Options and Futures: the problem for Islamic Banks

The ethical framework governing Islamic Finance prohibits interest, but also gambling and speculation. Within this framework money is not seen as a store of value, but solely as a means of exchange, which results in the fact that Islamic Banks are mainly applying structures in which the underlying assets or projects are financed and they basically do not just provide money to their clients.

The Islamic financial industry is young, but developing at a fairly rapid pace and individual transaction sizes are increasing, which in turn results in a requirement for more and more complex structures. However, the prohibitions the banks are facing are also the main cause of their restrictions in the application of hedging instruments such as futures, options and other derivative products. Although hedging as a risk mitigant is permitted, the speculative nature of most of these products is a hurdle for their use. This article explores why traditional futures and options are not available to Islamic banks and explains the alternatives that are.

Islamic Banking: History, Growth and Prohibitions

Though Islamic finance remains a relatively young industry (the Islamic Development Bank, the first Islamic Bank, was established in Jeddah in 1972), it has grown significantly and has branched out into new geographic regions. For example, there are now a total of 24 financial institutions offering Islamic financial services in the UK[1], including three UK-based banks that are wholly compliant with *Sharia'a* – or the principles of Islamic law.

Globally, after a fairly slow start, the Islamic Finance industry has grown to an estimated size of USD 400 billion at the end of 2006[2]. Over the past 10 years, the industry has grown at a rate of 15 to 20% per annum and is expected to sustain a level of growth of 15 to 20% per annum over the coming years, which is not only driven by the expected increase of wealth in Muslim regions, but also by other issues such as:

- Greater understanding and acceptance of Sharia'a compliant offerings by issuers, investors and borrowers;
- Growth in Islamic capital market products, particularly the Sukuk, which is evidenced by the recent large issue sizes such as the USD 1 billion Dar Al-Arkan Sukuk Al-Ijara listed on 1 August 2007;
- Continuing development of Middle Eastern capital markets and the numbers of Middle Eastern borrowers seeking credit ratings suggest increasing requirements to be able to borrow in international financial markets;
- Project finance and Islamic structured finance are earmarked for a similar growth driven by the influx of infrastructure development projects in GCC countries.

All these factors assist in the continued growth of the Islamic finance sector. In addition, the economic growth goals in the GCC region are ambitious, with Dubai calling for compound annual growth of 11% per annum[3].

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Islamic banking, like every other aspect of Muslim life, is governed by the *Sharia'a* and the interpretation of this law *(Fiqh)*. Together, these provide the ethical framework outlining the essence of economic well-being and the development of individuals. This framework does not specifically apply to Islamic banks, but to life and business generally. Fairness, honesty, avoidance of hoarding and avoidance of tort are an integral part of the *Sharia'a* law, but so are the prohibition of *riba, gharar* and *maysir*. In brief, these prohibitions are defined as follows:

Riba (or usury) is the predetermined interest collected by a lender, which the lender receives over and above the principal amount it has lent out.

Gharar (or gambling) is the sale of a probable item whose existence or characteristics are not certain. A traditional example of *gharar* is the sale of any of the animals from a herd without specifying a particular one. In the context of Islamic Finance, a more current example is advising a customer to buy shares in a company that is the subject of a takeover bid on the grounds that the share price is likely to increase.

Maysir (or speculation) is an event in which there is a possibility of total loss to one party. Maysir has elements of *gharar*, but not every *gharar* is *maysir*.

In the context of the Sharia'a framework, money is seen as nothing more than a means to facilitate trade (rather than a store of value). Consequently, in combination with the aforementioned prohibitions, it is not possible for Islamic banks to provide financing in a similar fashion to conventional banks. Instead, other structures are applied in which the bank often plays a much larger role in the financing structure and becomes a partner in the project to be financed – rather than just a provider of money.

As defined in the accounting, auditing and governance standards for Islamic financial Institutions[4], Islamic banks are founded on the concept of profit sharing and loss bearing, which is consistent with the Islamic concept that **"profit is for those who bear risk"**. Profits are distributed per a ratio defined in the contract, and any losses are distributed equally depending on the share in the

Islamic Financial Products Explained

Islamic financial products work on the basis that the bank and the customer share the risk of investments on agreed terms. Profits are distributed based on negotiated terms; risk is distributed based on the share of the ownership. Islamic Financial products typically have an underlying asset that requires financing. Six of the main transaction types are specified below.

Murabaha
Deferred sale of goods at cost plus an agreed profit mark-up under which a party (the seller) purchases goods at cost price from a supplier and sells the goods to another (the buyer) at cost price plus an agreed mark-up. Murabaha has a variety of applications and is often used as a financing arrangement for instance for receivables and working capital financing.

Ijara
Bilateral contract allowing the transfer of the usufruct which basically equates to an operational lease in which the bank leases the asset to a client. Ijara takes on different structures depending on the specific financing requirements of the counterparty.

Musharaka
Partnership of two or more owners of a property held in common. Partners do not have to own a proportional share in the property. Any profits and losses are shared according to the terms of the contract. Ownership of the underlying property can be transferred gradually during the term of the contract (Diminishing Musharaka). The Musharaka structure is for instance used for mortgages and development financing.

Sukuk
Document or certificate evidencing (part) ownership of an underlying asset. Profit is depending on the performance of the underlying asset. Typically referred to as an Islamic Bond

Arbun
Non-refundable down payment on a sales contract.

Salam
Contract for spot payment against deferred delivery of an asset. Assets typically have commodity-like characteristics and must be fungible. The price on delivery is expected to be higher than the current price. Typically used for pre-financing of agriculture, construction or manufacturing.

project a party holds. The bank or financier partners with the company or individual seeking financing; the bank therefore holds (part) of the title to the underlying assets as well, depending on its degree of ownership.

Derivatives in Islamic Finance

The prohibitions regarding speculation and uncertainty result in the situation that options, futures and other derivatives are not generally accepted by Islamic scholars. Even forward FX contracts are generally not permitted since they not only include an element of uncertainty, but are in addition priced to incorporate an interest differential. Derivatives, with their inherent uncertainty and speculative characteristics are not acceptable in the *Sharia'a* framework. This does however not mean that Islamic investors do not have any possibility to hedge their exposure. Contrary, within the *Sharia'a* framework taking measures to mitigate risk is seen as good stewardship.

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However, in the absence of options and futures, other contracts need to be applied. There are two main basic contracts that the Islamic investor has available to provide the opportunity to hedge against risks that occur within the normal course of their

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business. There are two main products available to hedge. Firstly, there is *Arbun* which is a down-payment on a sales contract. In this case, the buyer and seller agree a price and date and if the buyer would pull out, he loses his deposit. If the buyer takes delivery of the asset, the down payment becomes part of the total price and only the difference is payable. This is different from an option premium which represents an amount separate from the actual exercise price.

A second type of contract that can be used for hedging purposes is the *Salam* contract which is a contract executed with spot payment in full for the purchase of assets which have commodity-like characteristics and must be fungible like base metals promised for future delivery. The *Salam* contract has characteristics of a conventional futures contract with the main exception that contrary to a conventional futures contract, a *Salam* contract does not accept non delivery of the asset at the end of the contract.

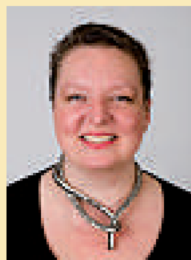
Concluding

Due to the prohibitions in Islamic finance associated with uncertainty and speculation, traditional options and futures or other derivatives are not available to Islamic investors. There are however other structures available to them which can, in combination with other available products provide a sufficient level of risk mitigation. However, the complex derivative instruments available to the conventional investors are, at this point in time, far out of reach of the Islamic investor.

"The Sharia'a and its interpretation provide an ethical framework which applies not only to Islamic banks, but to life and business generally."

1 All of these firms, including the Sharia'a-compliant banks, are regulated by the Financial Services Authority, which means they must follow the same rules as every other UK bank under the FSA's "no obstacles, no special favours" -policy.
2 Standard & Poor's – 2006
3 Financial Times Special Report, 24 July 2007
4 AAOIFI (2002) *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, Accounting and Auditing Organisation for Islamic Financial Institutions, Bahrain.

The views represented in this paper are those of the author and do not necessarily represent those of BLME.



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