Islamic Development Bank
Islamic Research and Training Institute

ISLAMIC FUTURES AND THEIR MARKETS

With Special Reference to their Role in Developing Rural Financial Market

Research Paper

No. 32

ISLAMIC RESEARCH AND TRAINING INSTITUTE (IRTI)

Establishment of IRTI

The Islamic Research and Training Institute was established by the Board of Executive Directors of the Islamic Development Bank (IDS) in 1401H (1981). The Executive Directors thus implemented Resolution No.BG/14-99 which the Board of Governors of IDS adopted at its Third Annual Meeting held on 10 Rabi Thani 1399H (14 March 1979). The Institute became operational in 1403H (1983).

Purpose

The purpose of the Institute is to undertake research for enabling the economic, financial and banking activities in Muslim countries to conform to shari'ah, and to extend training facilities to personnel engaged in economic development activities in the Bank's member countries.

Functions

The functions of the Institute are:

A) To organize and coordinate basic and applied research with a view to developing models and methods for the application of *Shari'ah in* the field of economics, finance and banking;

B) To provide for the training and development of professional personnel in Islamic Economics to meet the needs of research and shari'ah-observing agencies;

C) To train personnel engaged in development activities in the Bank's member countries;

D) To establish an information center to collect; systematize and disseminate information in fields related to its activities; and

E) To undertake any other activities which may advance its purpose.

Organization

The President of the IDB is also the President of the Institute. The IDS's Board of Executive Directors acts as its supreme policy- making body.

The Institute is headed by a Director responsible for its overall management and is selected by the IDB President in consultation with the Board of Executive Directors. The Institute consists of three technical divisions (Research, Training, Information) and one division of Administrative and Financial Services.

Location

The Institute is located within the headquarters of IDB in Jeddah, Saudi Arabia.

Address

telephone: 6361400
Fax: 6378927/6366871
Telex: 601407 - 601137
Cable: BANKISLAMI - JEDDAH
P.O. Box 9201
Jeddah 21413
Saudi Arabia

ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE .

ISLAMIC FUTURES AND THEIR MARKETS

With Special Reference to their Role in Developing Rural Financial Market

M. Fahim Khan

Research Paper
No.32

King Fahd National Library Cataloging-in-Publication Data

M. Fahim Khan
ISLAMIC FUTURES AND THEIR MARKETS 76
P, 17 x 24 cm- (Research Paper No.32) ISBN:
9960-627-87-X
Islamic Economy

Legal Deposit No. 1448/16
ISBN: 9960-627-87-X

First Edition 1416H (1995)
Second Edition 1421H (2000)

In the name of Allah, the Beneficent, The Merciful

CONTENTS

FOREWORD

One of the objectives of IRTI is to conduct basic research with a view to developing models and methods for the application of *Shari'ah* in the fields of economics, finance and banking. As a fulfillment of this objective, IRTI carries out research activities in several dimensions. Within a defined theme, research projects are identified every year with reference to any particular applied activity of a typical contemporary Muslim economy that currently is not very much in line with Islamic principles and then attempt is made to study how this activity can be organized or restructured to fulfill the Islamic requirements and obligations. The output of the research project is published and disseminated to reflect the message of the Islamic Development Bank that the Islamic economic principles are. not only practical feasible for the application in the contemporary world but also help in the economic development of the developing countries.

Futures Trading and Futures Market was identified as one such activity and the present study provides an Islamic insight into the issue whether such an activity is needed for a Muslim economy and if yes then how to organize this activity in Islamic framework. This study basically addresses itself to the following questions:

a) What is un-Islamic about the contemporary Futures Trading.

b) Can Futures Trading and Futures markets be possibly organized on the basis of Islamic principles of exchange.

c) Would it be beneficial for an economy if the Futures Market Trading is promoted and organized on Islamic principles.

It is hoped that this study will not only be useful to the policy makers in the Muslim countries that are involved in Islamizing their economies or intend to do so in near future but will also be of interest to students of Islamic economics, banking and finance.

Dr. Omar Zuhair Hafiz
Deputy Director, IRTI

I
INTRODUCTION

The origin of "Futures" and their market lies in the exchange of commodity. Exchange is a means to economic development whereas economic development itself promotes exchange. Exchange and economic development thus form a cycle of economic progress for a society. Any thing that serves as a fair and just instrument to enhance exchange should, therefore, be desirable for society. Islam's economic teachings make particular reference to the institution of exchange.

ALLAH PERMITS EXCHANGE AND PROHIBITS *RIBA* (AL-QUR'AN 2: 275)

The contemporary Futures and Futures markets have originally been developed from the concept of forward trading that was meant to enhance the exchange of agricultural commodities by providing the fanner a protection against price uncertainties in the agricultural markets. The need for forward trading as means for enhancing output and exchange, which was recognized in the Western economies only a couple of centuries ago, however, was recognized in Islamic society fourteen centuries ago.

It is instructive to note that whereas Islamic teachings which categorically prohibited to sell commodities that is not in hand (a principle essential to maintain order and confidence in the exchange and market mechanism) provided an exception in case of forward trading in the interest of supporting and protecting the producers of small means particularly in such sectors as agriculture where vagaries of nature leave very little in the hand of producers to effectively plan their production decisions.

The significance and rationale of this exception is as evident today as it was fourteen centuries ago.

The Western economies realized the need of introducing forward trading for the purpose of redistributing the risk of producers of agricultural commodities which consequently developed into the institution of Futures market. The philosophy of capitalist economy as well as its institutions (such as interest based banking), however, soon developed this concept into a means for deriving speculative gains only. Now the most developed Futures market in the Western world are simply being used for speculation rather than helping the farmers or producers. It is now a universal truth that "The members who are trading [in Futures markets] are typically speculators, those who hope to make a profit by exercising their trading acumen".[1] The fact is that Futures market which emerged out of the concept of enhancing the trade of primary commodities have ended up not doing any trade at all. "In fact more than 99 percent of all futures contracts are closed out by reversing trade rather than through [making or receiving] delivery process".[2]

Islamic concept of redistributing risk and promoting production and exchange of financing goods through forward trading has very little room to exploit the concept for making pure speculative gains. Islam has two powerful concepts for forward trading namely *Ba'i Salam* and *Jo'ala / Istis^{n}a'a*. Both these concepts have the objective of redistributing the producers' risk and hence promoting production and exchange simultaneously. But the way these two concepts have been defined in *Shari'ah* clearly indicate that these concepts cannot be used merely for pure speculation purposes. They can be used only for real productive and exchange purposes.

With these features, it is logical to think that these concepts of forward trading can help Muslim economies develop more powerful and productive Futures markets which may not be very attractive to pure speculators and will mainly be catering to the needs of the producers and of such traders who are interested in actual trade.

With the fact that almost all contemporary -Muslim economies depend heavily on primary commodities involving high uncertainties about their prices and facing unfavorable terms of trade, the application of the Islamic concepts of forward trade and development of Futures markets on the basis of these concepts can play an instrumental role in giving boost to their primary commodities sectors and hence to their economies.

---

1. See Kolb [6] pp.4

1. See Kolb [6] pp.36

This paper concentrates mainly on utilizing the concept of *Ba'i Salam* for developing a Futures market for agriculture or primary commodities. The development of Futures market on the basis of the concept of Jo'ala and *Istisna'* particularly for promoting the production/construction of infrastructural projects though has been touched upon but in depth treatment has been left for a separate discussion.

There are two major components of this paper. It first gives a critical evaluation of conventional Futures market and then provides an outline of how Islamic Futures markets can be developed. This paper concludes that since almost none of the Muslim economies with the exception of one or two have developed Futures markets for commodities so far, it is high time that Muslim countries realize the usefulness of the concept of *Ba'i Salam* in developing a Futures market for their agriculture products for the sake of promotion and development of their agriculture sector. A start can be made with a single commodity which can easily be standardized for the purpose of Futures contracts and then this can be gradually developed and expanded to include more commodities. It has been emphasized in the paper that only strict adherence to Islamic principles of exchange will lead the development of these markets to make useful contributions to the economy.

It should be noted that bulk of the farmers and agriculture producers in contemporary Muslim economies are constrained by liquidity and they often have to look towards local (informal) lenders who charge exorbitant rates of interest in order to meet their consumption as well as production needs. This has put the rural population in a vicious circle of poverty and debt which is a serious hindrance in the development of agriculture and hence of rural population and which also gets reflected in the development of the whole economy.

The paper emphasizes that the Futures market developed on Islamic lines can serve as a powerful financial mechanism that can ease the problem of rural credit to a great extent.

In order to understand whether or not it is possible to have Islamic Futures Market, it is very important to understand how the original concept of Forward Trading developed in to the modern concept of Futures Market.

The conversion of the original futures market (to be referred to as Forward Trading) into the modern futures market (to be referred to as Futures market) is only a recent phenomenon starting from mid-seventies. It was only since the mid-seventies that new forms of commodities (such as currencies, interest rate, stock indices etc.) started being introduced for Forward Trading and new methods of operations and market dealings for forward trade started being developed.

Most of the unIslamic components of the Futures Markets being identified in the contemporary Islamic economic literature in fact are only of recent origin.

Many people dealing or having an eye on the Futures Markets and their developments believe that the markets of forward trading was converted into the Futures Market in order to increase speculative activities by trading Futures in foreign currencies and interest rates. It should, therefore, be quite instructive for those interested in having a concept of Islamic Futures Market to look into the structure of markets of original Forward Trading, starting in late 18th Century and early nineteenth, and the developments therein since then, from the point of view of exploring the possibility of developing a structure of Futures Market on Islamic lines.

By reviewing the contemporary Futures Trading and Futures Market in attempting to find an Islamic alternative for it we are not looking forward to "Islamize" an intrinsically un-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 will also be in line with Islamic legal framework.

We should realize that even in the modern degenerated form of Futures trading, some of the underlying basic concepts as well as some of the conditions for such trading, are exactly the same as were laid down by the Prophet (Peace Be Upon Him) for forward trading. For example, there are clear sayings of the Prophet (Peace Be Upon Him) that he who makes *a salaf* (forward trade) should do that for a specific quantity, specific weight and for a specific period of time.. This is something that contemporary Futures trading pays particular attention to. By looking into the conventional Futures market we are just looking for such un-lslamic elements that got developed in the process of moving from forward market to Futures market in order not to slip into these un-Islamic elements and in order to keep our markets on same footings on which they were introduced by our Prophet (Peace Be Upon Kim).

II
A REVIEW OF CONTEMPORARY FUTURES MARKET FROM ISLAMIC POINT OF VIEW

A REVIEW OF CONTEMPORARY FUTURES MARKET FROM ISLAMIC POINT OF VIEW

2.1 DEVELOPMENT OF "FUTURES" AND FUTURES MARKET

The underlying concept of "Futures" trading is simply to enhance commodity exchange. Commodity exchange always entails some risk elements and the risk element is particularly significant if the commodity to be exchanged entails some time for its production/supply. The risk element is further pronounced if the production/supply depends more on such natural factors as weather rather than merely on human efforts. The supply of agricultural commodities, for example, depends on seasonal and other natural factors which cause wide seasonal fluctuations in their prices and hence introduce a significant risk element in the exchange of these commodities.
Such risk elements may affect production decisions adversely.

The prices of agricultural commodities at the time of making production decisions are high because of this being an off-season for these commodities. But the farmer knows that when he will harvest his crop and bring it into the market, the prices will be much lower because of the abundance of supply. The more he produces or the better is the weather, the more will be the supply in the market and lower will be the price and he may end up not making even the break-even point. Several other primary commodities like live-stock, minerals, and even some industrial products face the same dilemma. For such commodities, the producers face quite high risks when taking decision to supply these commodities for trade. It was this risk element in the marketing of some, commodities that led to the concept of forward trading in the West during 18th and 19th century which then developed into the contemporary Futures market.

In order to protect them against the seasonal fluctuations of such commodities, producers (as well as consumers) started buying and selling for forward delivery. These transactions (which became known "to arrive" contracts involved a binding sale by a farmer to a buyer for a designated amount of grain to arrive a couple of months later) were in fact a starting point for the modern futures markets. Such delivery contracts helped both the buyer and the seller by making the price known definitely to both of them and hence eliminating the risk associated with the price uncertainty. This of course helped both of them in their respective investment decision making. No payment however, was made in advance by the seller to the buyer. The payment was subject to the delivery.

This concept of "to-arrive" contracts was similar to the Islamic concept of *Ba'i Salam* only to the extent that it helped eliminating, for the farmers, the uncertainty relating to the price that will prevail in the market at the harvest time. *Salam* Sale Contract, however, has another useful concept which these "to-arrive" contracts failed to capture. The seller is legally obliged to pay to the buyer in advance in full at the time of contract. This useful concept makes the farmer liquid to purchase inputs for the production as well as support his and his livelihood until his crop is ready..

This concept, perhaps, was the backbone of the need for forward trading that was recognized by Islam. "To arrive" contracts did not recognize this need. Farmers generally have been a less privileged class compared to the traders and businessman. If any exception was to be granted to the principle of trading of non-existent goods, it could be only on the ground of helping the less privileged parties in order to make the market place a more equitable and just institution for all members of the society. Islam recognized this while the Western concept of forward trading totally overlooked it.

By not giving the liquidity to the farmers the, "To-arrive" contracts introduced by the West for forward trading also introduced two unwelcome element in the exchange of commodities. First, it put the traders (often already a privileged class compared to farmer) in a more comfortable position. A supply glut to push down the prices unexpectedly is very unlikely because the production or supply capacity of primary commodities is fixed in the short-run and cannot drastically increase. A shortage to push up the prices unexpectedly is always very likely because so many factors including weather can affect the supply adversely. The traders will always be able to get a bargain from the farmer with a price that may most of the time yield him windfall gains.
Farmers cannot benefit from these windfall gains. Second the trader did not lose anything by making speculation for windfall gains. Had he been forced to make the payment in advance, this could impose upon him a cost (in terms of

foregone opportunity cost of his funds) if he would like. to benefit from possible windfall gains.

With the passage of time these forward sales transactions did not confine to merely agriculture commodities. Other commodities kept entering into forward sales market. For a long time (even until the late 1960s), the market, however, still remained confined to primary commodities only. This continued to reflect the original spirit that was lying behind the forward sales i.e. to reduce the risk of the producer. The basic argument for the expansion of the forward sale market to include other commodity was that the forward sale helps shifting the risk from those who cannot afford to bear it to those who can afford to bear it. It was recognized that producers of primary commodities face too large a risk to be left to be borne by them alone, and part of this risk may be borne by traders and businessman who are relatively in a better off position to assume risk than the farmers. This argument though appealing in theory suffered with the same implications mentioned earlier. The limit of supply to exceed of expectation, for almost all primary commodities is more or less given in a short run. The limit for the possible shortage in the expected supply however is wide open. Fixing a price in advance for such commodity without paying it up immediately serves the interest of trader more than the interest of producer.

2.2 SPECULATIVE ACTIVITIES IN THE FUTURES MARKET

Originally the forward sales contracts were not traded in the secondary market. Only actual commodities were marketed after their delivery has been made and received. Later on, however, these contracts found a secondary market for themselves. The forward sale contracts started getting bought and sold without waiting for delivery. This prompted such traders who just wanted to earn money by assuming speculative risks but were not willing to take the actual delivery. The emergence of this element generated the concept of what is now known as "Futures". The traders now could simply sell a Futures contract (i.e. contract to sell a certain quantity of a commodity at a certain date in future) without the intention of making a delivery and purchase a Futures contract without the intention of receiving a delivery. When this concept got entry into the forward sales market, the speculators took the driving seat pushing the producers and genuine traders in the back seat. These speculators were interested in the possible gains arising out of merely their guesses about prices of the commodities rather than in profits arising out of the actual sale of the physical commodities/themselves. Though all Futures contracts include the clause relating to delivery of the commodity concerned, the market developed mechanism where the traders could sell and purchase forward sale contracts without getting involved in actual deliveries. This was of course a total departure from the original concept and philosophy of forward sale.

The producers or farmers were forced to compete with the pure speculators. Whereas speculators did not have much on stake, the producer 'had the decision about his whole crop at stake. Forward sale of commodities for the purpose of promotion of production and trading was no more the underlying concept. The actual trading and exchange of commodities in fact was finally separated from the forward trading. The market for forward trading was made a market of Futures. Futures markets were made only to sell and purchase contract documents which were called Futures and not for actual trade or exchange of commodities. The purpose of these modern Futures Markets still remained same that is transferring the risk. But now the Futures Markets were not rendering this service to farmers only. They were rather inviting speculators to benefit from this service. The producers and farmers, though could also benefit if they so wanted, but the producers and farmers too could benefit from this service only hi the capacity of speculators not the actual traders. They could contract without the intention to deliver.

Futures Markets are now working as an independent industry where traders can earn income by trading risks without getting involved in actual production or delivery of any commodity. Futures Market is not a part of the commodity market as the Forward Trading was. It is now a separate market where farmers and producers can also enter for the purpose of forward sale for hedging themselves against the risks associated with price variability of their productions or just to speculate like others.

"The members who are trading in [Futures Market] are typically speculators, those who hope to make a profit by exercising their trading acumen"[3] [6]. The speculators can use Futures market to make a great deal of

---

[3] Robert W. Kolb, Understanding Futures Markets, 2nd Edition SCOTT, Foreman and Company, London, 1988, p 4.

profit by merely making a good guess of Futures prices. They are not interested in purchasing or selling of actual goods. They make profits without rendering or getting involved in any productive efforts. This puts a discouraging impact on producers and farmers. When it is possible to make profit without producing then why to bother about production. This generates a tendency to leave the production to some one who cannot play with the market and allowing the market to be used who are smart enough to exploit market for making more and more speculative incomes. This tendency is not a healthy sign for an economy.

Islamic spirit of exchange is totally against this philosophy that isolates the producers from the markets. It was in this spirit that;

A) the trade of goods that do not exist was prohibited as a principle,

B) the traders were not allowed to meet the farmers outside the market to make a deal with them before the goods are presented in the market,

C) the forward sale was made strictly regulated to ensure that this will not be a speculative activity but a real economic activity fully integrated with spot/cash market. (The Islamic conditions for foreword sales discussed in detail in the next section make this point more clear).

2.3 HEDGING AND FUTURES MARKET

It is argued that the modern Futures markets can still be utilized by farmers and producers to reduce their risk, to protect their commercial and productive interest and make better production decisions. Farmers can sell Futures contract in a Futures market simply as a hedging device. They will sell Futures contract in Futures market in order to hedge against any unexpected decline in the cash market. If the cash market turns out to be unexpectedly favorable, they will buy back their own Futures sale contract and sell their goods in the cash market. But since Futures Market and cash market are independent, a farmer or a producer will hardly be a good player in the Futures Market. His entry in the Futures market thus will not be so much to make money out of the Futures Market as to avoid losing the reward of his productive efforts in the cash market.

To understand the nature of the hedging and how it differs from the concept of forward sale in general and from the Islamic concept of helping the farmer in particular, let us consider the following example:

Suppose a farmer wants to grow corn. Suppose the corn price m cash market is $2.50 per bushel and this is a price good enough for him to take a decision to sow the crop. But before he sows the crop he likes to hedge himself against any decline in prices particularly at the time of the harvest. So he looks for Futures contracts. Suppose the Futures contracts are selling at the price $2.55 per bushel. He purchases as many Futures contracts as he expects his crop to be (say 1000 bushels) at this price obliging himself to sell 1000 bushels at the price of $2.55 at the harvest time.

Now suppose that at the time of the harvest the price of corn in the cash market goes down to $2.40 per bushel. But since prices in the Futures market and the prices in cash market move in unison, the Futures prices are also expected to come down to say $2.45-per bushel. Since he sold Futures contract of 1000 bushels at the price of $2.55 he will offset them (as he is not obliged to make the delivery) by purchasing 1000 Futures contract at the price of $2.45 and thus making a profit of 0.10$ per bushel and offsetting the same loss he made in the cash market. The two profits/losses in both markets may not always compensate each other exactly but they provide a considerable compensation to provide sufficient hedging.

This concept of hedging through Futures thus in the Modern Futures Market, though, is. an indirect way of reducing the farmer's risk. But the Futures market being totally independent and separate from the cash market is quite likely to give wrong signals to the farmer and the farmer not being a player of the Futures market and having forced to compete the professional speculators, they may often end up being exploited by the wrong signals.

Futures markets are believed to serve as price equalizers for farmers and producers and the above example is an explanation of this phenomenon. But this process of equalization works more in favor of speculators and their speculative incomes than in favor of the farmers and their production decisions. The difference between Futures market and the spot market is highest neither at the time of sowing the crops nor at the time of harvesting the crops. It is highest in between when the farmers are busy in their production process. The speculators benefit from the fluctuating markets. All the benefits of rising Futures prices during this period is, therefore, taken away by the speculator. Unless farmer also decides to be speculator he cannot benefit from the Futures market as much as a speculator does.

Also it should be noted that though Futures trading are generally expected to stabilize prices, they may lead to destabilization when prices are reaching the peak. Though often these destabilization effects may be short lived but situations may and do occur when the market may totally collapse and the farmers will be loser rather than getting hedged.

2.4 GROWING SCOPE OF MODERN FUTURES MARKET

A further development that has taken place during the transition from the original concept of forward trading to the modern concept of Futures trading, is list of commodities included in the trading. Since originally the concept of trading emerged out of the necessity of reducing the risk of price uncertainties faced by the producers, the agriculture products were considered to be the only commodities needing this type of arrangements because it was only the agricultural commodities that faced the seasonal fluctuations and hurt the farmers most. On the same analogy other primary commodities particularly the metallurgical and products including Petroleum as well as some manufactured goods were also included in the list of forward trading as they too faced seasonal or frequent fluctuation in their prices. With the development of modern concept of Futures market as separate and distinct from cash market, the following commodities, however also got included:

1) Foreign currencies
2) Interest based financial assets
3) Stock indices

Inclusion of foreign currencies can be assigned some rationality under the Western concept of forward trading because foreign currency is a sort of real goods (as it gives command over a certain basket of goods of a foreign country) and the risk in their trading was required to be reduced as their prices (exchange rates) too fluctuated widely and frequently. The Futures trading of interest based financial assets and stock indices, however, simply provided an extra base to the pure speculators to make income merely on their speculations. The necessity to include financial assets in the scope of the Futures marked arose out of the same reason as for commodities and of foreign exchange i.e. wide fluctuations *in* the prices. Wide fluctuations were observed in the interest rates and hence of financial assets prices during 1970s and that was the period when the financial assets were introduced into the Futures markets.

Thus the only rationality or the key element for including of any item in the scope of modern Futures market is the possibility of volatile uncertain fluctuations in its prices. *This* risk management became the objective rather than means. This is in variance with the rationality of the origin of these markets (in terms of Forward sale) which was to promote exchange of goods by partial redistribution of risks created by uncertainty of prices. Risk management was then considered as means rather than the objective. When forward trading was an integral part of the commodity market, and delivery of goods was binding, this trade did serve the purpose of distribution and management of risk for the sake of promoting production and hence exchange. When the delivery no more remained a binding obligation and when forward trading was separated from the commodity market and named as Futures market, the primary concern became to earn income by managing and manipulating risk only.

Islamic economic philosophy does not permit pure speculation. The primary concern in Islam, therefore, is the commodity exchange and not merely financial exchange for the purpose of making economic gains. Not only The Qur'anic verse that permits trade and prohibits *Riba* [verse 2:275] leads to a direct conclusion that:

> God has permitted trade (to earn income from transactions of goods and services) and prohibited *Riba* (to earn income from pure financial and monetary transactions)

is clearly reflective of this philosophy but also various traditions from Prophet (Peace Be Upon Him) also emphasized the same.

The fact is that financial instruments Futures market, also known as interest-rate futures market, provide an easy source of income that does not involve any real economic activity. This is reflected in the fact that trading volume in the interest rate Futures market is much greater than the corresponding trading volume in the cash market.

Until the early 1970s, Futures trading as well as Futures markets have changed at a fairly slow rate. Until 1970s, there were no financial Futures of any type and the volume of Futures trading was relatively low and not too variable. After the introduction of financial Futures, the volume of Futures trading accelerated and had increased more than 25 times by early 1990s. The list of contracts in the volume of trading was dominated by financial Futures contract. In 1987, the Financial Futures which started only' less than three decades ago are accounting for more than 50 per cent of all Futures trading.

There were only commodities and no foreign currencies or financial assets introduced in the Futures market until the end of 1960s. Foreign currencies Futures were introduced in early 1970s and interest based *financial* assets entered the market in mid 1970s. Stock indices began only in 1982. One of the most striking things about the stock indices is they do not admit even the remote possibility of actual delivery. A trader's obligation had to be fulfilled only by reversing trade or cash settlement of the gains or losses at the end of the trading (an activity invented for pure speculation purposes with no intention of any real purpose of hedging or reducing production risk). This is nothing but a pure gambling in words and spirit, to be played in a market place.

2.5 CONSEQUENCES OF THE GROWTH IN FUTURES MARKET

This phenomenal growth in Futures market particularly of financial Futures is raising a lot of concern for the policy makers from the point of view of the health of their economies. The main concern, of course, is that the Futures markets, particularly the interest-rate Futures markets are being more and more used by the pure speculators only.

A second concern is that the increasing volumes of transactions in the interest-rate Futures markets would divert funds away from cash markets and hence will not only harm the governments financing schemes for mobilization of resources, but will also harm the private capital formation process in the economy. Fears are being repeatedly voiced to the effect that if Futures are allowed to grow on this pattern, they will increase their turnover in paper dealings to the extent that cash or physical trading will not only be adversely affected but that the market in the commodity may even be put out of business altogether.

The Western economists have started worrying of this exploding nature of financial markets based on merely speculative activities. Maurice Alais a French Noble Laureate in Economics strongly blames the speculative activities generated by Futures market as one of the key factors that are making the world monetary and financial system potentially instable.
According to him "while forward markets for commodities like wheat, coffee, cocoa, etc. are useful to enable producers and users to hedge against ineliminable futures uncertainty, one may legitimately query the real economic utility, from the point of view of efficient economic functioning of an economy of Markets, of forward markets for securities, shares and bonds as those markets operate at present".

2.6 SUMMARY & CONCLUSION OF THE REVIEW

To summarize the previous discussion, we need to note the following:

1. The modern concept of Futures originally was introduced in 19th century in the form of forward trading for the marketing of agricultural commodities.
2. The objective originally was to improve exchange and market operations of agricultural commodities and provide an opportunity to farm producers to hedge against the possible losses arising out of seasonal price fluctuations in the market.
3. The concept of making a Futures contract without intending or getting involved in delivery was introduced later on along with the establishment of the concept of Clearing House. This of course led to a tendency to indulge in speculation activities in this market.
4. The scope of Futures market expanded mostly from 1970s to include more commodities not only to include industrial products but also to include

---

[4] See Alais [7] .

financial instruments (like bonds, bills, mortgages and shares), currencies and stock indices.

5. The scope of the Futures Market expanded not only with respect to commodities but also with respect to its beneficiaries. The speculators entered in the market to benefit merely by speculating and making good guesses of futures prices. The role of speculators in the Futures Market is increasing at accelerated rate.

6. It was perhaps the growing interest of the speculators in the Futures market that led to the segregation of Futures Market from cash market. This segregation served more the purpose of speculators than of producers interesting in hedging. Whereas speculators make profit by confining themselves to Futures market only, the producers have to deal in cash market and Futures market to get the benefit of hedging.

7. The innovations are continuing to further expand the scope of the market of Futures. Introduction of options on Futures contract is one such innovation.

8. Being an integral part of cash markets, the forward sales contract originally were expected to be constrained by the production capacity of the producer. The modern Futures markets do not face such constraints. The process of contract creation can go on and on indefinitely as long as buyers find sellers and vice versa irrespective of the actual supply of the commodity in question.

9. Also the concept & spirit of hedging the farmers and producers got practically diluted in the development of modern Futures Markets though theoretically it is still there. In the framework of the modern Futures Market, a fanner or producer, in search of hedging himself against the uncertainties of future prices in the cash market has to assume another risk in the Futures market which is supposed to compensate him to a large extent for any loss in the cash market if the prices in cash and Futures markets moved in unison. No doubt cash and Futures prices have a tendency to adopt to each other during the delivery period at the delivery points because of the pressure caused by deliveries in the expiring Futures, but at any particular point they may not move in a perfect relationship and hence the loss in cash market may not be fully compensated the gains in the Futures market.

10. It is believed that the existence of speculation is essential for futures market because speculators are supposed to provide bridge between hedger X who wants to sell now and hedger Y who wants to buy later. But of course this loses its significance if a market allows the pure speculators to play in the

market and in fact is developed in a way that it serves the pure speculators than the real traders as producers.

11. Futures markets got themselves confined to the Commodities that have short term volatility in prices. This of course encourages the speculators to enter.

12. Futures markets role does not exist at all to distribute risks for such commodities which do not face risk at supply side (because of price uncertainties or volatility prices) but face risk at the demand side. There are goods whose prices may be known to be stable or may not be fluctuating in a certain time frame but they cannot be produced unless there is a definite demand for them. Infra-structural products, buildings, houses etc. fall into this category. These projects also may take a long period to be produced. A concept of Futures trading to help the production of such commodities is non-existent despite that such commodities carry a lot of economic significance for countries in developing stage.

III

EXPLORING ISLAMIC FUTURES

EXPLORING ISLAMIC FUTURES

As highlighted in the previous section, Interest Rate Futures, Foreign Currency Futures[5] and Futures of stock indices fundamentally violate the Islamic economic concept and principles of exchange and therefore it will be no use to go into further details of the Futures markets of these items. Futures markets of commodities, however, do have common base from Islamic point of view and therefore is explored further. This section discusses in brief the basis on which it is possible to develop the concept of Futures trading that would be in line with Islamic injunctions and will discharge useful as well as Islamically acceptable functions in a Muslim economy.

3.1 ISLAMIC NEEDS FOR FUTURES MARKET

Futures market is an institution to help promote exchange of goods. Since this institution can help improving efficiency in production and exchange by redistributing the entrepreneurial risks from those who are in less privileged position to afford them to those who are in a more comfortable position to *afford* them, the nature of this institution cannot be declared to be intrinsically against *Shari 'ah*. Though the methodology can be objectionable but the underlying objective is not inconsistent with the objectives *of Shari'ah*. There is, therefore, a need to see if it is possible to organize this institution to operate according to Islamic principles. Development of Futures market consistent with *Shari'ah* is needed to promote trade which Islam has permitted as an economic activity and has given principles to enhance it.

[5] This refers to the present concept' and practice of Foreign Currency Futures in the Futures market which involves interest as well as violates the Islamic principle of delivery with respect to exchange of currencies (as a specific tradition of Prophet, peace be upon him, exchange of currencies hand to hand). The issue of hedging the producers and traders of commodities across borders against volatility of exchange rates needs developing Islamic concept of Foreign Currency Futures. This subject, however, has been left for a separate independent discussion.

As explained earlier in the previous sections, the modern Futures Market, were developed from the simple concept of forward trading which aimed at;

i) reducing risk of farmers arising out of uncertainties of market prices of agriculture good particularly at the harvest time,

ii) giving liquidity to traders in the sense that traders could make future sales contract without committing any funds now.

If this concept of forward sales can develop the modern Futures market, then it is quite logical to assume that Islamic concept of *Ba'i Salam* and similar exchange contracts can develop Islamic Futures market. The *Ba'i Salam* contract is more logical than the western concept of Forward Sale from the point of the objective of helping the producers and enhancing exchange. It has following features;

i) Reducing risks of farmers arising out of uncertainties of market prices of agricultural goods particularly at the harvest time.

ii) Giving liquidity to farmers by making out the advance payment of the price while making forward trade contract. This helps the farmer to purchase necessary inputs to materialize the production as well as to meet his personal needs during the production period.

iii) Discouraging the traders (by forcing them to pay in advance) to avail the opportunity and temptation to venture into speculative activities and earning income without playing a productive role.

A Futures market developed on the Islamic concept of *Ba'i Salam* is expected to generate more healthy effect not only by marginalizing speculative activities in the commodity markets but also becoming a means of financing agriculture sector. This aspect of serving as a source of agriculture financing makes the institution of Futures markets based on *Ba'i Salam* concept all the more important in view 'of the economic situations of contemporary Muslim countries. Economies of most of the present day Muslim countries depend overwhelmingly on agriculture sector while the agriculture sector is extremely underdeveloped. Most of the agriculture farming is subsistence farming. Very little is meant for marketing and that too fails to enter the competitive markets. Farmers, when needing financing to cultivate their crops or to meet their personal needs had to take recourse loans which is often: to the informal creditors in the absence of formal credit institutions in the rural sector. These creditors, particularly those in the informal sector, not only charge them high rates of interest but also force them to sell their crops without waiting for its sale in the competitive places at appropriate timings. They get a price even less than the market price which is already low because of the seasonal glut in the market.

Introducing a market for *Salam* trading (as it was done in the West in 19th century in the form of introducing forward trading), with all underlying Islamic conditions, for this trade, can trigger an Islamic Futures market to take its course not in the direction that Western markets took (to make it overwhelmingly a place for speculation and gambling) but in a direction that helps improving the production and exchange without creating unhealthy elements for the economy.

The dynamic needs at the initial development stages of a growing economy require future needs to be matched with present production plans. This becomes particularly necessary when raw materials prices fluctuate widely and make it difficult to work out production plans for the manufacturing sector. Futures market can play important role in this respect for the Muslim economies as most of them face serious problem in implementing their economic plans due to volatile fluctuations of raw materials in the national and international markets.

Muslim economies need to mobilize resources for development. Futures markets can serve as an instrument for resource mobilization particularly from the rural sector if proper institutional arrangements are developed for the operations and dealings of Futures markets.

Futures markets in the West have mobilized small savers to invest in these markets. But the nature of these markets has simply led them to become speculators and gamblers. Futures markets developed on Islamic lines will mobilize small savers to directly contribute to economic growth and development.

It has already been emphasized that the farmers in developing countries in general and Muslim countries in particular are severely constrained by liquidity which does not allow them to come out of the poverty trap. Futures markets can provide them a powerful institution to get out of this trap by improving their liquidity position. This would, however, be possible, as will be elaborated later, if Futures markets are developed strictly on Islamic principles of exchange.

Two prominent aspects of economic development in contemporary Muslim economies can be very effectively taken care of by Futures market. 'One is the rural development and the other is infrastructural development. Resource mobilization for financing these two sectors are constrained by several factors. Borrowing on interest simply adds up to the debt burden for the government and often turn out to be non-productive. Futures market can get these sectors developed through market mechanism.

3.2 PRINCIPLES FOR 'IRE DEVELOPMENT AND OPERATIONS OF ISLAMIC FUTURES AND THEIR MARKET

Convinced with the need for introducing Islamic Futures and their markets for a contemporary Muslim economy, it may be instructive to highlight, at the outset, basic principles that would govern the introduction of such an institution. *The* following principles need particular attention in this respect:

1. *Shari'ad* principles relating to Forward trading.
2. Principle of Prohibition of gambling and hence speculation (for the purpose of earning income merely by guessing the price movements).
3. Principle of Futures. market to be an integral part of the commodity market.
4. Criteria for the selection of commodities for Futures trading.
5. Principle of standardization.
6. Principle of matching the sale with productive capacity.
7. Principle of Productive Hedging.

These principles are elaborated in more detail below:

3.2.1 Principle of Adherence to ***Shari'ah*** Rules Relating to Forward Trading

The concept of Islamic Futures will be derived from the *Shari'ad* concepts of *Ba'i Salam, Istisna'* and *Jo'ala* contracts. The *Shari 'ad* principles for these concepts are briefly described below:

A) BA'I SALAM

Sale of a deferred commodity against a present price, or purchase of a deferred commodity for a present price is called *a Salam* of Forward Trade Transaction.

There are three elements of this contract:

1) The commodity sold/purchased
2) The purchaser or the one who is paying the price now.
3) The seller or the one who agrees to deliver a specific commodity at a determined future date.

In *Shari 'ad* terminology, when *a Salam* contract is effected, the commodity in question is called a "debt" on the seller, as all *Fuqaha'* agree.

A Salam (Forward) contract in Islamic framework is subject to following main *Shari'ah* conditions:

1) Price must be paid by the purchaser in advance and in lump sum.
2) Using debt owed to the purchaser by the seller as price of the *Salam* commodity is prohibited[6] First because it will violate the principle that price must be received by the seller in advance and secondly, and more importantly, it implies exchanging debt for debt which is prohibited. The practice of

---

[6] See Ibn-e-Qudana, *Mughni wal-sharh-al-kabir[.]* *Vol.4* pp. *336.*

[7] *By* Tradition *of* the Prophet [peace be upon him] which says "Ubada b. al-Samit (Allah be pleased with him) reported Allah's Messenger (may peace be upon him) as saying: Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley,

paying the *Salam* commodity by debt may lead to exploitation of Farmer and will defeat the purpose of helping the Farmer to finance his production.

3) Depositing the received price with the purchaser is permissible if the seller receives it at the time of signing the contract and then deposits it with the purchaser.

4) Price should be determined and fixed in advance at the time of signing the contract though it may or may not be the price currently prevailing in the market.

5) The *Salam* commodities according to all *Fuqaha'* is any thing that can be sold and which can be specifically described.

6) The *Salam* commodity can be goods as well as services of an real asset.

7) The characteristics to be mentioned in describing the commodity sold should include those which could apparently affect its price without including other unnecessary details in order not to make *Salam* contract impracticable.

8) *Salam* contract is not permitted when commodity sold is money or another currency.

9) Commodity sold should be of known quantity.

10) Commodity sold should be a thing that can possibly be delivered.

11) ' The two objects exchanged should not be such that their exchange will lead to *"Riba".* For example exchange of currencies cannot be made in the form of a *Salam* contract because it will violate the principle of exchanging hand to hand (and hand to hand means no *Sabin).*

12) The contract should be binding and with no option especially contractual option.

13) Purchaser cannot resell or transfer the ownership of the *Salam* commodity before it is delivered to him. He cannot dispose of the commodity through any such action that leads to the ownership transfer like *Ba'i Murabaha, tawliyah* and *wadi'ah, hawalah* etc. (This is the opinion of

---

dates by dates, and salt by salt, like for like and equal for equal, payment being made hand to hand. If these classes differ, the sell as you wish if payment is made hand to hand.

Hadith No. 3853 Chapter DCXXIV Conversion of Currency and Selling of Gold for Silver on the Spot, Kitab al Buyu. Sahih Muslim Vol. III translated by Abdul Hamid Siddiqi, published in June 1976 and reprinted in 1981 by Sh. Muhammad Ashraf, Lahore, Pakistan.

majority of the schools of thought including *Hanafi, Shafi'i* and *Hanbali. Malik* school, however, permit resale or transfer of ownership before delivery is made provided the *Salam* commodity is not a food item)[8]. There is, however, permission to sell a parallel *Salam* on the basis of a *Salam* already purchased. The issue will be discussed later in more detail.

14) There is, however, no objection issuing a parallel *Saloom* contract against the *Salam* commodity to be received in future. The two parallel contracts, however, will be independent with independent obligations.

15). If the seller does not deliver or tries to evade the delivery of the commodity of *Salam* contract in time while the commodity is available in the market, then this will be treated as refusing or evading to pay a debt. A legal sanction through court can be obtained against him. (It is, however, not permissible to include any clause in the contract to impose a fine for delay.)

16) If the seller is unable to deliver the commodity, the following can be done:

i) The seller agrees with the buyer to postpone the delivery till the next crop (output) comes.

(ii) . If buyer does not agree, the seller will return him the advance paid to him (without any increase).

(iii) The contract can be canceled by mutual agreement.

The detailed discussions of these conditions can be seen in Umar (3).

Three points require serious attention in the concept of *Salam* trade from the point of view of Futures and their markets. Firstly, delivery of the goods is mandatory and compulsory. There is no way to get around it. This is completely opposite to the practice in the contemporary Futures trade.
Though the delivery is legally binding but there is a mechanism to absolve the traders of the obligation to make or take delivery. This will not be possible in Islamic framework.

Secondly, reselling of a *Salam* commodity before it is received is not permitted in Islam, whereas contemporary Futures market have not only made it permissible but have separated the Futures market from commodity markets

---

[8]. See *Mughni al-Muhtaj [14] vol. 2 pp.* 70; *al Mughni wal-sharh al-kabir [13],* vol. *4* pp. *341 &* 342 and lbn Qudana [11] vol. 5 pp. 218-219.

in order to focus only on selling and reselling commodities without receiving them.

Thirdly, *Salam* contract strictly require advance payment of the price of the goods. The contemporary Futures market, on the contrary do not require any payment to the farmer. They require only a small deposit, usually 5 percent of the price, with the Futures exchange as **a** security. This deposit is not paid to farmer.

B) ISTISNA' CONTRACT

Under this. contract a party A agrees to construct/manufacture a particular product (with predetermined specific features) and to deliver it to the party B against a pre-determined price. According to some schools of *Fiqh* the price has to be paid in full in advance and this contract is required to be stipulated strictly according to the same conditions as of *Salam* contract.
The *Hanafi* school of *Fiqh* who, in fact, originally introduced this type of contract in the Islamic Jurisprudence are of the view that the price may not be paid in advance. It can be paid in installment, or can even be deferred until the product is delivered.

For the purpose of this discussion on Islamic Futures, only *Hanafi* school's position need to be discussed further as they treat *Istisna'* contract to be distinct from *Salam* contract. The position of those Fiqh school which consider it exactly as *Salam* contract need not be discussed for the case of Islamic Futures as it will be covered within the discussion of the *Salam* contract based Futures.

The need for introducing the *Istisna'* contract as a distinct contract was realized (by *Hanafi* school) on the fact that in various phases of man's civilized development, there has been always been need for commodities that will never be produced unless some one sponsors them and guarantees their purchase. In other words the production will follow demand or only demand will generate its supply. The uncertainties with respect to demand will not encourage production particularly in cases where it entails high costs to produce it. This is also true for goods which are required to be custom made and individual taste and choice is important in its demand. Under the modern context, several commodities can be identified to fall in this category. Some examples include, building of a house, bridge, a dam, a refinery, a ship, manufacturing a factory, making crafts, any other particular product for meeting some specific needs of a client or group of clients.

Various considerations, including technical difficulties or unique specification of the product (which are customized and will vary from client to client) or the high cost of production that a manufacturer is unable to afford or is reluctant to make huge investment without any particular purchaser in hand etc. necessitated the need of the *Istisna'* type of contract. Here the price or fluctuation in prices is not the problem as in the case of agricultural commodities. Here the problem is the demand itself Will the commodity be demanded or not? Whereas in the *Salam* contract it is the price that is not certain and protection has to be sought against the fluctuating prices, in the *Istisna'* contract, it is he demand that. is not certain and the demand is to be secured and guaranteed in advance. As far as price for an *Istisna'* contract is concerned, the question of price uncertainty or price fluctuations is not relevant because it is customized commodity and has no market to determine its price. The price will be determined mutually by the client and the manufacturer keeping in view the cost of manufacturing the product.

One useful function of the *Istisna'* contract in the modern context is their use in the development of infrastructure in the economy. All infrastructure projects are essentially built under an *Istisna'* contract. It is neither possible nor feasible to pay the entire amount of the contract in advance to the contract. *Salam* contract will not, therefore, be useful for such projects. *Istisna'* contract with the possibility of payment in installment, or at the time of delivery will be the only instrument to implement such projects.

For these reasons, and in order to cater for the needs of the modern age and facilitate business transactions for Muslims, it was very important to allow deferring of price. This view has been adopted by the Islamic *Fiqh* Academy of OIC[9].

---

[9]. See Resolution No. 7-3-67 of the 7th Annual Meeting of the OIC Fiqh Academy held on 7-12 Dhul Qada 1412H (9-14 May 1992) in Jeddah. The resolution clearly mentioned, "It is permissible in *Istisna'* contract to defer the whole price or pay in installments over a defined period".

As regards the definition of *Istisna'* contract, it can be said that a contract thus effects the immediate purchase of something that is subject to manufacturing and which the manufacturer undertakes to deliver duly manufactured, using materials available to him, in accordance with certain specifications, for a specific amount of money is called *Istisna'* contract.

The features of an *Istisna'* contract are as below:

1) *Istisna'* contract is a sale contract. It is neither treated as **a** hire contract treated as a promise to deliver. It is treated as a sale contract.

2) The subject matter of the contract is the commodity ordered by the buyer to be manufactured and not the work or services of artisan or manufacturer and that is what distinguishes it from the hire-contract.

3) The subject matter of the contract is deemed to be non existent at the time of contracting and the purpose of the contract is to manufacture it and bring it into existence and that is the only justification of the permission of such a contract as an exception to the general.

4) The realm of this contract is goods that are subject to manufacturing; it does not include natural goods like fruits, cereals and the like as these are in the realm of *Salam* contracts if there is a need to sell them before they come into existence.

5) The article to be manufactured constituting the subject-matter of sale should be duly described in a clear manner that would not leave any doubt or uncertainty about it. The same care is required in determining and fixing the price.

6) The price need not be paid in advance in *Istisna'* contracts contrary to the case of *Salam* contracts. The price, however, has to be precisely and definitely known in advance. The price may be totally or partially advanced, totally or partially deferred or paid in installments.

The following distinctive features, particularly in comparison to Salam contract, need to be noted in case of *Istisna'* contract:

Firstly, these contracts cannot be done in such commodities that are normally available in the market or are not. required to be customized. In other words these contracts cannot be done where there is no uncertainty about the demand and some demand is always expected to exist. These contracts are allowed only for such products which are not primary goods and which will be produced only when there is a specific definite demand already established. The examples include, buildings, bridges, factories, etc. This may include even such mundane items as tailored clothing. Only the buyers, therefore, will initiate a Futures contract in this case unlike the conventional Futures which can be initiated by either buyers or sellers.

Secondly, unlike *Salam* Sale the payment of price in this case can be deferred until the delivery of the product. The price, however, can be paid in installments as may be mutually agreed. Thus in this context it is in line with the contemporary Futures market where the prices are not paid in advance for Futures delivery. Despite this feature, this is still not a concept that be acceptable to or could be accommodated by the contemporary Futures market. Modern Futures markets are interested only in such items where the prices fluctuate in short run. In *Istisna'* commodities, there is little chance for the traders to earn income in short run on the basis of guesses and speculations as they currently doing in the Futures market. The nature of any Futures defined on the basis of *Istisna'* contracts will be quite different from the present day Futures. Such *Istisna'* Futures, if developed, may not strictly come into the conventional definition of Futures contract. When we are talking of short term Futures contract, in the structures of contemporary Futures market, where traders can easily sell and purchase their contract documents and make money out of the fluctuations of prices, then *Istisna'* based Futures contract, of course, will not fall into these types of Futures contracts.

But if we define a Futures contract which envisages a delivery at some future date, then of course this is as much a Futures contract as is the Futures contract of the sale of say 1000 bales of cotton. The only problem in case of such *Istisna'* contract will be, how do we develop a Futures market for these contracts and how these contracts can have a secondary market to provide the liquidity that Futures markets are meant to provide. This is question will be dealt with later in this section.

Thirdly, this contract is basically a production contract unlike *Salam* contract which is basically a trading contract. Thus a seller agreeing to provide a product in future under this contract will have to be a producer or will establish a contract-with a producer before entering into such a contract.

Under *Salam* contract, this is not necessary. Since the *Salam* goods are generally available in the market, the seller does not have to be a producer. He can purchase from the market to supply the promised goods.

C) *JO'ALA* CONTRACT

The concept of Jo'ala is similar to that of Istisna'. Whereas in Istisna' the seller provides a physical commodity, in Jo'ala the seller provides a service rather than a physical commodity. All other aspects of Jo'ala are same as of Istisna'. In Jo'ala deal, a seller will offer a definite service to be provided whereas the buyers will pay a definite price for this service. In many instances, . it may be difficult to distinguish whether it is an Istisna' deal or a Jo'ala deal.
For example, consider asking a tailor to make **a** particular dress where the client pays the tailor an advance only to cover the purchase of raw material, remaining payment (for the service of the tailor) to be made after the good is delivered. This activity can be done under either of the two concepts, though conventionally, this activity is regarded as a Jo'ala activity.

Some scholars, therefore, distinguish Jo'ala concept from Istisna' concept only on the ground that Jo'ala is for the payment of service which is undetermined and uncertain (and hence its price also remains uncertain) only and it is on the basis of this distinction that they do not consider Jo'ala as a contract. In the above examples since tailor is being asked to provide a definite service, it will be" an Istisna' contract and the price as well as goods to be delivered will be definitely determined in advance. The price, however, is not in terms of service delivered (as in having contract) but in the basis of goods delivered. Though there is payment for a service is involved in Jo'ala contract and is paid on the basis of the delivery goods concerned but it differs from Istisna' and *Ijara* (having contract) is that neither the amount of service is definitely known at the time of contract (as in *Ijara)* nor the delivery is certain as in case of Istisna'.

Jo'ala can be an open deal. For example a deal that any body who catches a bird will get US$ 10 will fall into the category of Jo'ala. No contract is required for such a deal. However, as soon as any one catches a bird he can come to claim US$ 10.- There is no specific party on the other side. The party will be identified only after the service has been done. But once this service has been done, there is no need of contract, only the payment has to be made. Another example of such deal is when a specified reward is promised to a specified person or group of persons to find a lost property or a stray animal. Similarly a deal with a doctor to cure a patient until he recovers from a certain illness etc. (9).

One evidence of such a deal can be seen in the following Qur'anic verse as:

"For him who produces it, is (the reward of) a camel-load and I will be bound by it" (al Qur'an 12:72).

There was no formal contract there too though there was a definite deal.

Islamic Jurisprudence, however, recognizes Jo'ala as an exceptional form of contract and the basis for the legality of this contract, again, is derived from the recognition of the necessity of such a contract in the society.

The necessity is that often, an output is desired for which it is not certain how much time and effort will be needed to get that output. The good may already be there but its delivery is not certain. Or the good may not even exist. But still it may be worthwhile to do the effort for the benefit of an individual or society. The regular forms of contract of sale or *Ijara* will not cover such an activity because the delivery of goods or service is uncertain. Similarly, the contracts of *Salam* and Istisna' also are not applicable because they are meant for peculiar situation different from this situation. Hence a separate category of contract was defined to fulfill a genuine economic need relating to the institution of exchange.

Jo'ala contract is essentially a contract for the beneficial use of a service. In this contract, two elements have to be precisely and certainly defined: (a) the amount of reward offered, and (b) the specific service to be accomplished.

The parties in such a contract often may not necessarily be obliged to be present at the time of carrying out the contract. There may, however, be certain contexts where a formal Jo'ala contract may be arrived at between two known parties.

There may always be situations in a society whereby certain arrangement is needed for the provision of a service whose need (with respect to amount or time) may not be known with certainty. Doctor's services is one example. There may be a contract with the doctor or a hospital to provide service (home visit) for example and payment will be made according to the actual service (actual home visits) provided. [This, of course, is different from *Ijara* contract where a doctor will be paid per unit of time irrespective of how much service he actually provided].

There can be several other such instances. Various community services, environmental activities, social services can be arranged on the basis of such contract.

An important area in the contemporary context in the domain of Jo'ala concept is the need for inventions and innovations. An individual or a company already involved in a certain research can be contracted to work out a certain specific innovation or invention and the payment will be made as and when innovation or invention is actually realized. Jo'ala contract thus can specifically be useful in motivating the resources already employed in certain direction to take care of a side direction as well, as a part of their activity.

The concept of Jo'ala contract though is not strictly a case for Futures market as far as the conventional concept of Futures market is concerned yet possibilities exist to develop Futures of this sort to mobilize resources from those who like to take such risks.

The essence of Futures market is the management of uncertainty. The uncertainty related to output whether or not it may materialize, is a type of uncertainty that can be taken up only with Jo'ala type arrangement. Just like *Salam* is for dealing with uncertainty of price in future, and Istisna' is for dealing with uncertainty of demand, the Jo'ala is for dealing with the uncertainty of output Since there is uncertainty about the output to be delivered in Futures, there is a case for Futures contract and hence for a Futures market. It will not be similar to that of conventional Futures market, but will be a Futures Market in its own right, serving the same useful purpose as was the original purpose of the conventional Futures market, i.e. promoting the exchange and production through management of uncertainties, affecting the exchange and production of the goods concerned. The Futures markets based on *Salam,* Istisna' and Jo'ala in fact will be moving a step further, promoting the exchange (and hence production) of goods as well as services in the real sector while conventional Futures market aim at only physical commodities.

Islamic Futures market thus will be required to be strictly developed on the principles of the three Futures contracts defined in *Shari'ah* described above; namely *Salam,* Istisna' and Jo'ala.

These contracts concentrate on three elements:

(a) Uncertainty about some aspects of the market (prices, demand or output) is constraining the production or exchange of goods/services.

(b) The uncertainty is dealt with in a way so as to minimize its effect on that aspect of the market that is constraining the exchange/production of the goods/services concerned. When it is the uncertainty of prices, the prices and the factors effecting it are the main focus for the Futures contract. When the uncertainty is about demand, determining and defining the exact nature and form of demand is the focus of the contract. When uncertainty is about the supply or output, then it is the output/supply which is the main focus of the contract. The objective in all these being to avoid the possibility of dispute because of the uncertainty about certain elements of the contract.

(c) Advance payment of price when the output is normally available in the market and hence certain to be delivered. When there is uncertainty of the output to be delivered because the output is not available in the market, the payment of price can be deferred until the delivery of the output.

3.2.2 Principle of Non-Gambling Speculation

Gambling is prohibited in Islam. Earning income from mere speculation on prices without having an explicit part of the real activity comes under the category of gambling.

No doubt dealings in market do require speculation on prices but we need to distinguish between two types of speculations particularly in terms of Futures market.

One is the speculation that is not related to any real activity and is meant to be merely financial or monetary transaction or a non-productive exchange.

All such activities in the Futures market that are meant to .make a possible income simply by making good guesses with no intention to receive or deliver or produce goods or manufacture or supply real services will not be allowed as this will fall into the category of gambling.

The other speculation (with particular reference to Futures trading) is the one that is a part of some real activity and helps in shifting risks from the vulnerable producers, who cannot afford bearing all the risk, to those who can afford to bear it. Speculation as a part of such activity, will be desirable and permissible. Also 'an activity that is a part of a deal that provides liquidity to farmers so that they can make better production decision, or enable the farmers to increase volume of their production will also be a desirable and permissible activity even if it involves speculation on future prices. Thus a *Salam* trade within Islamic principles that speculates on prices is a permissible because it helps farmers and also helps productive activities despite that the buyer in the *Salam* trade is involved in a speculative activity.

The trading in Islamic Futures market, however, defined will not be allowed to enter in the market for pure speculation purpose. They will have to establish that they are bonafide traders/producers and would deal in real goods and services and would not merely gamble.

3.2.3 Principle of Integration of Futures Market with Commodity Market

Futures trading is required to be done within the market of real goods and services. The creation of a separate market to trade only the documents of Futures contracts only will not be permissible in Islamic framework. This in turn means that every Futures trading transaction will involve actual receiving or delivering a commodity . or product or performing a real service. Unlike Conventional Futures market the actual delivery (by seller) as well as its receipt (by buyer) will be mandatory and cannot be offset by writing a reversing Futures contract in the Salam-based Futures Market. In Istisna' and Jo'ala market too the contract will be completed only by making or receiving actual delivery of the goods or service concerned.

3.2.4 Criterion for Goods and Services to qualify for Futures Trading

For *Salam* contract only these commodities will qualify for which a regular supply already exists in the market. These can be primary as well as manufacturing commodities.

Salam trade was originally allowed for agricultural commodities but the principle can be applicable to non-agricultural commodities. This can be permissible for virtually all primary goods and manufactured goods. Futures trading for primary goods will serve a dual purpose. Firstly, it will reduce the producer's risk as prices of primary commodities usually record seasonal fluctuations. Secondly, it gives liquidity to the producers which is of great significance particularly to the farmers in developing countries. The same is true if the *Salam* is done for a manufactured item. The *Salam* contract will reduce the risk on account of uncertain prices and will provide a working capital to the manufacturer. Istisna' contact can be made only for those commodities that are required to be specially produced according to defined specific and are not otherwise available in the market. For Jo'ala contract, no physical goods will qualify. Only services will qualify for such a contract.

3.2.5 Principle of Standardization

All futures contract requiring the goods/services to be delivered in future need to be standardized with respect to the contents of the contracts in order to develop a market for these contracts. In *a Salam* trade, it is important that all such details about the quality of the goods be specifically described that can affect the price of goods concerned. For the development of a market for *Salam* trading, it will be important that description of goods qualified for *Salam* trading is adequately standardized. Many countries have standardization institutes which are working for describing specific standards and qualities for different products. The services of these institutes will play an important role in standardizing the description of commodities for *Salam* trading. Same will be true for Istisna' and Jo'ala contracts.

The 'forms of contracts too will need to be standardized to develop an organized and efficient market for these contracts. An appropriate legal framework will be needed to standardize these documents.

3.2.6 Principle of Liquidity

Liquidity helps both sellers and producers and expands their abilities to invest.

The liquidity aspects have peculiar dimensions in Islamic Framework of Futures trading that are quite different from those of conventional Futures trading.

The conventional western framework takes care of liquidity consideration in the following ways:

i) The concept of forward or Futures trading enables the traders to purchase Futures without paying the price now.

ii) Segregation of the Futures market from commodity market enables the traders not to worry about liquidity even at the maturity of the contract to pay for the goods as he can always make an offsetting contract.

The existence of secondary market for Futures contract enables the traders to sell his old and purchase new contract (in order to benefit from the price movement) without making substantial investment.

The conventional concept thus has taken care of the liquidity needs of the traders only and facilitates him to increase his transactions without worrying much about the liquidity to support these transactions.

Islamic concept of Futures trading provides liquidity whenever feasible to the producers rather than to the traders. The concept thus helps producer to bring the product into the market. The trade is assumed to take care of its own liquidity once the product is available. The Islamic concept rather puts a further restriction on the liquidity of traders in the Futures market. The promises as well as the debts/obligations are not allowed to be traded. The trader will have to wait until the delivery is made before he makes a profit out of his investment.

For providing a liquidity to the traders, if needed, a separate mechanism may be allowed to be developed in the market. There can be several ways of providing liquidity to the traders of *Salam* contract. Financial institutions can take care of this aspect. One caution, however, is in order at this point. Interest based financial institutions will be keen to provide short term liquidity to the traders but the availability of this type of short term credit on the basis of interest will put the traders in very vulnerable situations when the Futures trading is being made on Islamic principles. The traders will use this liquidity to make advance payment to the producers. Any unfavorable movements in the market prices will make the traders more panicky (compared to a similar situation in conventional market) because the interest liability on the amount he borrowed to make the advance payment is large and fixed. The availability of interest based credit generates motivation for pure speculation in conventional Futures market, but such a credit in Islamic Futures trading will lead to instability and disorder in the market.

Traders, however, may genuinely need liquidity to make them more effective operators in the Futures market. This question will have to be addressed when the establishment of Islamic Futures market is considered.

One way of enhancing liquidity opportunities to traders of *Salam* contracts could be found in the fact that there is nothing in *Shari'ah* to bar the purchaser of the future delivery of a commodity to make an independent parallel contract to sell the same (or similar or even a different) commodity at some date in future (which may or may not be the same) date at which he is receiving the delivery of his own commodity. For instance, trader X purchases now (say in June) 1000 bushels of wheat to be delivered to him later (say in December). He, of course, has paid in advance the price of 1000 bushels.
Later on (say in August) he needs money to do something else which is more profitable than waiting for December delivery. He can offer an independent Futures Contract (say December) sale of the wheat. Since he too will receive the price in advance, his liquidity problem will be solved. He can deliver the goods promised by him in his forward sales contract when he receives the goods that has been promised to him in his forward purchase contract.[10]

For Istisna' contract, there is a provision to make an advance payment or a payment on installments to the producer in order to provide necessary liquidity needed to materialize the production. In case of Jo'ala, no advance payment can be made because the delivery of output is not certain.

3.2.7 Principle of Matching the ability to supply with the Sale of Futures Contract

Volume of Futures Contract cannot be allowed to exceed the production or supply capacity.

The conventional Futures markets often witness number of contracts exceeding the available commodity supply. As delivering month nears, the number of contracts tend to decrease as speculators start offsetting, leaving the actual commodity dealers to deal. But it may happen that a commodity may turn out to be in scarce supply and when the delivery month nears, the sellers of Futures Contracts (suppliers) will come under pressure to meet their obligations and it is possible that the seller may find it difficult to make the delivery (because at the time of selling the Futures contract there was no

[10] Trader 'K however, will have to fulfill his obligation of supplying the promised wheat in October irrespective of whether or not his own obligation has been fulfilled by 'Y'. For a discussion on *Shari'ah* basis of this issue, see Umar [3]

obligation to show that he had the capacity to supply the goods at maturity). Sometimes this situation may be exploited by an individual in their favor if they had the means to control the supply and hence corner the market. This is what happened when Hunt brothers in USA in 1979-80 offered to purchase a huge amount of Futures contracts of silver. (They could buy all this by only depositing small amounts of money margins). They simultaneously bought tremendous amounts of world supply of physical silver from cash market (getting their purchase financed by the Bank). When the delivery month came the seller of Futures Contracts of silver came under pressure to meet their obligations. Many traders lost huge sums of money as a result.

For the Islamic Futures exchange such a possibility hardly exists. It is not permitted for anyone to sell a Futures Contract for which he does not already have a basis to offer the supply at the due date. Either he is a farmer/producer or he already has land/plant to produce or he already has purchased a futures contract against which he wants to sell etc. The traders (who are not producers) though could also sell Futures contracts yet since the actual delivery is obligatory, he will have to carefully assess supply prospects on the due date before he sells a Futures contract. He can, for example, purchase a parallel *Salam* contract to ensure supply. Thus the possibility of Futures contract sold in excess of supply is very remote. Furthermore, in Salam sale no one is allowed to purchase Futures contract without making payment in advance. Thus it will be very difficult for any one to purchase huge amounts of Futures contract to corner the market as Hunt brothers could do.

3.2.8 Principle of Non-Substitution

It is not permissible for a seller to offset his obligations to make delivery by making an opposite offsetting contract. The obligations to make (as well as to receive) delivery will have to be fulfilled. The seller, as well as buyer will have to remain in the market for the entire period of the contract.
The seller is not allowed to sell his obligations in the market and get out of his obligation.

IV

POSSIBLE TYPES OF ISLAMIC FUTURES MARKETS

POSSIBLE TYPES OF ISLAMIC FUTURES MARKETS

Based on the three Islamic concepts of contract relating to future delivery, three different types of Futures markets can be considered for an Islamic economy:

a) Salam-based Futures Market (for commodities for which a regular market exists).
b) Istisna'-based Futures Market basically for the infra-structural and developmental projects.
c) Jo'ala-based Futures Market for service based activities.

This paper will concentrate more on the *Salam* based market as a viable Islamic alternative to the conventional Futures Market. The possibility of developing Islamic Futures Market based on Istisna' and Jo'ala concept will be discussed in brief leaving detailed analysis for a later exercise.

4.1 SALAM-BASED FUTURES MARKET FOR COMMODITIES

4.1.1 Basic Elements of Salam-Based Futures Market

The contemporary Futures Market for commodities in fact introduced two elements in the trading process of physical commodities. First, introducing the concept of sale contract or purchase contract in the form of promises to deliver or accept delivery of the commodity concerned in future and then introducing the so called, revolutionary concept of trading these promises as marketable instruments in their own right.

The first element has two dimensions from Islamic point of view. Islam accepts contract in the form of promises to deliver in Futures. But Islam requires, in case of such contracts, to pay the price in advance to the seller. Secondly, Islam requires in case of such contracts to fulfill the promises by actually making and receiving the delivery. The actual delivery is binding and mandatory on both parties. The seller will actually deliver and the buyer will actually receive the commodity concerned at the expiry of the contract.

These Islamic aspects about the Futures contracts, though totally at variance with the practice in the conventional Futures markets, yet they do not preclude the development of a Futures market because, in principle, even the conventional Futures markets have legally binding provisions of making or receiving actual delivery. The difference will be that whereas conventional Futures market have developed institutional arrangements to allow most of the traders of Futures contracts to bypass the legal provision of actual delivery through the provisions of the reversing contracts, the Islamic Futures market will not have such arrangements. Contractual obligations will have to be fulfilled in letter and spirit.

The economically useful function could still be discharged by the *Salam-based* Futures market. The market will still be redistributing part of the risk of uncertain prices from those who cannot afford to bear the risk to those who can afford to bear it. This in turn will help promoting production and exchange in the economy. The condition of advance payment as well as actual delivery do not affect this objective.

The only thing that will be affected by the introduction of Islamic concept of advance payment will be the liquidity of the traders. They lose liquidity by making advance payment to sellers or they face liquidity problem in making advance payment. This limitation, however, would lead to introducing one healthy element in Futures trading and that is that the traders will no more be tempted to enter the Futures market with pure speculative intentions. The condition of advance payment as well as recovering or making the actual delivery will attract only the genuine traders of the commodity to enter the market. Another useful aspect of the condition of advance payment is that the farmers get enough liquidity to realize their production plans and hence ensure that supply promise is met.

As *far* as the liquidity needs of the genuine traders to deal in Futures trading is concerned, they may prove to be a serious hindrance in the development of a *Salam-based* Futures market. Some financial arrangement through appropriate institutions will be required to be developed to solve this problem. Some of the possible arrangements in this respect will be discussed later in this paper.

The point, however, is that the Islamic conditions regarding Futures contract cannot be a hindrance in the establishment of a Salam-based Futures market to discharge useful function of promoting exchange and production in the economy.

We now come to the second element of conventional concept of Futures markets which is regarded as a "revolutionary" development. This is the concept of sale and purchase of the promises (of future delivery) as market instruments to form a secondary market. This development is not so revolutionary from Islamic point of view. The Futures trade contracts are only the promises to receive or deliver the goods. Only a minority of ***Fiqh*** schools *(Maliki)* allow these promises to be traded. Ibn Taimyyah is also reported to support this view. The majority of *Fiqh* schools *(Hanafi, Sahfi'i* and *Hanbali),* however, take the position that such promises are not allowed to be traded[11]. According to these jurists, the trader will have to wait until the delivery is made before he can resell those goods and make profit out of his investment. Such a restriction, of course, cannot develop a secondary market for Futures contract. And in the absence of secondary market, the Futures market will not be as active and probably not as useful as a contemporary Futures market is supposed to be.

The existence of secondary market serves two useful purposes:

(1) It mobilizes traders to expand their trading activities.
(2) It mobilizes resources from small savers for investment in trading activities which not only promotes trading but also yields income to small savers.

Is short term liquidity to traders to multiply their trading activities is an important issue? Do small savers really benefit from investments in Futures market? These answers though may not always be positive but probably in most of the contemporary sellings they may not be totally negative.

The restriction on the sale-purchase of promises, however, in itself is no hindrance to the development of an Islamic Futures market particularly when there is the concept of making parallel contracts as elaborated earlier.

". See the referenced cited earlier in Footnote No. 9.

The possibility of making parallel contracts will develop a secondary market of its own kind which on the one hand will be meeting the liquidity needs of the traders as well as of small savers/investors and on the other hand will still be discouraging pure speculators.

The following example explains this mechanism:

In June, A offers a sale of 1000 Bushels of wheat in Futures (December) at $10 per Bushel

B accepts the offer and B makes payment of $10,000 to A In August B sees a good opportunity in another trade (but finds his money blocked in the Futures Contract of Wheat)

B offers a sale of 200 bushels of wheat in Futures (December) at price of $10.50 per basket

X (a small saver) accepts the offer and makes payment of $2100 to B In September B sees another good opportunity in another trade compared to his wheat Futures.

B offers another sale of 800 bushels in December at price of $11.00 per bushel

C a trader accepts to purchase 600 bushels and pays $6600 to B

Y a small saver accepts to purchase 100 bushels and pays $1100 to B

C another small saver accepts to purchase 100 bushels and pays $1100 to B

In November 'X' wants to liquidate his investment. He offers a contract of 200 bushels at the price of 11.25 per Bushels .

In this situation there is a primary market where A and B are original traders. This trade has generated a secondary market where B is seller and X,Y,Z and C are purchasers and then X is seller and D is buyer.

In December if X, Y, Z do not want to receive the deliveries, they may offer sale of bushels equivalent to what they purchased in their Futures contract. They may offer the price as $ 11.20 as the market price is $ 11.50 in order to get rid of the stock. (Or they may receive the delivery and sell in the cash market at $ 11.50).

C, D and E may accept this offer and pay to X,Y, Z respectively these amounts.

B will receive the delivery from A and will make delivery to X, Y, Z and C.

X, Y, Z receive their deliveries and deliver them to C, D and E.

C, D, E sell the product in the spot market or keep them for their own use.

A clearing house may facilitate the transactions. A will make **a** delivery for B in the clearing house. Clearing house will keep the stock in the store. B will receive the delivery from the clearing house and issue delivery orders for X,Y,Z and C.

X, Y and Z receive the deliveries from the clearing house and make delivery orders for C, D and E.

C, D and E either will receive the delivery from the store or will sell it in the spot market and pass on their delivery order to the purchasers from the spot market. Since C, D and E are selling in the spot market, they can even sell their documents received from the clearing house and their buyers can receive the delivery from the stores of the clearing house.

If B fail to make delivery, he will have to purchase from the spot market and deliver it to the clearing house (while settling his claims with A independently).

The Basic Elements of *Salam-based* Futures Market thus will be :

All Futures contract will require;

(i) Advance payment to the seller
(ii) Actual delivery to be made by seller and to be received by purchaser at the expiry of the contract.

2. Futures contracts cannot be resold
3. Futures contract can be offered only by the actual producers/farmers or by the actual bonafide traders registered with appropriate bodies or by the holder of a Futures contract of the same commodity and quantity.
4. A clearing house may manage actual deliveries.
5. The clearing house will ensure deliveries and take necessary steps to guarantee that deliveries are made by the sellers.

This is, of course, a simplified version of a possible Salam-based Futures market. There may be several questions relating to practical operations of such a market. One question, for example, may be whether there will be a limit on establishing parallel *Salams*. Also there may be a question as to what will guarantee that only genuine traders would deal in the market and pure speculators will not come in to benefit from the concept of parallel *Salam* only for the sake of pure speculation rather than for the interest in trade. These questions, however, can be dealt with in the institutional and legal framework that will be developed to organize such a Futures market. A few essential elements of an institutional framework for such a market are highlighted below:

4.1.2 Institutional Framework for Salam-based Futures Market

A. REGISTRATION OF BONAFIDE TRADERS:

Registration of bonafide Traders of the commodity is required to be essential for Salam-based Futures market to operate in Islamic spirit. In order to reduce, if not possibly eliminate, the pure speculation, all traders in the futures market will have to establish that they are bonafide traders of the commodities concerned and have the ability and capacity to make the delivery in case of sellers and the ability and capacity to receive the delivery in case of buyers. The registration may qualify the traders with respect to the size of transaction they can undertake in the market and impose a limit on the maximum quantity of Futures contract that they can trade depending on their credentials for the purpose of Futures trading. Islamic banks who are involved in trade financing on the basis of Islamic modes of financing will also be eligible for registration as bonafide traders if they are involved in trading. Furthermore, in order to enable small savers to benefit from Futures market, they may be registered (even if they are not actually traders) to deal only in limited amounts of Futures contract of small amounts.

B. NATURE OF FUTURES TRANSACTIONS OF BONAFIDE TRADERS

Futures transactions would involve buying and selling of futures contracts which will provide for the delivery of a particular commodity during a specified future month involving no immediate delivery of the commodity but the buyer will pay full price in advance. The Futures contracts will not be resold and will be fulfilled on the expiry of the contract.

C. ESTABLISHING A STATUTORY AGENCY to regulate and monitor the Futures markets to keep them in line with the Islamic principles mentioned earlier and to ensure that futures markets are serving traders rather than speculators and that all contracts fulfill *Shari'ah* rules.

D. ESTABLISHING AN EXCHANGE as a central place where buyers and sellers meet to transact business. Only the registered traders will be allowed to do business. The exchange will promulgate rules and regulations in order not only to facilitate uniform transactions among buyers and sellers in the Futures market but also curb pure speculative practices. Determining reasonable interval in quoting prices would be one way of curbing the speculative tendencies. (Quoting minute to minute prices has been referred to as a big incentive for speculation[12].

The Futures exchange will provide an active and organized market place to facilitate for the members registered with it to trade Futures under established regulations. The exchange will also assume, as usual, the responsibility for the grading of (Cash). commodities for the purpose of standardizing Futures contracts.

---

[12]. Maurice Alais Economy of Markets (7).

The *functions of* Futures Exchange will be as follows:

1) To lay down rules and regulation for Futures Exchange according to Islamic principles *of* exchange and trade.
2) To provide an organized market place for trading of Futures contracts and establish and regulate the lines of trading.
3) To register bonafide traders to keep pure speculations out of the market place.
4) To establish mechanism for grading, inspecting, the weighing commodities.
5) To formulate uniform contracts with respect to quantity, quality, time and place *of* delivery and *terms of* payment.
6) To collect information on prices and disseminate them for the benefit of members.
7) To provide machinery to guarantee the settlement *of* contracts and payments of financial obligations in connection with trading among members.
8) To provide machinery to guarantee making and taking the deliveries as contracted.
9) To provide mechanism for settlements of disputes among members.

E. ESTABLISHING A CLEARING HOUSE in - order to facilitate and regulate enforcement and settlements of contracts and hence ensure the same order and confidence in the Futures market that the conventional Futures Markets enjoy through their own Clearing House. The job *of* clearing house in case *of* Islamic Futures market may be simple than those of conventional Futures markets:

Under conventional framework a person who buys a commodity Futures, in fact, contracts to perform either of the two acts. First he or she may accept delivery *of* the commodity according to the terms *of* contract at the specified time. Second, he may not like to accept the delivery and can fulfill his contractual obligation by making an offsetting transactions of selling the same position before the delivery is due. Same two options are available to the person who sells a commodity Futures. Payments involved in the contract are not made until the delivery time. This system generates a complex series of financial and administrative operations for the clearing house to deal with.

In the conventional framework, Clearing House assumes the role of the other party in all Futures contracts. It becomes the buyer of all contracts that were sold and the seller of all contracts that were bought. With this role, the clearing house winds up "buying and selling many contracts from and to itself".

The Clearing House of an Islamic Futures exchange will not serve as other party in any Futures Contracts. It will serve only as a guarantor that all the contracts are honored with respect to delivery. The major problem for the clearing house will arise when the original seller fails to make a delivery. Once original seller has made the delivery, the remaining settlement is only a matter of managing the simultaneous receiving and making deliveries at the warehouse. If the original seller fails to make the delivery the clearing house as a guarantor will arrange deliveries from the spot market.

There may be problems when some secondary sellers (who issue parallel Futures sales contract) fail to turn up to honor his obligation to deliver. But in this case he will also fail to turn up to receive the delivery for the Futures Contract that he bought and against which he sold his Futures contract. In such a case Clearing House will serve as an agent of the absenting buyer to receive delivery on his behalf and make delivery on his behalf to the buyer of his contract.

The clearing house thus will be a guarantor for the original seller of a Futures contract and an agent for all subsequent sellers and buyers of parallel Futures contract.

Clearing House will charge necessary fees and commissions to ensure (and insure if needed) to carry out these functions. Clearing House, thus, will no more be involved in such silly & irrational activities as "selling to or buying from itself".

F. PRICING OF FUTURES CONTRACT

Price will be determined by competitive bidding and offerings made by the traders interested in selling and buying particular Futures contracts. The present method of bidding by public outcry on the floor of the conventional Futures perhaps is consistent only for the Futures exchanges working on the philosophy of promoting speculation alone. For an Islamic Futures exchange this may not be very relevant particularly in view of the fact that a bidding to purchase means a commitment to make the entire payment in advance. This would also require determining a certain time interval for quoting the new prices unlike the conventional Futures exchange where new prices can be offered any minute.

G. ADVANCE PAYMENT VERSUS MARGINS

In the conventional Futures exchanges margin is only a sort of earnest money to guarantee that the spot transaction will be made at the specified time. But this earnest money is such a small fraction of the entire payment (typically 5 percent) involved that it hardly serves its purpose. In case of Islamic Futures Exchange, there will not be any margins and instead the entire payment of the price of the Futures Contract will be paid immediately (in advance) to the seller at the time of purchasing Futures Contract.

H. OPTIONS

A further development of recent origins in the Futures market is the introduction of the concept of options and establishments of their markets linked with the Futures market.

An option contract confers the right but not the obligation to buy or sell a fixed quantity of a standardized commodity at an agreed price on or before a given date in the future. If the price moves favorably, the option is exercised and the commodity is bought/sold at the agreed price. If the price moves unfavorably, the buyer of the option simply abandons it. The option to buy a commodity is known as call option and the option to sell a commodity is known as a put option. Option prices have two components:

a) The intrinsic value that could be recouped if the option is exercised to day.

b) The time value which is any positive value in excess of intrinsic value that results from the chance that prices may move favorably.

In general, the longer an option has to run the more it is worth (i.e. the higher is the premium on it).

Options contracts are strictly analogous to insurance contracts. To protect against rising prices, a manufacturer may buy call options for its inputs. If the spot price is less than exercise price for which option was paid, the option is abandoned. If the spot price is above exercise price, the option is exercised. The stake in option is much less than the stake in Futures.

From Islamic point of view though it is permissible to make an option contract but it is not permissible to sell this option in the market[13].

The argument that options in the Futures market help producers in reducing their risks with little amount of capital needs to be assessed in the context of Islamic principles of exchange. This subject, however, has been left for separate discussion.

4.1.3 Islamic Banks and the Capital Needs for the *Salam* Markets

The framework for *a Salam* market outlined in the previous section made one distinguishing departure from the conventional Futures market and that is with respect to the liquidity of the traders to purchase Futures contracts in as much quantity as they like without substantial financial implications Islamic concept of Futures trading has no room for such liquidity for the traders. This may pose two practical problems in the smooth functioning of Islamic Futures market:

1) The restriction to pay in advance may refrain several traders to enter into the market. Only the traders with sufficient capital will be able to enter

---

[13]. Seventh Annual Meeting of OIC Islamic Fiqh Academy held in Jeddah dining 7-12 Dhul Qadah 1412H (9-14 May .1992). Decision No. 65/1/7 Title: Futures Market: Subtitle No. 2: The options.

the market. This will limit the competition and may even generate monopolies or monopolistic/ monopromistic tendencies.
2) The condition to pay in advance also creates the problem of matching the sellers and buyers of Futures contracts. This too may not be very conducive in creating competitive conditions in the Islamic Futures market.

The short comings arising out of liquidity constraints on traders can be overcome by the introduction of Islamic banking or of a specialized Islamic Financial institution to finance the Futures trading.

Such an institution will register itself as a trading company in the Futures exchange, while it will also be an institution to accept deposits. (Many countries presently do not allow, in their law, the banks to get involved in trading business. Islamic banks, however, need to be given this permission, otherwise they cannot function as Islamic banks in the true Islamic spirit of financing trade).

This institution can purchase or compete to purchase all Futures contract of different commodities and of different maturities offered by sellers in the Futures market that are unable to find matching buyers because of the lack of liquidity with the traders.

The institution will then independently offer parallel sales of Futures contracts of same commodities that the institutions expect to receive in order to accommodate traders of small means. These Futures contracts offered by Islamic banks can be in smaller denominations so that traders of smaller means may also enter into the Futures market. The problem of mismatch of sellers and buyers thus can be handled. The only problem left, then, is the liquidity problem of the traders to purchase. As far as selling of Futures contract is concerned there will be no problem. The financial institution will be willing to purchase the contracts at the price that it will be offering in the market.

The problem only remains for financing the purchases of Futures contracts by the traders. There is no solution to this but whether this is really a problem to be attended to is itself a question. A trader who does not have even small means to purchase small amounts of Futures contracts issued by the bank if not by the producers themselves and insists to enter the Futures market, then the problem of these traders entering the Futures deserves separate discussion. Any effort of financing the activities of these traders into the Futures marketing, in fact, may tantamount to promoting pure speculative tendencies which Islamic principles of trade do not allow.

The financial institution giving support to Futures market by purchasing the Futures sales (particularly the one which fails to find the matching buyers because of lack of liquidity with the traders) can mobilize funds for this purpose by attracting deposits from small savers on profit-loss sharing basis.

On the deposits side, the financial institutions will receive investment deposits from the public for investment in Futures trading. There may be two types of investment deposits: a) Specific Deposits and b) General Deposits. The specific deposits will be of defined maturities to be matched by the bank with its specific purchases of Futures contract of specific commodities. The general deposits will not refer to any specific commodity and will be meant to be utilized by the bank for general Futures trading and share with depositors its profits from this trading.

A financial institutions intending to work on Islamic basis will find it very convenient to work as a financial institution for the Islamic Futures exchange.

4.1.4 *Salam* Market as an Institution for Rural Development

Establishing *a* Salam-Based Futures Market as a replacement of the conventional Futures market, of course, will be a significant item in the agenda of all those Muslim countries that are involved in or intend to initiate a process of Islamizing their economies. Besides the religious obligation of introducing Islamic economic institutions, *Salam* markets as outlined in previous pages have, on their own merit, several attractions for the contemporary Muslim economies. One merit lies in its possible role in agricultural and rural development which is very important sector in the economies of most of the contemporary Muslim countries. Most of the developing countries in general and Muslim countries in particular are agrarian economies with a very large part of their GNP and foreign exchange earnings coming from agriculture sector and bulk of their population living in rural areas mostly in poor economic conditions.

A) Problem of Rural Finance

Though agriculture and rural development is an issue that has several, and rather complex, dimensions; and though very serious attempt to tackle this issue in a number of countries have already proved to be futile, yet *Salam*based Futures market provide a new possible dimension at least to one aspect of the problem and that is the rural financial market.

The rural financial markets in Muslim countries are very weak and in many cases non-existent. The need to organize and develop the same can hardly be over emphasized in the interest of developing this sector where bulk of the population lives and which, in most of the cases serves as backbone of the economy.

Significant efforts have been made mostly at the state level, during last three to four decades, to introduce formal financial institutions to meet the credit needs of rural population with particular emphasis to agricultural and rural development.

Despite that these institutions primarily aimed at providing cheap credit (compared to the normal cost of credit in the economy), they not only failed to develop a self sustaining rural financial market but also failed to achieve the objectives primarily given to them[14] namely;

Help farmers to meet their liquidity needs by improving methods and inputs of their production.
Help low income population to improve their economic conditions.
To promote output of certain specific commodities crucial for the economy.

One study[15] has concluded that it is unrealistic to expect rural financial markets to work well with interest-based financial intermediaries if the sector

---

See (12), (13) and (14).

See (15).

they serve is not economically healthy. Such a sector cannot afford to bear the market interest rates and the cheaper or subsidized rates have proved to be counter productive and defeating the very purpose for which they are introduced.

It has been argued in the literature that widespread difficulties faced by agricultural credit projects were not due to the problems that were unique in each country but rather to the low interest rate policies[16]. They did not contribute much to the agriculture and rural development and they often failed to reach the rural poor. The low interest rates are reported to have frequently undermined the financial viability of leaders and discouraged the mobilization of voluntary savings by financial institutions. The experts are now rejecting the view of that institutions providing low interest rate financing for promoting the agriculture sector or helping rural poor. The experts are instead are advocating an institutional framework that can motivate and mobilize rural savings. Savings mobilization is believed to be the forgotten half of rural finance efforts made so far in the developing countries.

The only way of making the financial intermediaries like interest-based banks effective to mobilize savings is not to keep their interest rate low or subsidized. But if interest rate is kept high, it will fail reach the rural poor.

Salam-based Future market have potential to develop rural financial market on the basis that will not only help mobilize savings for the rural sector but also that its financing will reach the rural poor as well.

B) *Salam* Market as a Basis for Developing Rural Financial Market

Salam-Based Futures Markets can serve as an institution for financing the agricultural output and hence can contribute to improving the economic conditions of rural population. The farm producers are extremely short of liquidity which does not allow them to improve their production methods and also forces them to sell their product when their prices are lowest in the market and thus deprives them of the fruits of his efforts when the crop is ready. Though a lot of efforts have been made to make credit available to the farm producers, yet they have not been generally successful firstly because the

---

16. See (15).

procedures for borrowing from bank is often complicated, inconvenient and time-consuming. Secondly, they require collateral which are often non-existent and thirdly, borrowing from bank often contributed to creating debt burden for them (mainly because of the interest involved) rather than giving them an economic help.

No doubt some non-conventional approaches were also introduced in this area, which did succeed in overcoming these difficulties substantially and which did go a long way in providing a solution to the problem of agricultural financing yet Salmam-based Markets for agricultural commodities supported by Islamic banking system offer an altogether new approach to the agricultural financing problem which has its own value for Muslim societies that are looking for Islamic solutions to their economic problems.

Islamic banks having branches in the rural areas will make forward trade contracts *(Ba'i Salam)* with the farm producers and make them advance payments. On the basis of these contracts, the banks then can issue Futures contracts for sale in the Futures exchange.

The deposits of the Islamic banks that may come from within rural areas or from the rural population residing some where i.e. absentee landlords or emigrant workers will be utilized to make payment for the forward trade with farm producers. Hence the financial resources mobilized from rural areas will be utilized for the rural population. The profitability of banks in dealing with Futures contracts in agriculture market in fact may even transfer some urban deposits to rural banks or may help keep some funds generating out of rural areas in the rural banks.

One caution, however, is worth noting. Making forward purchases in rural areas and selling parallel Futures contracts in urban centers may turn out to be quite exploitative if some unscrupulous elements enter in the Islamic banking business. Since farmers in rural areas cannot have a good idea at what price to sell their product for future delivery as they may not have sufficient information about Futures markets in the urban centers, the banks might entice them to sell their crop at quite low price. This, of course, will happen only if the financial institutions enjoy monopoly power and there is not enough competition or sufficient regulation with respect to their operations.

Such exploitation on account of monopoly elements can be contained by appropriate government intervention. Government may even act as a competing party and announce a minimum price at which it will be willing to purchase the crop. Such support price activities are already done by Government in several Muslim countries. Government warehouses or purchase departments can sell their own Futures Contracts in Futures market.

Alternatively Government can oblige the Islamic banks that they will not purchase the crop at a price less than a fixed marked down price of Futures contract that they are selling in the Futures market. If the bank is selling a Futures contract of 100 lbs of cotton at the price of $100 then they will be obliged for example, to pay the fanner a minimum of $90 per 100 lbs of cotton (and hence allowing the bank to earn only a minimum of 10 percent mark up).

4.1.5 Conclusion on *Salam* Market

Irrespective of whether a Muslim country is launching a program of Islamizing its economy, there is an independent case on its own merit to establish Salam-based Futures Markets for contributing to the development of their economies.

Since most of the Muslim countries so far do not have a Futures market they can easily initiate the experiment at a modest level by starting the Futures Market on the basis of single commodity trade. The primary requirement for initiating the Futures trading is that the commodity concerned should be adequately standardized and graded with respect to its quality.
Countries like Pakistan, Egypt, Bangladesh and Indonesia have plenty of scope to start Futures market on Islamic lines in order to give boost to their producing sectors without generating speculative activities in the economy. Rice and/or cotton can be good starting commodities for *Salam-based* Futures markets from these countries as these commodities are fairly standardized and graded and their prices record wide seasonal fluctuations.

The practical procedures for using the institution of Islamic Futures market for agricultural and rural development, however, need to be worked out carefully. The first step that is required for the introduction of *Salam*based Futures markets in such cases is the development of appropriate legal framework to support the operations of these markets according to Islamic principles.

Once the beginning is made with adequate legal framework for *Salam*-based Futures markets, the markets then will take their own course to develop their system of trading within the Islamic framework.

4.2 ISTISNA' BASED FUTURES MARKET

So far the discussion was confined to the *Salam* Based Futures Market that can serve as an Islamic counter part of the conventional Futures Markets. Consideration need to be given to other Futures contract recognized in *Shari'ah* to develop their Futures market for the benefit of promoting exchange and production of goods and services in the economy. Istisna' is one such Futures contracts that deserves such consideration.

Let us consider only the infrastructural and developmental projects for the purpose of selling Istisna' contracts. An institution X, whether in private sector or in the public sector, may assign an Istisna' contract to a firm Y to build a certain project. Let us assume this is a housing complex: X sells shares in the ownership of this project to the general public to mobilize resources to pay to Y when the project is completed. When the project is completed, the proceed from the sales of the houses will be shared with the shareholders. The shares in the hand of the general public can be regarded Istisna' based futures contracts with their own secondary markets. The prices of these shares will move in line with the inflation in the economy with respect to prices in the housing sector.

The shares on their own may not involve actual delivery. Actual delivery will be between X and Y. It is, however, possible to oblige the share holders to receive delivery. Each share may involve delivering of a specified unit of the whole project. Each share may not necessarily be paid. It can be paid in installments. The institution X in this case may simply be serving as a financial intermediary leaving the delivery between the producer Y and the share holders or institution X may issue a parallel *Salam* to the public for small units of the whole product and that case, there will be first a delivery between X and Y of the product as a whole and the deliveries of small units of whole project between Y and the share holders.

Development of such markets can help governments in Muslim economies mobilizing resources for various developmental projects in Islamic way which presently have to be financed by interest based borrowing.

The Istisna' based Futures market will be quite different from *Salam*based futures market and hence will require a different legal institutional framework. Some of the distinguishing features of this market will be as follows:

1) The Futures contract in this market will be long term contracts compared to those of *Salam* market which are short run contract generally spread over the period of one season. Though there is nothing in *Shari'ah* to bar Istisna' contracts for short run and in fact a large number of contracts of short run may already be existing in the economy, yet for the development of a meaningful Futures market particularly with the aim of resource mobilization for development, it will be the long term Istisna' based Futures contract that will serve the purpose.

2) Prices of Istisna' based Futures contract in the market may not widely fluctuate over short run as they are expected in the *Salam* based Futures Market. The prices of Istisna' based Futures contract are rather expected to show only medium term or long term trends. This is what would make this market interesting for small savers who are interested in protecting the real value of their savings. These contracts in fact will help them a means to index their savings with inflation. Unlike *Salam* based contracts which are meant to be a source of short run income, the Istisna'-based contracts can serve as a store of value.

4.3 JO'ALA BASED FUTURES MARKETS

Development of these markets too can do a lot in mobilizing resources for development, though the scope of these markets is quite limited. There may be several activities being carried out on Jo'ala basis in any economy at a particular time but there may not be many activities that could be organized on

Jo'ala basis to make a Futures market. Scientific research, new inventions, mineral explorations, intellectual and art works are some of the useful areas for Jo'ala operations. Some of these operations that are commercially feasible can be utilized to establish their Futures markets. Award for mineral explorations is a Jo'ala operation that can serve as a possible basis of a Futures market. A mineral development corporation, for example, can mobilize resources from general public in the form of shares in the mine that may be explored some time in future. The shares will be liquid as they can be sold in the market at least at the par value because that amount is saved and guaranteed with the corporation. The price of the share may go up as the speculation on the prospects of exploration rise.

Development of Futures Markets on the bases of Jo'ala, however, is something that needs more careful study and investigation. For the purpose of this paper it suffices to say that Jo'ala transactions do have a basis to develop a Futures market of its own kind.

REFERENCES

1. International Chamber of Commerce, Futures & Options Trading in Commodity Markets ICC Publishing S.A., 38 Corers Albert - 1' 75008 Paris, France. 1992.

2. Zarqa, Sh. Mostapha Ahmad, *Istisna'* Contract, Islamic Research & Training Institute, Islamic Development Bank, Jeddah, 1994.

3. Umar, Muhammad Abdul Halim, *Shari'ah,* Economic and Accounting Framework of Bay al *Salam* in the Context of its Contemporary Application (translated by M. Mehdi), Islamic Research & Training Institute, Islamic Development Bank, Jeddah, 1992.

4. Horn, F.F. and V.W. Farah, Trading in Commodity Futures, New York Institute of Finance, 70 Pine Street, New York NY 10005, 2nd Edition 1979.

5. Kaufman, P.J., Handbook of Futures Markets: Commodity, Financial, Stock Index and Options John Woley and Sons, Inc. 1984.

6. Kolbe, Robert W. Understanding Futures Markets 2nd edition, Scott Forman and Company, London 1988.

7. Alais, Maurice, Economy of Markets Islamic Research & Training Institute, Islamic Development Bank, Jeddah, 1993.

8. Hammad, Nazeeh, *Salam* Contract, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 1994.

9. Eicher, C.K. and J.M. Staatz (ed.) Agricultural Development in the Third World 2nd edition, The John Hopkins University Press, Baltimore and London, 1990.

10. Hassan, Abdullah Alwi Haji, Sales and Contracts in Early Islamic Commercial Law, Islamic Research Institute, International Islamic University, Islamabad, 1994.

11. Shirazi, Habib Islamic Banking Contracts, Banking Training Center, Central Bank of the Islamic Republic of Iran, Tehran, 1980.

12. Adama, Dale W. and Douglas H. Graham "A Critique of Traditional Agricultural Credit Projects and Policies" Journal of Development Economics 8, No. 3, June 1981 pp. 347-66.

13. Donald, Gordon Credit for Small Fanners in Developing Countries Boulder, Colo: Westview Press, 1984.

14. Von-Pischke, John D., Dale W. Adams and Gordon Donald, (Eds.) Rural Financial Markets in Developing Countries: Their Use and Abuse Baltimore: John Hopkins University Press, 1983.

15. Adama, Dale W. and Robert C. Vogel, "Rural Financial Markets in Low-income Countries" in Eicher and Staatz (11).

ISLAMIC DEVELOPMENT BANK (IDB)

Establishment of the Bank

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent by a Conference of Finance Ministers of Muslim countries held in Jeddah in Dhul Qa'da 1393H (December 1973). The Inaugural Meeting of the Board of Governors took place in Rajab 1395H (July 1975) and the Bank formally opened on 15 Shawwal 1395H (20 October 1975).

Purpose

The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of *Shari'ah.*

Functions

The functions of the Bank are to participate in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other forms of economic and social development. The Bank is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds.

The Bank is authorized to accept deposits and to raise funds in any other manner. It is also charged with the responsibility of assisting in the promotion of foreign trade, especially in capital goods among member countries, providing technical assistance to member countries, extending training facilities for personnel engaged in development activities and undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to the *Shari'ah.*

Membership

The present membership of the Bank consists of 53 countries. The basic condition for membership is that the prospective member country should be a member of the Organization of the Islamic Conference and be willing to accept such terms and conditions as may be decided upon by the Board of Governors.

Capital

The authorized capital of the Bank is six billion Islamic Dinars. The value of the Islamic Dinar, which is a unit of ,account in the Bank, is equivalent to one Special Drawing Right (SDR) of the International Monetary Fund. The subscribed capital of the Bank is 3,654.78 million Islamic Dinars payable in freely convertible currency acceptable to the Bank.

Head Office

The Bank's headquarters is located in Jeddah, Saudi Arabia and it is authorized to establish agencies or branches elsewhere.

Financial Year

The Bank's financial year is the Lunar Hijra year.

Language

The official language of the Bank is Arabic, but English and French are additionally used as working languages.

ABOUT THE AUTHOR

M. Fahim Khan holds B.A. and M.A. (Statistics) from Punjab University, Pakistan, M.A. and Ph.D. in Economics from Boston University, USA. He is associated with the Islamic Research and Training Institute (IRTI) since 1988 serving at various positions such as Head Research Division, Acting Director IRTI, Head Training Division and he is currently Chief, Islamic Economics, Cooperation and Development Division. Before joining IRTI, he has worked in various teaching, research and managerial positions in the Ministry of Planning, Government of Pakistan as Deputy Chief, International Institute of Islamic Economics, International Islamic University, Islamabad as Professor and Director, School of Economics, King Abdulaziz University Jeddah as Visiting Professor and Quaid-e-Azam University Islamabad as Visiting Professor. He is currently on deputation to the State Bank of Pakistan as Advisor on Transformation of the Financial System.

M. Fahim Khan has published/edited 10 books on Islamic economics, banking and finance. These include *Money and Banking in Islam and Fiscal Policy and Resource Allocation in Islam* jointly edited with Ziauddin Ahmed and Munawar Iqbal and *Essays in Islamic Economics* published by the Islamic Foundation, Leicester, UK. In addition to that he has over 15 publications in refereed journals. He has extensively contributed to the development of teaching and research institutions, programs and activities as well as to preparing various reports and working papers. He has presented over 20 papers to various International Conferences and Seminars. The main areas of his current interest are Islamic economics, banking and finance particularly, the development of financial instruments for public sector resource mobilization. The author's e-mail address is <mfahimkhan@hotmail.com>.

ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE
P.O. BOX 9201 JEDDAH 21413
Kingdom of Saudi Arabia
Cable Address : BANKISLAMI - Jeddah Telephone : 6361400
Telex : 601137 / 601945 Facsimile : 6378927 / 6366871
E-Mail : ARCHIVES @ ISDB.ORG.SA Website : HTTP : // WWW. IRTI .ORG. SA

Legal Deposit No 1448/16 ISBN : 9960-627-87-X