance, Ibn Qayyim al-Jawziyyah, *I'lām al-Muwaqqīn 'an Rab al-'Ālamin*. (Beirut, Lebanon, Dār al-Kutub al-'Ilmiyah, 1991.), 389.
[440] Al-Bukhari, *Sahīh al-Bukhari with Fath al-Bari*, Book of conditions (Shurūt), v. 5, 354.
[441] Ibid.

the validity of *'Arbūn* . For example, al-Qardawi, in his analysis on 'Arbūn has stated that the opponents of *'Arbūn* , have relied on the *hadith* whic is unreliable, since it is also a weak, al-Qardawi detects that the issue should then be deterrmined on rational grounds, and here Imam Ahmad has further, relied on the precedent of Umar Ibn al-Khattab for the validity of *'Arbūn* .Thus, the ruling, al-Qaradawi seem more suitable to today's business requirement and is in harmony with the spirit of the *Islamic Law* which aims to remove hardship and facilitate convenience for the people.[442]

While rejecting Shawkani's argument al-Zuhaili stated that "since the two *Ahādith* contradict each other in that one prohibits *'Arbūn* while the other legalizes it, we should opt for the prohibition because, as it is well known in Islamic jurisprudence, if there are two conflicting commands on prohibition and permissibility, the prohibition should be given priority".[443] However, he further stated that "the evidence of the two parties, in this case, is not equal. The proponents relied on the precedent of Umar Ibn al-Khattab which could be considered as an *ijma*, because he was not opposed by any of the companions".

Kamali has highlighted the utility of *'Arbūn* in modern commerce along with the support it has received in general custom and legislation. He stated that "*'Arbūn provides* a useful formula, which can be utilized to facilitate a credible commitment, or a surety that the buyer will not change his mind after finalizing a sale. However, if he does so the seller can be compensated for possible loss that has been caused as a result. The need for such assurance is more evident in modern times when large orders

[442] Al- Qaradawi, *Shariat al-Islam*, (Maktabat Wahbah, Cairo, 1987), 114.
[443] Al-Shawkani, *Nayl al-Awtar*, vol. 5, p. 153.

have to be entertained by making elaborate preparations involving a chain of other subsidiary transactions that incur additional expenditure. Furthermore, it is likely that the seller who holds his goods or manufactures them for the purpose, and waits until the buyer ratifies the sale may lose the opportunity of selling his goods or may fail to sell them for a good price, in which case he should be entitled to compensation, and *arbūn* responds to this need".[444]

Ibn Mani, while rejecting the the argument that there is *gharar* in *'Arbūn*, stated "since in such a contract there is no time limit for the exercise of the right of cancellation of the contract said, we agree that there should be a time limit for the exercise of this right, otherwise the possibility of *gharar* may have some grounds".[445]

Although the humbali sources have not mentioned a time frame for exercise this option. Yet, Al-Bassam argues that "the Hanbals, as a matter of principle, reject all conditions of unlimited time in a contract, therefore, even if sometimes, some Hanbalī scholars did not mention explicitly this limitation in their works, they are considering it". He further mentioned that some other scholras of Hanbalī's school such as al-Maqdisi[446] have mentioned it. Moreover, he added that "it could be argued that the issue of time limitation in this case is similar to that of *Khiyār al-shart*".[447]

[444] Quoted by Kamali, *Islamic Commercial Law an Analysis of Options and Futures*, 367–8.
[445] Abd Allah Ibn Mani', "Bahth fi Hukm Bay al- Arbūn", *Majallat al-Buhūthal-Islāmiyyah*, Riyadh Saudi Arabia, 170.
[446] Al-Maqdisi, Ghayat al-Muntaha, al-Maktab al-Islami, Damascus, 1961, vol. 2, 26.
[447] Abd Allah al-Bassam, *Majallat Majma al-Fiqh al-Islami* (discussion about *bay al- 'Arbūn)* no. 8, vol. 1, 1994, 766.

Bashir, on the other hand mentioned that "the legislation of several Arab countries has opted for the legality of *'Arbūn* as an indication that both parties in the contract have the right to cancel the contract during the agreed period except for the civil law of Iraq, which considers *arbūn* as an indication that the contract is final and conclusive. Thus, Article 103 of the Egyptian civil code, Article 74 of the Kuwaiti civil code, article 103 of the Jordanian civil code And 104 of the Syrian civil code state that *arbūn* is an indication that both parties have the right to cancel the contract during the agreed period".[448]

After considering the above mentioned fact and to solve the problem of some of the contemporary scholars whom opposed *bay' al-'Arbūn* on the ground that "there is *gharar* in *'Arbūn* since in such a contract there is no time limit for the exercise of the right of cancellation of the contract" the participants in the Islamic Fiqh Academy discussion on *'Arbūn opted* for the inclusion of this condition in every *'Arbūn contract* seems to be a proper solution to the issue.

6.9.3. The Nature of *Bay'-Al-'Arbūn*

It is however necessary to determine that that whether *'Arbūn* is a kind of penalty clause in the contract that will be imposed on the party who has not honored his commitment and will be considered as compensation for the imminent harm or it is a clause for liquidated damages in the contract or is it something else of different nature?

[448] Quoted by Muhammad al-Bashir Muhammad al-Amine, '*Risk Management in Islamic Finance An Analysis of Derivatives Instruments in Commodity Markets*', Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), 121.

Bashir has stated in this regard that "If we consider *'Arbūn as* a kind of clause for liquidated damages, this would mean that the damage should be assessed by a court of law even if the parties have agreed at the beginning to a certain amount of compensation. If what is agreed upon between the parties is more than the real damage, the court would reduce it to the appropriate amount of the real damage and if it is less, then, the one who fails to honor his obligation should be obliged by the court to pay more. This is totally different from the nature of *arbūn*, which is an exchange of the "right" to cancel the contract as it is agreed upon between the parties, and cannot be subjected to the court's intervention. Moreover, in the case of liquidated damages, the occurrence of the damage is a condition for receiving the compensation. If no damage has happened, then, there are no grounds for compensation and this is not the case with *'Arbūn* where the beneficiary is entitled to it whether there is damage or not. Similarly, if we consider *arbūn* as a penalty to compensate against the harm suffered by the owner of the commodity because he has reserved his commodity for the buyer and waited for him to ratify the contract or he may have lost the opportunity of selling his item at a good price, a court intervention is necessary to assess the damage. However, this is not in line with the spirit of *'Arbūn.*[449] In fact, in *'Arbūn the* parties have agreed and fixed the amount just for the "right" to cancel the contract.[450] Therefore, on the basis of above we can conclude that the deposit of *'Arbūn* is paid just in exchange for the right to cancel the contract and not a compensation or penalty for the damage suffered by the seller.

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[449] Muhammad al-Bashir Muhammad al-Amine, '*Risk Management in Islamic Finance An Analysis of Derivatives Instruments in Commodity Markets*', Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), 113.

[450]See for instance, 'Abd al-Razzāq al-Sanhūrī, *Masādir al-Haq*, pp. 89–103; al-Sanhuri,*al-Waīīt*, vol. 4, 90; 'Abd Allah Ibn Mani', "Bahth fi Hukm Bay' al-'Arbūn", .173–175; Rafiq al-Masri, "Bay' al-'Arbūn", 726–729.

6.9.4. *'Arbūn* as Alternative to Options

The main purpose, after determination of the legality of *''Arbūn e'* here is that, to discuss and look deeply into the innovation and development of a type of contract which will not only provide the same benefits as of conventional option as a tool of risk management only but will also be in conformity with the Islamic norms. *'Arbūn*, as analyzed above, has some similarities with options, mainly in the sense that both that both can be used as risk reduction strategies.

6.9.5. *Bay' Al-'Arbūn* and Conventional Option:

'Arbūn is the closest alternative to the conventional option, though it cannot be regarded as same as an option (because, unlike an 'Arbūn contract, the premium paid under a conventional option is not deducted from the purchase price if the buyer chooses to exercise the option).[451]. Therefore, it can be used as a *Sharia*-complaint alternative to options. So, the deposit paid by the buyer to the seller will be part of the price of the goods if the buyer proceed further and confirm the contract, otherwise, it will be considered as *hibah* (gift) from the buyer to the seller.[452]

A 'Call Option' can be considered near to *Bay' al-'Arbūn* in the sense that the 'seller does not return the premium or advance payment to the buyer in case the latter does not exercise the purchase option and the buyer loses the option premium even if the option is exercised

[451] Islamic Derivatives: Theory and Practice (Chapter 14) Global Islamic Finance Report (GIFR 2010), 131.
[452] Atila Yanpar, *'A New Approach to Derivatives: Financial Engineering With Islamic Rules'*, (Capital Markets Board of Turkey, Expert Eskisehir Yolu 8. Km No:156 Ankara)

and the contract is confirmed. In case of Bay' al-'Arbūn, however, the option premium is adjusted in sale price when the contract is confirmed'.[453]

The main difference between *Bay'* Al-'Arbūn *and* a traditional call option is that, in '*Arbūn*', the deposited money becomes a part of the price of the subject matter of the contract while in the case of a conventional 'call option', the down payment is not a part of the actual price rather it is the price of the of the 'right of option' bought which will not be adjusted when the right holder confirm the contract.

6.9.6. Islamic Versus Conventional Options

Based on the above mentioned discussion differences of Islamic option and conventional option may be summarized as follow:

	Islamic option	Conventional option
1	Option is deemed as earnest money	Premium- cost to buy the option
2	Option is not tradable (international Sharī'ah standards)	Option is tradable
3	Underlying asset must be compliant	Underlying assets must not necessarily be compliant

Some scholars of Islamic finance have suggested the concept of *al-'urbun* to replicate conventional option in Sharī'ah compliant manner. By concluding *al-'urbun* contract, the buyer must pay a deposit to the seller in advance, but commodity delivery will not be executed until after the payment of the price in full, either during the option period or when

[453]Muhammad Ayub, Derivatives and Islamic Finance, Research paper available at www.sbp.org.pk/departments/ibd/derivatives_islamic.pdf, access dated 16.08.2016.

it expires. However, it is not possible for Islamic financial institutions to exploit *'urbun* except in the case of purchase as they cannot use it to sell anything before the good is possessed by them (Mohd. Daud 2008). Hence, concept of *al-urbun* is suitable only for the right to purchase, not the right to sell. Therefore, Aznan (2010) views that "structuring of *al-urbun* to replicate the conventional call option is complicated and may contradict Sharī'ah principles if it not considered carefully".

6.9.7. How can 'Arbūn serve as alternative to Call Option.

As we have mentioned earlier that the basic resemblance of the 'Arbūn *and* a call option is that both can be used as risk reduction strategies. For example, we may oppose that "a bakery owner wishes to expand his business and thinks that the current market price of $2.50 per bushel of wheat is reasonable. He may want to lock into the current market price for six or nine months ahead, and yet, because of the element of uncertainty in the success of his expansion plan, he may choose to tread cautiously and decide to limit his possible loss to a small amount but still be able to reserve the price level for the next several months. This he can do by means of buying a call option on, say, ten wheat contracts of 5,000 bushels each, but instead of committing himself to the full price of such a large contract he may decide to pay an option of $100 per contract. This means he will have limited his possible loss to only $1000. The basic notion can also operate along similar lines: the buyer risks a small amount of money to give himself flexibility and also to limit his possible losses to a much smaller amount".[454]

[454] Kamalī, *Islamic Commercial Law an Analysis of Options and Futures*, 369.

'Alī El-Gārī, has upheld that "achieving a balance between the two formulas is not difficult. If we assume the presence of a central authority (or several central authorities), such as the stock exchange authority or the clearinghouse that concludes these contracts including one hundred shares, for instance, for a fixed price on the basis of delivering them within a specific period (90 days for instance). Instead of the investor's payment of a price for the option, he may pay a certain percentage of that amount on the basis of advance on the sale. If he feels that it is in his interest to go ahead with the sale during the period of time specified, he may sign the contract. If he feels that this course of action is not in his interest, he will give up his claim to the advance payment. Such a percentage may be raised or reduced depending on the factors of supply and demand. What is paid against the transfer of risk is not the least affected by the fact that such payment is a lump sum or a percent- age of a sum known well in advance. Therefore, the formula suggested above is quite appropriate to serve as a model for the call option and does not involve any contradiction with the rules and requirements of the *shari ah*".[455]

On the other hand, after quoting parts of Ibn Qudamah's analysis on *'Arbūn,* Vogel and Hayes said, "The discussion shows how closely the *'Arbūn contract* can be analogized to the pure call option. It also shows how, if it has been given the right market or institutional framework, an *'Arbūn contract* could be devised with results and pricing identical or nearly identical to the call option".[456]

Accordingly it could be concluded that *'Arbūn* could be the Islamic alternative to a call

[455] See, Mohamed 'Alī El-Gārī, "*Toward an Islamic Stock Market*" (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, Saudi Arabia, 1993), 14.
[456] Frank, E. Vogel and Samuel Hayes, '*Islamic Law and Finance, Religion, Risk, and Return*' (The Hague: Kluwer Law International, 1998), 162.

option without contravening *Sharī'ah* principles.

6.9.8. *'Arbūn as an Alternative to Put Option*

So for as the alternative to put option in connection with *'Arbūn* is concerned it will be possible to include a condition in the contract that "if the seller fails to fulfill his contractual obligations, he should pay the buyer a certain amount in the form of reverse *'Arbūn*". Although the issue has not been directly addressed by the classical scholars, the case of *arbūn* in *salam* discussed above is somewhat similar to this one.

This issue may be properly understand with the help of an example of such a transaction and how it is needed, it could be said that "a retailer may enter with another into a *salam* contract to purchase 1 million barrels of oil at a price of US$25 a barrel, which is to be delivered within six months' time. The buyer here is hoping that the price of oil in the coming six months will reach US$30 a barrel. Then, he will take delivery from his counterpart and sell his stock on a retail basis to his client on the spot market to make some profit. He pays the price at the time of contract, as it is stipulated by the majority, or some time later, according to the Malikīs. However, four months after the signing of the contract, the buyer realizes that his prediction may not be true due to some external factors, such as weather, which is not as cold as it was in the year of issue and therefore, the demand for oil fell unexpectedly resulting in sharp drop in the price of oil. Or some oil producing countries, due to domestic economic problems, increase their quotas of production which affects negatively the price of oil in the international market which is now US$23 a barrel and there is even a possibility that it may go down to US$20. In such a case, the buyer may be willing to rescind the contract and collect his money. After negotiations with the seller, the contract is cancelled and the buyer has relinquished US$2 per barrel to the seller in exchange for this cancellation. In such a case, the buyer has minimized his loss. Thus, rather than losing US$5 per barrel, in case he would have taken delivery from the seller on the agreed date, now he is just losing US$2 per barrel".[457]

In this regard Muhammad Al Bashir stated that "Although such a transaction is permissible as a kind of *iqalah* based on what is reported in Musannaf 'Abd al-Razzāq and Ibn 'Abī Shaibah based on the opinion of the scholars mentioned above and could solve the problem of such a risk partially, it is not sufficient in today's volatile and complex economic climate. It is quite possible that the seller may not be willing to cancel the contract and consequently the buyer may suffer a huge loss. Thus, to manage such a risk, the buyer may be willing from the beginning to include a condition in the contract to the effect that if the purchaser fails to take delivery, for one reason or another, during an agreed period, he will have the right to rescind the contract on condition that he forfeits to the seller US$2 per barrel".[458]

Some modern Muslim jurists have addressed this issue. Al-Sanhuri, for instance, is of the opinion that if the seller, who has already received the *'Arbūn*, fails to fulfill his

[457] Muhammad al-Bashir Muhammad al-Amine, '*Risk Management in Islamic Finance An Analysis of Derivatives Instruments in Commodity Markets*', Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), 238
[458] Ibid

obligation, he should return twice the amount of the first *'Arbūn as* compensation to the buyer. This opinion has also been endorsed by Rafiq al-Masri who did not see any difference between the originAl-'Arbūn *and* the reverse *'Arbūn.* In both cases, the payment is in exchange for the right to cancel the contract or an option with a price. Al-Masri" added that by giving this right to both parties, the transaction will be much fairer than just giving it to one party.[459]

However, some other jurists like al-Darīr have rejected the reverse *'Arbūn without* further analysis on the grounds that such a clause is only discussed under secular legislation and not under Islamic legal works. It should be noted that almost all Arab legislation has opted for the legality of reverse *'Arbūn,* including the Jordanian civil code which is recognized as being based on the principles of Islamic law principles. Thus, al-Sanhūrī tried to prove that the reverse *'Arbūn is* in accordance with Islamic principles. However, according to al-Darīr, al-Sanhuri did not take the right path in this case.[460]

However, despite al-Darīr's conclusion, it seems that al-Sanhuri's argument is legally well established. Al-Sanhuri maintained that "if Imam Ahmad based his argument on the adoption of *'Arbūn* by drawing an analogy between *'Arbūn* and the legality of the case where a person, who has bought something but after some time wants to rescind the contract, could do so by relinquishing part of the price to the seller. Therefore, based on Imam Ahmad's analogy, we can say that, as al-Sanhuri argued, it is possible to give to the

[459] Rafiq al-Masrī, "Bay' al-'Arbūn", 730.
[460] *Mjallat Majma al-Fiqh al-Islaīī,* discussion (about *'Arbūn),* 759.

seller also the right to rescind the contract and pay the amount of *'Arbūn twice*. Moreover, if it is permissible to give the right to the buyer or the seller to rescind the contract in exchange for something, it is possible to grant it to both of them in a contract at the same time".[461]

Considering this difference of opinion and the absence of any explicit text regarding the issue, we will try to accommodate it in line with the general theory of freedom of contract. Thus, it is clear that such a stipulation does not contradict the objective of the contract or any explicit text. Moreover, it is to the benefit of the contract and agreed upon by both parties with their full consent. Therefore, it is a legal condition or clause as Imam al-Shaf 'ī said, "in principle all contracts are permissible if they are concluded with the full consent of the parties unless there is an explicit text from the prophet to prohibit such a sale, or such a prohibition could be understood from the explicit text".[462] Similar statements have been echoed from different scholars of the different schools of Islamic law.[463] Thus, it could be concluded that the reverse *'Arbūn* is legally permissible and could serve as an alternative to a put option.

[461] Abd al-Razzaq al-Sanhuri, *Masadir al-Haq*, Dar al-Ma'arif, Cairo, vol. 2, 96.
[462]Quoted by Muhammad Al-bashir. Al-Shaf 'ī i *al-Umm*, vol. 3,. 3; Ibn Rushd, *al-Muqaddimāt al-Mumahhidāt*, vol. 2, 61–62.
[463] See for instance, Ibn Rushd *al-Muqaddimat al-Mumahhidat*, vol. 2, 61–62; Ibn Taymiyyah, *Majmu al-Fatawa*, vol. 29, 226; Ibn 'Ābidin, *Rad al-Muhtar*, vol. 4, 176.

6.10. Swap Contracts

Swaps contracts are another important and smartest nature of contracts in derivative market frequently used by conventional institutions over the last two decades.[464] They are different in nature from the other derivative instruments, especially, because swaps contracts do not take place in an organized or regulated market, therefore, are not subject to any legal conditions acknowledged in the trading process. The most important aspects of swaps can be clarified as follow:

6.10.1. The concept and meaning of Swaps

Various definitions of swaps have been carried out by the scholars based on their nature and forms. However, swaps are generally defined as "a contractual commitment to exchange cash flow or a particular asset for another cash flow or asset with certain agreement conditions"[465]. Others have defined as "swap representing an agreement between two or more parties to exchange a series of cash flows during a future period "or as "series of contracts that are subsequently implemented and settled at periodic intervals"[466] Another scholar has denied Swap as "as a financial transaction in which two counter-parties agree to exchange streams of payments overtime according to a predetermined rule"

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[464] Ayub, Use of W'ad and Tawarruq for swaps in the frame work of Islamic Finance, Research Paper, available at www.iefpedia.com/english/wp-content/uploads/2011/12/Muhammad-Ayub.pdf, access dated 15.2.2017.

[465] Ramadan, Ziad, '*Principles of Real Financial Investment*. Amman: Dar Wael. Trad, Ismail, 1998), 133

[466] Nazih Hammad, '*bay al-kāli bi al-kāli*' (Jeddah: Markaz, Abhāth al-Iqtisād al-Islāmī. Jāmi at al-Malik Abd al-Azīz, 1986), 28.41

From the above mentioned definitions, we can derived a set of criteria or contents, which may help in the understanding the nature of swaps contract, important ones are:

- Swaps include a huge bowl that makes it possible to swap in securities, interest rates and to exchange goods and currencies through swaps etc.
- Swaps are binding contracts in nature, they are binding on both of the counter parties, unlike options contract. Moreover, swaps contracts are settled on a regular basis rather than a daily basis as is the case of futures contracts.
- Swaps are devised to manage risks especially in the area of interest rates and currencies. In reality, the speculators continuously in struggle to divert the interest rate and exchange rate movement towards their interests, and to reduce the risk of any unexpected losses.

There are various kinds of swaps currently used by the conventional finance, however, the most common are interest rate (IR) swaps, currency swaps, credit default swaps, commodity swaps and equity swaps, and each category has their own importance and specification.

While declaring the objective of swaps Muhammad Ayub stated that they are excessively used for speculative activities to maximize the gain and as compared to any other derivatives, they are provide the highest degree of leaverage which could lead to insolvency of any big financial institution and even distort the whole system".[467] Likewise caution has been given by Dr. Alfred Steinherr (1998: 200) in the following words:

[467] Muhammad Ayub, Use of W'ad and Tawarruq for swaps in the frame work of Islamic Finance, Research Paper, available at www.iefpedia.com/english/wp-content/uploads/2011/12/Muhammad-Ayub.pdf, access dated 15.2.2017.

"Derivatives are Dynamite for financial crises and the fuse wire of the international transmission at the same time. Unfortunately, the ignition trigger does not seem to be under control." Due to the high speculative benefits swaps deals increased exponentially as compared to other deals.[468]

6.10.2. Islamic Swaps

With the fast growth in the Islamic finance industry, like other markets, various hedging instrument in relation to the money market have been suggested by the modern scholars to replicate the conventional swaps. We have discussed the major instruments like Islamic Forex swaps, Islamic Cross-Currency swaps, Islamic profit rate swaps based on Murābahah and *Wa'ad* structure along with their detail process flow, mechanism and their sharia compliance have been mentioned in detail in the previous sections.

6.11. Summary

On the basis of Sharī'ah reservations and arguments advanced by the Islamic Jurists. it can be said that Conventional Derivatives are Sharī'ah Non-compliant. Hence, cannot be used in Islamic finance. However, this non-acceptance have lead and deprived the financial institutions and corporation of many advantages associated with derivatives as a suitable risk transfer mechanisms specially when they want to expand their activities well beyond their original jurisdictions to almost all over the world. This global diversification of Islamic finance will definitely require new and more flexible updated instruments to

[468] Ibid

manage the associated currency and other risks. Due to today's un-avoidable international business requirement and considerable demand from the public, a sharia compliant instrument for management of risk and for the competitiveness of the Islamic financial institutions and corporations is essential.

A number of instruments /contracts exist in Islamic finance that could be considered and used as the basis or building block for derivative contracts within an Islamic framework. These contracts include but not limited to *Bai Salam, Wa'ad, Murābahah, Istijrār, Khiyār Al-Shart*, Bay' al-'Arbūn. In this chapter, we have discussed in detail the theatrical i.e. jurisprudential concept and requirements of these instruments and practical procedure (modus operandi) along with cash flow and industry usage of these Islamic concept/ products have been made which can simultaneously achieve the same goals as those provided by conventional derivative instruments.

After comprehensive Discussion on *Bay Salam*, we can say that *salam* is in line with *qiyās* and not against it, and it could be form the basis of *qiyās* , and it could be used a financing technique for generating working capital. The *salam* based structure is basically to replicate the mechanics of conventional short-selling, although different solutions seem more acceptable for different regions, however, many Saudi scholars prefer the *Salam* contract for equities.

The concept on *Wa'ad* is one of the most flexible and useful concept used in almost all products of Islamic Finance. *Wa'ad* has also been considered to be the possible version of the forward contract in Islamic finance as mentioned by the modern jurists, though, this concept is still under debate among the jurists. However, more financiers look to this concept with sympathy. Since the procedural aspects of conventional forward contract is not correct according to Sharī'ah due to deferment of both counter values, *Wa'ad* is seen as the most suitable principle to be adopted in the forward contract. Hence, forward foreign exchange transaction may be done on a promise basis instead of a contract. "Under *Wa'ad* structure, only one party promise to buy/ sell certain asset or currency in the future and he is bound by that promise. While the other party will proceed with the promise undertaken by the promissory. Even though *Wa'ad* is binding upon the promissory, but it is not deemed as contract under Islamic law. This is because contract will bind both parties. Islamic financial institutions can enter into forward foreign currency transactions for hedging purposes based on *Wa'ad* but no fee is to be charged on the promise. This is due to the fact that upfront cash payment for forward currency transaction would lead to a bilateral *Wa'ad* which was not allowed by *Sharī'ah*. This is in line with the view of the majority jurists who opined that unilateral-binding *Wa'ad* without any consideration was permissible in a forward currency transaction.

Murābahah is a sale transaction (also known as cost-plus financing) and commonly used as Shari'a compliant financing technique, on the asset side of the bank's balance sheet. *Murābahah* is particularly popular and frequently used as Islamic financing technique in the realms of consumer finance and asset finance. Further, *Murābahah* can also be used as a building block for *Sharī'ah* Compliant derivatives such as profit rate swap and/or a cross-currency swap as discussed above in detail.

The new innovated concept of Istijrār and it industry usage along with its stepwise procedure, price determination and documentation have been analyzed which shows that Istijrār is an agreement between the buyer and the seller, where a buyer purchases a particular asset on different intervals on an on-going basis from the seller; there in no need of bargain or offer or acceptance each time. All the terms and conditions upon which Istijrār to be executed are confirmed in a master agreement. Bacha described Istijrār contract as the most complicated among the Islamic contracts which is based on the complex combination of the options, average prices and Murābahah agreement (cost plus profit mode). What the Istijrār contract attempts to do is to allow for the impact for price changes but to cap the benefits that accrue. Since changes are allowed only within a band, the advantage to one party and the disadvantage to the other is capped. The maximum potential gain or loss is limited. Such a contract fulfills the need to avoid a fixed return on risk less asset which would be considered riba and also avoids gharar in that both parties know up front price and the range of other possible prices. (This concept is recently developed and use in Pakistani market, although yet, has not get frequent utilization by the IFIs)

From the discussion on *Khiyār al-shart*, it is clear that *Khiyār al-shart,* as a tool of risk hedging could serve and fulfill the benefits of conventional options. Moreover, while considering the legality of charging a fee for giving the option, will bring the *Khiyār al-shart* in a similar position to the conventional option as a tool of risk management. Although some jurists have objection to such a proposition on the grounds that the subject matter in such a transaction will be a pure right, which is not eligible to be the subject matter of a contract. However, the others have rebutted the same as we have mentioned the same in detail in the legality of option.

Some jurists are of the openion that on the basis of ''Arbūn ' a *Sharī'ah* compliant instrument may be developed like option contract by which one party (the buyer)will buy the right to purchase from the other party (the seller) identified assets for a determined price on a certain date. The "purchaser" pays to the "seller" at the inception on the contract a deposit, and the purchaser has right to revoke his commitment at any moment.

Some scholars of Islamic finance have suggested the concept of *al-'urbun* to replicate conventional option in Sharī'ah compliant manner. By concluding *al-'urbun* contract, the buyer must pay a deposit to the seller in advance, but commodity delivery will not be executed until after the payment of the price in full, either during the option period or when it expires. However, it is not possible for Islamic financial institutions to exploit *'urbun* except in the case of purchase as they cannot use it to sell anything before the good is possessed by them. Hence, the concept of *al-urbun* is suitable only for the right to purchase, not the right to sell. Therefore, Aznan is of the views that the structuring of *al-urbun* to replicate the conventional call option is complicated and may contradict *Sharī'ah* principles if it not considered carefully.

Swaps contracts are another important and smartest nature of contracts in derivative market frequently used by conventional institutions over the last two decades. They are different in nature from the other derivative instruments, especially, because swaps contracts do not take place in an organized or regulated market, therefore, are not subject to any legal conditions acknowledged in the trading process. Islamic alternative to Swap i.e FX Swaps, Cross Currency Swap and Profit Rate Swap as the main products based on the combination of above mentioned Islamic contracts along with *Bay' al-Sarf* have been examined with proper procedure, cash flow and industry practices which may paved the way of competition for the Islamic society in the relevant global financial market.

CHAPTER NO. 07

LEGAL PERSPECTIVE OF THE DERIVATIVES

In this chapter we will discuss the legal frame work and governance issue for the emerging Islamic financial industry in general and the legal frame work related to Derivatives Market in particular. The existing legal provisions available for Islamic Derivatives with special reference to Pakistani legal system have been examined and further suggestions and recommendation has been given. To proceed further, it is well-meaning that the nonexistence of the uniform and definitive guidance on sharia compliance. the lack of uniformity and harmonization is compounded by the absence of a codified body of laws and regulations governing *Sharī'ah*- compliance of the products and divergence of opinions of the jurists based on their own *Fiqhī* Jurisdiction are the overall issues and hindrance in the development of an efficient Islamic Legal system for Islamic Financial Institutions.

For the development and growth of any industry, an enabling policy environment and legal frame work for implementation is the pre-requisite and Islamic Banking industry is not an exception to this rule. However, legal frame work and governance issue is one of the major challenge for the new emerging Islamic financial industry. This is also one of the main protest of the critics to the validity of the Islamic financial system. In the recent years, the incredible growth in the Islamic finance industry at global level has provoked several commentators to demand for the existence of a proper legal system and regulatory bodies at central/regional level for Islamic Financial Institutions.[469]

[469] Frank Kane, 'The West's bankers may learn from their Islamic brothers', http://www. thenational.ae/apps/pbcs. dll/article?AID=/20090307/ USINESS/448194510/1005, access dated 2.5.2017.

Financial contract, being the backbone of everyday dealings, the basis of these contaract have been derived from the basic sources of Sharīʿah[470] (a) the *Quran*, (b) the *sunnah* (the practices, writings, pronouncements and examples of the Prophet Muhammad (SAW), (c) *ijma`* (consensus, particularly the consensus of the community of scholars or the -assembly of the learnedl), and (d) *qiyās* (or analogical deductions and reasoning). These sources have established the foundation of various commercial contract and attendant liabilities.[471]

Although sharia rulings *(fatwas)* (and their underlying reasoning) are disclosed by the Islamic jurists to each and every product, based on the on the Sharīʿah principles. However, due to the absence of unified principles on which sharia scholars relay for the Sharīʿah compliance of the new products, these rulings and *fatwas are* not consolidated, which inhibits the adoption, and cross-fertilization of Islamic banking products across different countries and jurisdiction.

As the inferences of the modem jurists are variant and their interpretation and reasoning are based on different grounds. Moreover, this was further clouded through differences of the scholars among the various *Madhāhib i.e Hanafī, Malikī, Shafʿī and Hanbalī* and their preference on the basis of their affiliations.[472]

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[470] H. Askari, Z. Iqbal & A. Mirakhor, *'Introduction to Islamic Economics: Theory and Application'*, (Singapore: Wiley, 2015), 2.

[471] N. Mohammed, *'Principles of Islamic Contract Law'*, (Journal of Law and Religion 6(1) (1988), 115-130.

[472] *See*-M. Obaidullah, *'Ethical Options In Islamic Finance'* (India:Xavier Institute of Management, 1997), *6.*

Therefore, the split opinions of the various sharia boards (which act as quasi-regulatory bodies), remain a source of continued divergence of legal opinion about the new products. Particularly, the level of this divergent of opinion of the Sharī'ah Scholars based on different grounds is too much with the respect of the legality of derivatives, which testifies the general controversy about derivatives to be used as a tool of risk management.[473]

The legal integrity of the Islamic financial system in general and derivative instruments in particular has been largely affected by the nonexistence of the uniform and definitive guidance on sharia compliance. Further, Regulatory consolidation, supervisory harmonization through standard setting and development of Islamic Legal system for the Islamic Financial industry is still at an early stage. Prominent regulatory bodies and organizations in Islamic finance, such as the Accounting and Auditing Organization of Islamic Finance Institutions (AAOIFI), the General Council for Islamic Banking and Finance Institutions (GCIBFI), Islamic Financial Services Board (IFSB), the Islamic International Rating Agency (IIRA), International Research and Training Institute (IRTI) and, most of all, the Fiqh Academy in Jeddah, have been working on the alignment of sharia principles on a consistent basis and they have successfully achieved various tasks. Further, the efforts of

[473] Andreas A. Jobst, '*Derivatives in Islamic finance*, available at http:// papers.ssrn.com/sol3/papers. *Derivatives increase liquidity*, available at http:// www.asx.com.au/profession- als/companies/derivatives increase liquidity.htm, last accessed dated 10.05.2016. See also Peter Kunzel, Paul Mills and Amadou Sy, ''*Islamic Bond Issuance—What Sovereign Debt Managers Need to Know*' , *International Journal of Islamic & Middle East Finance and Management* (2008),14

Accounting and Auditing Organization of Islamic Finance Institutions (AAOIFI), and the Islamic Financial Services Board (IFSB) to the produce guidance notes and *Shari'ah* standards etc. are commendable, however, all these, yet not achieved the desired level of harmonization.

For example, in December 2006, IFSB (Islamic Financial Services Board) has published the 'Guiding Principles for institutions offering only Islamic financial services (excluding institutions offering takaful and Islamic mutual funds)' and a working group has been established to address implementation issues. The guiding principles (Seven in number) issued by IFSB can be divided into (i) General governance approach of IIFS;(ii) Rights of investment account holders (IAH) (iii) Compliance with Islamic Shari'ah rules and principles; and (iv)Transparency of financial reporting in respect of investment accounts.

Similarly, the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) has issued various standards such as Accounting and Auditing Standards, Sharī'ah standards, Governance Standards for Islamic financial institutions, which are related to appointment, composition and removal of the Shari'ah Supervisory Board. However, the adoption of these standards and guiding principles are not mandatory for IFIs in Pakistan, though SBP is a founding member of these institutions is likely to consider the adoption of these standards and principles for Islamic Banking Industry in Pakistan with appropriate amendments, wherever required. Thus, there is a need for setting up of Islamic Financial Accounting, Auditing and governance standards for IFIs in Pakistan.

Mostly, regulation is carried out at the micro and local or regional level, as the banks appoints their own Sharī'ah Boards who examine and monitors Shari'ah compliance of new products/transactions. However, divergence of rulings of the different Sharī'ah Boards lead to the lack of uniformity mentioned above. The impact of such divergences of opinion among the Sharī'ah scholars as highlighted by Taqi Usmani through a declaration in 2007 and declared that up to majority of the sukuk (upto 85% of the sukuk-based products) in the market, at that date, were not Sharī'ah compliant and hence, unenforceable. The sukuk market was then restored after the boundaries of permissibility have been declared by AAOIFI in 2008. Another outlook of such divergences take shape on a cross-jurisdictional basis. For instance, *bay al-'Arbūn* has been used as a product in Malaysa where as in Pakistan it is not yet acceptable and the validity of *bai bithaman ajil* contract is is not recognized in the GCC region, where as it is viewed as Shari'a compliant in South-East Asia.

Moreover, various commentators, such as Sheikh Yusuf Talal de Lorenzo, criticized the Sharī'ah compliance of the complicated derivative products on the ground that majority of the financial decisions are based on the profit maximization which in turn erode Sharī'ah tenets. They further, argued that "Shari'a- wrapping i.e. the tendency of certain Shari'a Boards to approve financial products that are delivered by ostensibly halal means (even if the actual return delivered by those products is ultimately derived from non- compliant investments) is threatening to obscure and override Shari'a-based products i.e. products which are rooted in the Shari'ah, rather than being merely superficially compliant".[474]

[474] Sheikh Yusuf Talal de Lorenzo,74

So far as legal aspect of Islamic Derivatives are concerned, they are at too initial stage, efforts to introduce legal standards and uniform market practices for sharia-compliant derivatives have started only recently. Although profit rate and currency swaps have been successful introduced in several Islamic countries but general legal benchmarks for Islamic derivatives are yet to emerge, due to divergent market practices and lack of consolidated and unified sharia approval process, and the non-binding character of precedent in Islamic jurisprudence

7.1. Current Regulatory Frame Work (Legal grounds available for these instruments) In Pakistani Legal system.

In Pakistan being an ideological state, efforts for Islamization of the economy started in the mid-1960s. Significant attempts were made in the mid-1980s for the transformation of financial sector into interest free financial system. However, since early 2000s, Islamic Banking system was re-launched in parallel to conventional banking system to make the transformation of the system gradual and market driven. The recent re-launch of Islamic banking system in Pakistan based on the lessons learnt from the history of Islamic banking efforts in Pakistan and also on the rich experiences of Malaysia and Bahrain and other countries that are currently known for their leading role in the Islamic financial industry.

Islamic financial Industry is less transparent as compared to conventional, particularly with respect to accounting and auditing standards. Although a number of reforms have been carried out in legal and regulatory framework since initiation of transformation efforts in 1980s. However, due to the evolving nature of products and risks of Islamic banking and finance, not only in Pakistan but globally, there is need for an ongoing review of the specific legal, regulatory and supervisory framework to ensure their responsiveness to the evolving dynamics of Islamic finance.

7.2. Over all legal Frame work for IBIs

In 1998, the 1st initiative taken by the Institute of Chartered Accountants of Pakistan (ICAP) to develop a code for best practices. A committee having representation from Institute of Cost and Management Accountants of Pakistan (ICMAP), the ICAP, the Securities and Exchange Commission (SEC) and all the three stock exchanges (KSE, LSE & ISE) has been established and the task to formulate recommendations for the preparation of draft has been given, hence, a draft was prepared and issued by SEC in 2002.

The SEC by exercising its power, conferred to it by Securities and Exchange Ordinance, 1969 of Pakistan (Sec.34 (4). All the three Exchanges have been directed for incorporation of the Code (hereinafter called the Code, 2002) in their listing regulations to be applicable to all listed company in Pakistan. (The code, 2002 was basically a code of best practices, where most of its provisions were not mandatory. Later on a survey was conducted by SECP, ACCA, and PICG in Collaboration with International Finance Corporation (IFC) and recommendations have been given for bringing improvements in the current practices and subsequently, a revised code was issued in 2012).[475]

This Code is primarily, applicable to listed companies in Pakistan. However, as per prudential regulation G-1, it shall be applicable to banks/DFIs subject to, if it does not contradict with the provisions of BCO, 1962, the Prudential Regulations and the instructions/guidelines issued by the State Bank of Pakistan. (It is inferred that the code, 2012 is applicable to IBIs being a bank, so long as it does not contradict the provisions of the above mentioned laws. It means that it is not the code, 2012 which is a core governance code for banks, rather these are BCO, 1962 and other instructions and guidelines issued by SBP, which govern banks. But the BCO, 1962's provisions basically concern about conventional banking companies and not Islamic banking companies).[476] Islamic banking in Pakistan is not properly recognized in the legal framework, and just accommodated through the instructions issued by SBP from time to time thereby allowed the IBIs to offer Islamic banking through various Islamic Banking modes.

State Bank of Pakistan through various instructions and guidelines (in exercise of the powers conferred by section 7 of Banking Companies Ordinance, 1962) has allowed Sharī'ah Compliant Modes of Banking and Finance. For example, in Annexure 1 and Annexure 2 to SBP-IBD Circular No. 02 of 2008 respectively various Shari'ah-compliant modes of banking and finance for IBIs have been explained and allowed. [477]Further, as per

[475] Available at secp.gov.pk

[476] BCO, 1962.

[477] See also State Bank of Pakistan (2008-09)

clause 4 of section E which clarifies that such modes does not preclude the possibility of developing new products by the IBIs with prior approval of their Shari'ah Advisor. So as per section E of the instructions, IBIs may offer others Mode and products subject to that these must be Sharī'ah compliant with prior approval of their Shari'ah Advisor. In addition, as authorized by section 7 of BCO 1962, Islamic Banking Institutions may also engage in other businesses provided that they are *Shari'ah* compliant and clarified by the Sharī'ah Board/Advisor.

The instructions in IBD Circular No. 02 of 2008 (which cover various areas related to appointment, removal and working of Shari'ah Advisors; conflict resolution in Shari'ah rulings; Shari'ah compliant modes; use of charity fund, introduction of new products and services and schedule of services charges etc) provides guidelines for Shari'ah compliance, internal Shari'ah audit, investment in shares, policy for profit distribution etc. Further, these instructions minimum requirements for Shari'ah compliance products. However, where Islamic modes for which essentials have not been prescribed, AAOIFI Shari'ah Standards may be used as guidelines by IBIs in consultation with their SA (Until now, the Shari'ah Standards are not mandatory for IBIs in Pakistan. The SBP in collaboration with ICAP has planned to adopt the AAOIFI Shari'ah Standards with necessary modifications).

Keeping in view the recent developments taken place in the Islamic banking industry in Pakistan, where in the SBP revisited and the previous instructions issued through IBD

Circular No. 2 of 2008, section A, B, C & D of Annexure-1 (Instructions) and Section I & II of Annexure 2 (Guidelines) were replaced with the comprehensive "Shari'ah Governance Framework" issued in April 2014, whereas its implementation was made compulsory from January 2016. Whereas all other instructions contained in the said Circular shall remain the same .were replaced with the primary objective of the framework is to strengthen the overall Shari'ah Governance and compliance environment in the IBIs. This framework (SGF) is a comprehensive document, which covers various role of Board of Directors (BOD), role of Executive Management, Shari'ah Board, Resident Shari'ah Board member (RSBM), Shari'ah Compliance Department, Internal Shari'ah Audit, External Shari'ah Audit, Conflict Resolution, competence of the organs dealing with Shari'ah governance framework, report of Shari'ah Board.[478]However, we can say that overall, available legal provisions with respect to Islamic Banking Industries in Pakistan are in scattered form.

The financial reporting and accounting architecture for IBIs is based on conventional banking and finance transactions, despite of their substantial difference from conventional banking. As the Islamic Banking Products has its own distinctive characteristics and peculiar transactions for which the conventional accounting standards are not always suitable. So, IBIs should to have a standards accounting system appropriate for IBIs' transactions. Up till now, only three Islamic financial accounting standards (i.e. IFAS-1 and IFAS-2 have been issued by ICAP for IFIs in Pakistan. IFAS-1 deals with Murābahah,

[478] See also State Bank of Pakistan (2014-2017)

IFAS-2 with ijarah, whereas, IFRS-3 with Profit & Loss Sharing Deposits). Therefore, we can say that the IBIs in Pakistan, are forced to follow the provisions of BCO, 1962, Companies Ordinance, 1984 and The Code, 2012, which are basically related to conventional banks. Moreover, the Risk Management Guidelines issued by the State Bank of Pakistan (SBP). These guidelines are basically a set of best practices (fifteen principles of risk management that give practical effect to manage various risks) and provide an effective risk management environment for Islamic Banking Institutions (IBIs).

It is inferred that the provisions (i) CO, 1984, (ii) BCO, 1962,(iii) SBP Directives, (iv) IFRS notified by SECP(v) IFAS issued by ICAP and various instructions and Risk Management guidelines are applicable to IBIs in Pakistan: So the accounting, auditing and governance Framework is so scattered for IBIs, which is un-organized and not uniformed in character.

7.3. Legal Frame work with respect of Derivatives:

The State Bank of Pakistan, consequent upon the power delegated by the Banking Companies Ordinance 1962 and Foreign Exchange Regulations Act 1947, has been formulated the Financial Derivatives Business Regulations (FDBR) through BSD Circular No.17 of 2004 to permit, regulate, and supervise financial institutions entering into derivative transactions. All of the financial institution engaging in derivatives business are subject to the approval, supervision and scrutiny of the State Bank of Pakistan. As per the above mentioned regulations entities eligible to undertake derivative business includes to all Financial Institutions, NBFCs, DFIs etc. The Authorized Derivatives dealer, while dealing with such entities, is responsible to exercise due diligence to ensure that their Customers are allowed to enter into derivative transactions as described in 5(a) and 5(b) against their underlying exposure.

According to the State Bank of Pakistan (2011) the following five banks have been granted the license to conduct derivatives business as Authorized Derivatives Dealers (ADDs) in Pakistan: Citibank, Deutsche Bank, Habib Bank Limited, Standard Chartered Bank (Pakistan) Limited, United Bank Limited. In Pakistan, the total volume of derivatives transactions had been increasing. Use of currency swaps and FX options was particularly on the rise due to the stability of the exchange rate in the last few years.

Type of derivative transactions currently allowed under these regulations include to (a) Foreign Currency Options (b). Forward Rate Agreements(c). Interest Rate Swaps. All the relevant detail such as the type, tenor, structure, and specifics of derivatives permitted have been mentioned in the Annexure P-I to P-III of these Regulations. For all other transactions, not covered by these regulations, prior approval of State Bank of Pakistan must be obtained.[479] Further, while conducting the derivative transactions, the institutions are subject to the compliance of all relevant regulations, such as Foreign Exchange Regulations etc. issued the State Bank of Pakistan from time to time. State Bank of Pakistan, periodically examine the material and statements of the financial institution engaged in derivative transaction whether these are in line with the context of its risk

[479] See also State Bank of Pakistan (2008-09)

management system, internal control system, and business processing system etc.[480]

It is worth mentioning here that apart from the above mentioned derivatives instruments, other financial derivatives like foreign currency forward contracts, futures contracts, interest-rate options, etc. are also offered by various financial institutions in Pakistan.[481]In addition to all these, Pakistan Mercantile Exchange (PMEX) is the 1st and only commodity futures exchange in Pakistan. Through this platform, world-class commodity such as Gold, Silver, Crude Oil, and other commodities trading has been carried out, which provide better opportunities for the market participant.[482]

An MOU (Memorandum of Understanding) for the development of master agreement protocol for Islamic Derivative has been signed by the International Swap and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM), in cooperation with the International Capital Markets Association (ICMA). This was the 1st ever attempt, in October 2006, of the joint working group (IIFM/ISDA) for the development of standard documentation for cross border Sharī'ah compliant derivative transaction. [483]. Now, all derivatives

[480] For further details, see Securities and Exchange Commission of Pakistan (2006)

[481] The researcher garnered this information from the relevant banks through e-mail.

[482] See http://www.pmex.com.pk/

[483] Already in November 2006, Malaysia's only fully-fledged Islamic banks, Bank Islam Berhad and Bank Muamalat Malaysia Berhad, broke new ground by agreeing to execute a derivative master agreement for the documentation of Islamic derivative transactions (Andreas A. Jobst, "Double-Edged Sword: Derivatives and Sharī'ah Compliance" (2008) July–August *Islamica* 22). This standardization initiative was sponsored by the Malaysian Financial Market Association (Persatuan Kewangan Malaysia) with the participation from both Islamic and conventional Malaysian banks in a bid to buttress Malaysia's aspirations of becoming a center of Islamic finance.

transaction to be carried out by the Authorized Derivatives Dealer (ADD) or Non-Market Maker Financial Institution (NMI) are subject to the execution of International Swaps and Derivatives Association (ISDA) Agreement to be exchanged with the other entity. Furthermore, the recently issued MATP (Master Agreement for Treasury Placement) in related areas of Capital Market have shown hopeful results to contribute towards standardization of documentation for the sharia-compliant commodities market.

In Pakistan, "derivatives based on financial assets trade on the Pakistan Stock Exchange (PSX), while commodity-based derivatives trade on the Pakistan Mercantile Exchange (PMEX).While the trading of cash settled and deliverable equity futures on the PSX started in 2001, the PMEX became operational in 2007. Despite the exceptional performance of the Pakistani stock market in recent years, investors' interest in exchange-traded derivatives is marginal, resulting in unimpressive turnovers. In fact, Pakistan's derivative markets rank the lowest in the region in terms of volumes traded".

The Financial Derivatives Business Regulations, as mentioned above, emphasize that the institution carried out the derivative transaction must establish a proper Risk Management System, Internal Control and Compliance System, and a Processing System matching with the scale, nature and complexity of its derivatives business.

Clear policy and standards in relation the qualifications of dealers, analysts and other staff shall also be formulated by the institution, which shall cover the training related aspect of the staff that corresponds to the complexity nature of derivatives transactions and the associated risk management, to ensure that they possess the necessary skills and qualifications, Moreover, Responsibility of the senior management of the financial institution have been declared that they shall understand the risks associated with the derivatives transactions. They shall review and approve the policies and procedures for the operation of business authorization and an independent risk management function, a sound examination and reporting system to properly manage derivative business. In addition to the credit risk management, the Regulations also emphasize that collateral or other techniques to reduce credit risk of the counterparties may be used. Similarly, various risk assessment methods shall be used to assess the market risk of derivatives, level of risk exposure and type of transaction to adjust derivative business scale.

Due to high speculative nature, excessive usage and unregulated framework, derivatives is blamed for the financial crisis in 2008. Therefore, extreme caution has been exercised by the PSX, PMEX, and SECP while developing necessary regulatory frameworks for the use of derivatives, which in turn have hampered their promotion, acceptance and growth in Pakistan. Though, significant attempts towards the progress and growth has been made to grow derivative markets in Pakistan, however, the desired results with respect to increased volumes, values, and product innovation especially Sharī'ah compliant product innovation are yet to be achieved.

Suggestion and Recommendation for the legal frame work has been given in the subsequent chapter.

CHAPTER NO. 8

CONCLUSION

This research examined the basic concept and evolution of conventional derivatives, discussed their evaluation, needs and benefits along with the Islamic viewpoint regarding their use. The discussion and analyses of Sharī'ah arguments clearly shows the presence of flaws and reservations on conventional derivatives which renders these instruments namely Forward, Future, Options and Swaps Sharī'ah non-compliant and not suitable to be used under Islamic Finance. Thus, it is submitted that all these contracts are not permissible in Islamic law in currencies, interest rate and stock indices due to the clear involvement of *riba* or excessive risk which is a form of gharar.

The literature review and the relevant discussion shows that there is no consensus of opinion on the validity of derivatives. Majority of the scholars have taken a different approach and evaluated them on the basis of contractual arrangement to arrive at their conclusion on validity. Further, their conclusion also appears to be based on their individual perception of derivative instruments. Moreover, it was observed that majority of the scholars seem on safer side that is the side of conservatism, however, such a position have placed Islamic institutions in a disadvantageous position. Although some scholars have mentioned that they can be accepted and used under certain circumstances along with certain adjustments but their arguments are weak and can not be accepted in Islamic environment.

The majority *Sharī'ah* scholars who objected to the permissibility of conventional derivatives have stated the reasons that futures sales, due to the deferment of both counter-values is a sale of one debt for another (*Bay' Al-kāli' bi al-kāli'*), which is forbidden in *Sharī'ah*. Moreover, counter-values in Futures and Options sales are nonexistent at the time of the contract and they involve high risk and *gharar* resulting from the sale of what is not in the possession of the seller, debt by debt sale and gambling is prohibited. Moreover, another main reason of the prohibition is the falsity of these contracts. As these contracts are ended by cash settlement and many of them are conducted on prohibited assets, in fact, these are not genuine contract.

However, most of these objections have been rebutted by some modern scholars including Kamali and have mentioned various reason and justification. They said that apparently the upholders of these objections, have ignored the operational procedure of the futures and have premised on theoretical *Fiqhī* positions on conventional sale. Point wise elaboration of these objections along with their basis and counter counter-arguments and rationales have been mentioned in detail in the relevant chapter. On the basis of strong analyses and justification, with these scholars in some respect like, the nonexistence of the underlying asset may invalidate the contract in principle. However, it is clear from the fact that it is not the nonexistence of the asset per-se, which invalidated the contract, but rather, the existence of excessive uncertainty and *gharar* that makes the contract invalid. If *gharar* is removed, then the nonexistence of the subject matter at the time of the contract should not invalidate the contract, therefore, we are of the view that the approval in such cases may be given on case to case basis, after proper analyses by the advisors and proper attention is required in this respect.

Another example is that of a forward contract in commodities, as mentioned by the modernist that it is required to be permissible contract since it does not contradict any clear text of the *Sharī'ah* and there is a general need for it either by individual businessmen, companies or even by governments. Moreover, it is clear that this contract is rejected by many contemporary Muslim jurists on the grounds that it contradict the "*hadith*" about *bay' al-kāli' bi al-kāli'*, the *ijma* which is believed to have materialized upon this "*hadith*" or the principle "do no not sell what is not with you" are all weak arguments as explained. This is because the *hadith* is unanimously agreed that it is a weak *hadith* and therefore, could not be a genuine evidence. Regarding the *ijma* it is unanimously agreed that not all form of sale of debt for debt are illegal or *haram*, therefore, even if we admit the existence of an *ijma* regarding the prohibition of the sale of debt for debt it would definitely include only some forms of sale of debt for debt and not all. However, there are different opinions about what kind of sale of debt for debt is covered by this *ijma*. And it is the principle in Islamic jurisprudence that whenever specific evidence is doubtful it shall be rejected Therefore, it is submitted that even if we accept the existence of an *ijma* it would be limited only to cases of sale of debt for debt involving *riba* or excessive *gharar* which are definitely not present in case of the conventional forward contract. So the same justification seems to be preferred as compare to the conservative approach.

It is also submitted by the modernist that the claim of the few scholars "that there is no benefit in forward contract is unwarranted as it is an established fact nowadays that the forward contract represents the backbone of contemporary international trade and no country or company can ignore its importance in managing its businesses. Ironically, many contemporary scholars have admitted the legality of *'Istisnā'* where both counter values are deferred, typically as it is the case in the conventional forward contract based on *istihsan* and need but rejected the conventional forward contract. Perhaps for the simple reason that *'Istisnā'* is admitted by the early Hanafī jurists while the conventional forward contract is not. However, it is submitted that if these contemporary Muslim jurists have opted for the legality of *'Istisnā'* based on the Hanafī s opinion and, putted aside the opinion of the three other schools which regard *istisn* as an illegal contract, due to the need for such an independent contract in contemporary business, they have to accept, similarly, the legality of the conventional forward contract which has the same legal characteristics as *'Istisnā'* and which is much needed today than *'Istisnā'* itself. Therefore this approach and justification is also needs to be properly review by the Sharī'ah scholars instead of to prefer the safe side.

Moreover, alternative to futures and forwards as proposed by the opponent is that a *salam* contract. However, a number of scholars and economist have expressed that the *salam* could not solve these problems and there is a genuine need for the forward contract. Hence, the proposed *salam contract is* the only alternative means putting the society and Islamic minded businessmen in a disadvantageous position so, they may invest their wealth and undertaken transaction in foreign financial institutions for better planning and management even that will lead to a clear contradiction with the principles of Islamic law. Thus some scholars, who are also members of the Islamic Fiqh Academy and regular participants of al-Barakah forum such as Mukhtar al-Salami,[484] Rafiq al-Masri,[485] Hasan al-Jawahiri[486] Muhammad 'Ali al-Taskhiri,[487] accepting this contract and rejecting the claim that it is a kind of prohibited sale of debt for debt, the sale of nonexistent, a sale of *gharar* or a sale without benefit.

However, implementation of the following necessary recommendations in the forward and future contracts will remove the ambiguity in these contracts:

- The contract must not include any prohibited element such as *riba*, excessive *gharar*, and gambling *(maysir)*.
- The intention of such contract must be for genuine buy and sell (economic activity).
- The clearing house must ensure the availability of the underlying asset though in future and possession the underlying assets before entering into these contracts.
- The contract do not include currencies to avoid *riba* as they can only be traded on spot market and hand to hand.
- The contract must be conducted on *halal* products or on assets that are accepted in Islamic law (*halal* commodities).

[484]Mukhtar al-Salami, *"Tajil al-Badalayn Fi al-Uqud"*, (Nadwat al-Barakah al-Tasiah Asharah lil Iqtisad al-Islami Makkah al-Mukarramah, 1421H, December 2–3, 2000.
[485]Rafiq al-Masri, *Munaqasat al-Uqud al-Idariyyah*, Dar al-Maktabi, Damascus, 1999.
[486]See the discussion regarding *Uqud al-Munaqasat Majallat Majma al-Fiqh al-Islami*, no. 9, vol. 2, pp. 308–309.
[487]*Majallat Majma al-Fiqh al-Islami*, no. 9, vol. 2, pp. 297–306.

- Finally, the clearinghouse must be included in all transactions as guarantee to all parties in an attempt to eliminate *gharar* resulting from counterparties' risk and ensure underlying asset delivery.

The use of conventional derivatives are relatively lesser in Islamic countries. However, this have lead and deprived the Islamic financial institutions and corporation of many advantages associated with derivatives as a suitable risk transfer mechanisms as they also have expanded their activities well beyond their original jurisdictions to almost all over the world. This global diversification of Islamic finance will definitely require new and more flexible updated instruments to manage the associated currency and other risks. Due to today's un-avoidable international business requirement and considerable demand from the public, a sharia compliant instrument for management of risk and for the competitiveness of the Islamic financial institutions and corporations is essential.[488] As a complete code of life, Sharī'ah rules offeres several risk management strategies which are compatible with the Islamic ethics and can simultaneously achieve the same goals as those provided by conventional derivative instruments.[489]

After a thorough understanding of the concept and development of conventional derivatives, how and why the conventional derivative instruments evolved, what benefits they provide to the user, what kind of *Sharī'ah* prohibitions they involved and why they are

[488]Andreas A. Jobst, '*Derivatives in Islamic finance*, available at http:// papers.ssrn.com/sol3/papers. *Derivatives increase liquidity*, available at http:// www.asx.com.au/profession- als/companies/derivatives increase liquidity.htm, last accessed dated 10.05.2016.

[489] Nevi Danila, *'Derivatives: An Islamic Perspective'*, (STIE Malangkucecwara School of Economics, Malang, Indonesia Agatha E. Jeffers, Montclair State University, New Jersey, USA), 23

not acceptable in Islamic Finance. We have devised towards the understanding, developing and exploring, financial structures available within the boundaries of Islamic finance having derivative like features and can serve the same purpose.[490] Thus, *Sharī'ah* Compliant derivatives are financial instruments which pursue the similar benefits as of conventional derivatives instruments through *Sharī'ah* compliant mechanism. As we have mentioned in detail earlier that all the Sharī'ah compliant transaction must be free at least from *riba, maysir, gharar ang jahal,* these prohibitions are most relevant in the context of derivative instruments.

A number of instruments /contracts exist in Islamic finance that could be considered and used as the basis or building block for derivative contracts within an Islamic framework namely *Bay' Salam* (A sale or purchase of a deferred commodity for the present price (*bay' ajilin bi ajil)*[491], *Wa'ad* (a term used currently which according to Islamic transaction means "promise")[492], *Murābahah* (cost plus profit sale), *Istijrār* (A contract between a client and a supplier, whereby the supplier agrees to supply a particular product on an ongoing basis, for example monthly, at an agreed price and on the basis of an agreed mode of payment)[493], *Khiyār Al-Shart* (the option to rescind a sales contract based on condition)[494], *Bay' al-'Arbūn* (*a* sale contract, in which a down payment is paid by the

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490 Syed Aun Raza Rizvi1 & Dr. Ahcene Lahsasna, "*Derivatives in Islamic Finance: The Need and Mechanisms Available for Islamic Financial Markets*" ,10-11

491 Siddīq al-Darīr., *Al-salam wa Tatbiqatuhu al-Muasirah* (Jeddah: Islamic Research and Training Institute 2003), 5.

492 Mohd Noor Mohd Ashraf b. Aripin, *Mechanism of Al-W'ad (Promise): Theory and Application in Islamic Banking in Malaysia* (Serdang: Penertit University Putra Malaysia, 2003), 26.

493 M.Obaidullah, '*Istijrār: A Product of Islamic Financial Engineering*' (London:New Horizon, Islamic Institute of Islamic Banks,1997), 8.

494 Abu Ghaddah, '*Al-Khiyār wa Atharuhu fi al-'Uqūd*' (Jeddah: Dallah al-Barakah, 2003), 19.

buyer)[495]. These available contracts in Islamic finance can be considered and used as the basis or building block for derivative contracts within an Islamic framework.

To understand the proper theoretical concept and practical procedure (modous operandi) along with cash flow and industry usage of these Islamic contract having derivatives like feature, a detailed discussion of these products have been made. Subsequently, Islamic alternative to Swap i.e FX Swaps, Cross Currency Swap and Profit Rate Swap as the main products based on the combination of above mentioned Islamic contracts along with Bay' al-Saraf have been examined with proper procedure, cash flow and industry practices which may paved the way of competition for the Islamic society in the relevant global financial market.

After comprehensive discussion on *Bai Salam,* we can say that *salam* is a popular technique for generating working capital, so it's *Sharī'ah* compliant structure has been mentioned. This structure is basically to replicate the mechanics of conventional short-selling. While commenting on the replication of conventional short-selling through *Salam*, Teilhard de Chardin, global head of prime brokerage at Newedge in London says: "Although different solutions seem more acceptable for different regions, many Saudi scholars prefer the Salam contract for equities, which is why we have taken this route. Moreover, it is clear from the discussion on *salam* that it is in line with *qiyās* and not against it, and it could be form the basis of *qiyās* , so we could say that the modern forward contract can be validated by way of analogy to *salam*. However, the implementation of the

[495] Al- Bājī, '*Al-Muntaqā Sharh Muwattā al-Imām Mālik*. (Beirut: Dar al-Gharb al-Islami, 1991), 30

above mentioned recommendations and shortcoming identified is necessary to remove the ambiguity.

The concept on *Wa'ad* as mentioned above advocate that this is one of the most flexible and useful concept used in almost all products of Islamic Finance. *Wa'ad* has also been considered to be the possible version of the forward contract in Islamic finance as mentioned by the modern jurists, though, this concept is still under debate among the jurists. However, more financiers look to this concept with sympathy. Since the procedural aspects of conventional forward contract is not correct according to *Sharī'ah* due to deferment of both counter values, *Wa'ad* is seen as the most suitable principle to be adopted in the forward contract. Hence, forward foreign exchange transaction may be done on a promise basis instead of a contract. "Under *Wa'ad* structure, only one party promise to buy/ sell certain asset or currency in the future and he is bound by that promise. While the other party will proceed with the promise undertaken by the promissory. Even though *Wa'ad* is binding upon the promissory, but it is not deemed as contract under Islamic law. This is because contract will bind both parties. Islamic financial institutions can enter into forward foreign currency transactions for hedging purposes based on *Wa'ad* but no fee is to be charged on the promise. This is due to the fact that upfront cash payment for forward currency transaction would lead to a bilateral *Wa'ad* which was not allowed by Sharī'ah. This is in line with the view of the majority jurists who opined that unilateral-binding *Wa'ad* without any consideration was permissible in a forward currency transaction. This concept becoming widespread in the financial transaction of the Islamic banking

The study also discussed that Murābahah is a sale transaction (also known as cost-plus financing) can also be used as a building block for *Sharī'ah* Compliant derivatives such as profit rate swap and/or a cross-currency swap as discussed above in detail.*Murābahah* commonly used as Shari'a compliant financing technique, on the asset side of the bank's balance sheet. *Murābahah* is particularly popular and frequently used as Islamic financing technique in the realms of consumer finance and asset finance.

The new innovated concept of Istijrār and its industry usage along with its stepwise procedure, price determination and documentation have been analyzed which shows that *Istijrār* is an agreement between the buyer and the seller, where a buyer purchases a particular asset on different intervals on an on-going basis from the seller; there in no need of bargain or offer or acceptance each time. All the terms and conditions upon which Istijrār to be executed are confirmed in a master agreement. Bacha described *Istijrār* contract as the most complicated among the Islamic contracts which is based on the complex combination of the options, average prices and Murābahah agreement (cost plus profit mode). What the Istijrār contract attempts to do is to allow for the impact for price changes but to cap the benefits that accrue. Since changes are allowed only within a band, the advantage to one party and the disadvantage to the other is capped. The maximum potential gain or loss is limited. Such a contract fulfills the need to avoid a fixed return on risk less asset which would be considered riba and also avoids gharar in that both parties know up front price and the range of other possible prices. (This concept is recently developed and use in Pakistani market, although yet, has not get frequent utilization by the IFIs).

From the discussion on *Khiyār al-shart*, it is clear that *Khiyār al-shart,* as a tool of risk hedging could serve and fulfill the benefits of conventional options. Moreover, while considering the legality of charging a fee for giving the option, will bring the *Khiyār al-shart* in a similar position to the conventional option as a tool of risk management. This study have addressed in detail the legal basis, terms and ownership related issue during the period of *Khiyār* and how of these contracts can be devised as new tools for risk management.[496] Although some jurists have objection to such a proposition on the grounds that the subject matter in such a transaction will be a pure right, which is not eligible to be the subject matter of a contract. However, the others have rebutted the same as we have mentioned the same in detail the legality of option. I personally will prefer the use of *Khiyār al shart* without charging fee for it.

Some jurists are of the opinion that on the basis of *'Arbūn'* a *Sharī'ah* compliant effective risk management instrument may be developed in Islamic Finance like option contract. By concluding *al-'urbun* contract, the buyer must pay a deposit to the seller in advance, but commodity delivery will not be executed until after the payment of the price in full, either during the option period or when it expires. However, it is not possible for Islamic financial institutions to exploit *'urbun* except in the case of purchase as they cannot use it to sell anything before the good is possessed by them. Hence, the concept of *al-urbun* is suitable only for the right to purchase, not the right to sell. Therefore, Aznan is of the views that "structuring of *al-urbun* to replicate the conventional call option is complicated and may

[496] Sāmi Hassan Hamoud, *'Islamic Banking: the adaption of Banking practices to confirm with Islamic Law'*, (London: Arabian Information, 1985), 119.

contradict Sharīʿah principles if it not considered carefully". Though, the legitimacy of this contract have been controversial between the classical jurists, however, the modern or contemporary scholars are almost in consensus that it is a valid contract.[497] So the legal status of *ʿArbūn is* of great importance to be declared while using *ʿArbūn as* an alternative to option. Therefore, the study investigated on these issues.

Swaps contracts are another important and smartest nature of contracts in derivative market frequently used by conventional institutions over the last two decades. They are different in nature from the other derivative instruments, especially, because swaps contracts do not take place in an organized or regulated market, therefore, are not subject to any legal conditions acknowledged in the trading process. However, keeping in view the nature of swaps transaction and their difference from other derivative instruments, this study have not undertaken comprehensive literature review on swap transaction but limited to forward, future and options, however, swaps, being an important aspect the derivative market the concept and Islamic alternative to swaps have been discussed. Thus, Islamic alternative to Swap i.e. FX Swaps, Cross Currency Swap and Profit Rate Swap as the main products based on the combination of above mentioned Islamic contracts along with *Bayʿ al-Saraf* have been examined with proper procedure, cash flow and industry practices which may paved the way of competition for the Islamic society in the relevant global financial market.

[497]Muhammad al-Bashir Muhammad al-Amine, '*Risk Management in Islamic Finance An Analysis of Derivatives Instruments in Commodity Markets'*, Mark Holy, Martin Lau, (Brill's Arab and Islamic Law Series, ISSN1871, 2008), *22.*

We have discussed in detail the theatrical i.e. jurisprudential concept and requirements of these instruments and practical procedure (modus operandi) along with cash flow and industry usage of these Islamic concept/ products have been made which can simultaneously be used for the same purposes of hedging and achieve the same goals as those provided by conventional derivative instruments.

8.1. Suggestion and Recommendations

The following Suggestion and Recommendations may help in promoting and developing the nascent Overall Banking system in Pakistani and derivatives markets in particular. First i have mentioned over all suggestions for IFIs in Pakistan and subsequently for the Derivative Market. From the above mentioned analyses, it is clear that still there is a lot to be done specially concerning the product innovation and legal structure of derivative trade in Pakistan. The key issues and weaknesses in the policy environment is identified and suggestions and recommendations for the legal frame work is given to ensure the proper functioning of the derivatives market i.e. to minimize and hedge the risk associated with the buying and selling of an asset or securities as only a sound legal and regulatory framework can ensure the same purpose.

8.1.1. Overall Suggestions for the IFIs in Pakistan

From the above discussion it is evident that, a separate comprehensive legal system for IFIs is not available in Pakistan, therefore, IFIs rely on conventional system, which in turn create doubts in the minds of general public regarding their Shari'ah compliance. Therefore, to remove the confusion and strengthen the Islamic Financial system, the gaps found in the current Legal system for Islamic Financial Institutions should be fulfill on priority basis. As we have mentioned earlier that the most important building block for the development and growth of Islamic banking is the enabling legal framework. Currently, there is no separate legal framework for the Islamic Banking Institutions. The existing framework does not differentiate between conventional banking and Islamic banking. Banking Companies Ordinance (BCO) 1962 is equally applicable to both conventional and Islamic banks. For proper recognition of the Islamic banking in the legal framework, it is suggested that a separate chapter/Part in BCO 1962, necessary changes in SBP Act 1956, Recovery of Finance Ordinance 2001, Microfinance Institutions Ordinance 2001 and any other related law must be carried out and in this regard, exertions are required to be made with government for the enactment of the proposed changes.

Keeping in view the unique nature of Islamic banking products a thorough revision of the existing legal framework and regulations are required to be undertaken in order to remove confusions and inconsistencies, improve transparency and disclosures and crystallizing the scope and mandate of IBIs. This exercise will identify any anomalies/conflicting instructions in the existing regulations and propose rectifying measures to address the same.

IFIs in Pakistan needs to be statutorily recognized, and they shall derive their authority from the proper statutory law. Therefore, there should be separate Islamic Banking Act which shall define authorized businesses activities for Islamic banks. Roles and responsibilities of different corporate governance bodies shall be included in the Act. Eligibility criteria and Minimum qualification and experience shall be statutorily introduced and covered in it. After covering all these areas in statutory law and their legal recognition and making these mandatory. Necessary action for the noncompliance of these requirements should also be shall be taken against the responsible persons.

The best practices issued by the international standard setting bodies like Islamic Financial Services Board (IFSB) should be adopted, to be at par with the latest global regulatory practices. Therefore, the standards issued by IFSB is required to be revised with appropriate amendments, wherever required in the light of local legal framework and shall be implemented

Separate Islamic Financial Accounting, Auditing and Governance Standards for IBIs in Pakistan should be developed as the financial accounting and reporting architecture of Islamic Transaction is based on conventional system despite of their substantial difference from conventional banking. The SBP will have to collaborate and work closely with ICAP in issuing financial accounting and reporting standards for the industry.

For the standardization and harmonization of *Sharīʿah* practices in Islamic banking industry of Pakistan essentials of permissible modes of Islamic banking and finance in Pakistan shall be issued and AAOIFI Sharīʿah Standards should be implemented in Pakistan. In order to enhance the reach of Islamic banking and promote trust of masses on

Islamic banking, standardization and harmonization of Islamic banking products and services is critical. This step is expected to improve the confidence and acceptance of Islamic banking by the masses.

Islamic banking system provides an alternate products and services to conventional system, however, it does not provide differentiated solutions. There is severe concern regarding this issue, in order to alleviate the issue, necessary amendments and changes should be made in the existing legal frame work or to engage Islamic banking institutions in real trade, real estate, real commodities and investment banking, and to frame a legal and regulatory framework in this regard and Separate PRs (Prudential Regulations for Islamic Financial Institutions may be developed)

To promote the marketability, it is also necessary to understand and address the concerns in relation to cash liquidity of the supply-side market participants. This can be achieved by price discovery, low transaction costs, high volumes, and enhancement of the market's resilience to negative shocks and margin requirements shall be kept at a level that do not increase the opportunity cost for the investors.

Increase of financial literacy, online platform for the inventors to reach the market, satellite offices, and regulated marketing companies in simple language will increase and enhance confidence building among investors to opt for investments in derivatives.

8.1.2. The proposed plan and the required regulations for Islamic derivatives:

The prerequisites and a proposed plan for the introduction of exchange-traded derivatives in Pakistan and the main areas which need to be regulated in relation to Derivatives market are:

There is instant need for a legitimate database from the institutions of collective Ijtihād like International Fiqh Academy, fatwa councils, AAIOFI etc. on the controversial issues in derivative markets which would help the dealers and participants in the derivatives markets to know their legitimate rule and identify any illicit activities they involved. Thus there is need to clarify the reality of these transactions and activities.

There is a need for unified standards and advisory opinion in the field of Islamic derivatives. The legitimate institutions and the research academies can work together to put unified fatwa (advisory opinion). This will resultantly help the regulatory authority for issuance the binding instructions governing the investment operations in derivative market for the preservation of social security.

There is a need for greater uniformity and central regulatory body to ensure the growth of investor confidence in Islamic finance. A good example and starting point to address this concern is the MATP project (a joint initiative between ISDA and IIFM to produce a Master Agreement under which *Shari'ah*-compliant hedging transactions can be documented). The ISDA/IIFM Tahawwut Master Agreement was launched on the 1st March in Bahrain after 4 years of hard work. It is very much hoped that, based on the structure on the ISDA 2002 Master Agreement, it will bring liquidity, confidence and a convergence in pricing to the Islamic derivatives market.(The most important concept within the ISDA/IIFM Tahawwut Master Agreement is the dichotomy between Transactions (concluded transaction) and Designated Future Transactions (non-concluded transactions). The appreciation of this concept lies at the heart of the agreement and forms the cornerstone of the Islamic closeout mechanism.

Basically the ISDA/IIFM Tahawwut Master Agreement is a multiproduct agreement on which all *Murābahah*, musawama and *Wa'ad* based Islamic products can be documented on. More analysis needs to be done to conclude whether salam, Istijrār, *Khiyār al shart* and *'Arbūn* based products can be documented on the ISDA/IIFM Tahawwut Master Agreement. The same pattern is required to be followed here in Pakistan. The ISDA-IIFM Tahawwut Master Agreement (together with an explanatory memorandum) is available on the website of both the ISDA website (www.isda.org) or at IIFM's website (www.iifm.net) the same can be downloaded from there. Such type of initiatives, definitely demonstrate progress towards attaining greater uniformity in Islamic derivative market.

Regulations for the legitimate investment channels should be made which will serve interests of the various parties rather than direct investment in derivatives contracts which involves several prohibited operations such as usury and gambling that in fact, do not serve neither the interests of society nor the dealing parties.

Sharī'ah compliant derivative products/contract based on proper regulatory framework should be developed which will attract market participants and investors who consider that derivative are purely derivative instrument. However, product innovation must not be at the cost of *Sharī'ah* compliance further, consideration may also be given that to ensure the achievement of the objectives of *Sharī'ah* before allowing the practitioners to apply that structure.

A comparative analysis with other emerging markets and regulatory frameworks of the developed market in neighboring countries would not only help in formulation and development of derivatives markets but also safeguard investors' interest and promote the derivatives markets.

Market infrastructure, including exchanges, clearing-houses and intermediaries should be upgraded. Further, the regulators, exchanges and intermediaries should adopt International Best Practices (IBP) for risk management.

A Comprehensive Legal infrastructure should be created and be expanded to the the Financial Intermediaries, the aims of regulation should be to ensure, financial safety including the integrity of clearing houses and market participants as the existence of a clearing house and its defined functions and working is very crucial for any derivative exchange to work smoothly.

The main areas which need to be regulated in the derivatives exchanges are: Customer protection and fairness (which include trustiness of customer (investor) and its related protection concerns), very few steps have been taken till now in this regard.

Market efficiency and the recognition of Markets and products (i.e. that will be the only those products, in which the market itself is the issuer; the products which are subject to the rules of an exchange; and for which a clearing organization is operational with all its functionalities). Further, the regulators, exchanges and intermediaries should build competent staff at all levels.

Alternate Dispute Resolution Mechanism (ADRM) is being encouraged, across the globe, as legal proceedings and Arbitration are usually costly and time consuming, so the SBP in coordination with stakeholders should work on this and to find out easy resolution of Islamic banking dispute and issues by developing customized dispute resolution mechanisms.

Financial Institutions providing derivatives to Customers should obtain an approval from its Board allowing it to enter into derivative transactions for hedging/altering risk profile purposes. Moreover, the Authorized Derivative Dealers should also obtain written confirmation from the authorized signatory/ signatories of such Customers to the effect that the transactions undertaken by them are meant for hedging/alter the risk profile of their underlying exposures only, and no derivative currently exists against such exposures with any other Financial Institution, the same practice will discourage speculation and will stream line the genuine use of derivatives.

At the end, to bring standardization and uniformity in these structured products across the globe, we recommend that there is instant need for a legitimate database from the institutions of collective *Ijtihād* like International *Fiqh* Academy, Fatwa Councils, IFSB, IIFM, AAIOFI etc. on the relevant highlighted issues in these structured products. Though few institutions have taken initiative in this regard, such as IFSB recently has collected information from IFIs through a survey Questionnaire about the products offered for hedging in the derivative market with the objective to capture the existing practices in relation to the use of *Shariah*-compliant hedging instruments and the regulatory and *Shari'ah* compliance concerns raised across jurisdictions for standardization which is appreciable.

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