A Review of Forward, Futures, and Options From The Shariah Perspective. "From Complexity to Simplicity".

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Abstract

Forwards, Futures and Options are instruments that are widely used for hedging and speculating. Futures and Options are derivatives, which values derive from other financial products. However, because of it complexity and speculative nature, it have not been a mesmerizing topics to be openly discussed by Muslims academicians. Forward and future which are compliance to shariah law has been developed with stringent shariah rules and regulations attached to the products but still it creates confusions amongst scholars in finance industry because of the unavailability of the products in the market and lack of knowledge. On the other hand, options are yet too speculative, which involve gharar and maisir, which are not in accordance to the shariah laws. An attempt to review these derivatives from the shariah perspectives would be the aim of this paper in order to encourage consequent papers to be written in this area especially from the Islamic perspectives.

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Introduction

Islamic Finance has been emerging from the 70s and developed in accordance to the shariah laws to facilitate the needs of the Muslims governments, businesses, individuals in fulfilling their needs such as acquiring shelters, education and financing business to satisfying wants. The Islamic banking is getting recognition world-wide with institutions operating under the close supervision of the shariah advisors with varieties of products mostly duplicated from the conventional banks.

The Islamic financial market is also developed with the introduction of shariah compliance stocks and index as a basis of platform for Muslims to enter into the stock market and would not have to worry on the permissibility of the return. Despite the rapid growth of the Islamic banking and Islamic stock market, the derivatives markets seems gloomy because the complexity of the instruments itself shoving Muslim scholars away from it. Not only the Muslim scholars are having this problem but also CEO's, business individuals, financial managers and individuals that are closely involved in making financial decisions or "derivatiphobia" (Warren Edward, 1997). Lacking of information on derivatives, it speculative and complexity nature, and cost pricing are some of the reasons that hinder Muslims from using the instruments for hedging purposes.

In this paper we will highlight forward and two types of derivatives for review, which are future and options. Forward contract is an agreement where the buyer agrees to buy from the seller an underlying asset for a fixed price during a future period of time.

Conventional future is a *commitment* to deliver a certain amount of some specified item at some specified date in the future.

The transaction will not be completed until some agreed-upon date in the future and the delivery date and quantity are all set when the future is created. The seller has legally binding obligation to make delivery on specified date and the buyer has legally binding obligation to take delivery on specified date and make payments. In contrast to futures, options by definition is the right to buy or sell a certain amount of an underlying financial asset at a specified price for a given period of time.

Forward and derivatives could be used to hedge from financial losses due to transaction, currency and accounting exposures. For example a forward contract could reduce the risk of foreign currency fluctuations when entering into export or import agreement by locking the exchange rate at a future date.

The cost of imported products or the proceeds of exported products are certain even though the exchange rate fluctuates. Other derivatives also could also become hedging instruments despite the cost which is quite expensive especially options.

This paper would attempt to review the forward, futures and options instruments according to Islamic perspectives with no intention of issuing decrees as this role of ijtihad should be left to the Islamic scholars or ulama's.

Literature Review

Derivatives from Islamic perspective is an issue which many scholars have different opinions on its permissibility with different reasoning for approving and prohibiting such contracts. An extensive review was done by Obiyatullah Ismath Bacha in 1999 regarding the evolution of modern financial derivatives, the financial instruments from shariah perspective point of view, some of the Islamic instruments that are the same as derivatives and the objection of Islamic scholars regarding derivatives that might need some rethinking and evaluation (Obiyatullah, 1999). He explained the instruments in details and laid out critical issues on why the Islamic communities need these instruments in the market place highlighting several consequences that would affect the Islamic business in ignoring these instruments.

In contrast, Mohammed Obaidullah (1999) has laid out that future and options are prohibited with emphasis on the definition of sarf from two different point of views. The first view stated that only gold and silver will be governed in the rules of bai as-sarf while the fiat or paper currencies do not fall into bai-sarf category. He cited Ibnu Taymiyah definition of sarf, which is any currency that could perform as a medium of exchange.

Therefore selling and buying currencies with other currencies with deferred delivery is acceptable. The latter view states that fiat or paper currencies fall into bai as-sarf category therefore deferring delivery is riba as stated by the hadith that the sale of sarf of different types must be hand to hand or immediate (Obaidullah, 1999). This is also supported by the decree issued by the OIC Fiqh academy regardingbai-as-sarf. Another prominent Islamic scholar, Monzer Kahf also prohibits the sale of currency with deferred delivery based on the same hadith.

An urge to reconsider derivatives to be accepted in the light for the maslahah of ummah was portrayed from the work of Ali Salehabadi and Mohamad Aram especially for the Iranian export of oil and commodities (Salehabadi and Mohamad Aram, 2002). All of the scholars that discussed the extensive details of the permissibility and prohibition of derivatives analyze the instruments based in the current capitalist monetary system, which uses the fist money as currency.

None of the scholars discuss the instruments viability and applications if the Dinar and Dirham are revisited except for Mohammed Obaidullah which touched on the differing opinions of the categorical of fiat or paper currencies as sarf as laid out in the hadith when he stressed on the existence of riba in currency forward, future and options (Mohammed Obaidullah, 2001).

If we revisit of the bimetallic currencies, consensus among scholars on differing opinions on derivatives could be achieved because it will eliminate deviation of interpretation of sarf and rules regarding sarf itself. This is because the regulation of sarf is clearly stated in Al-Quran and hadith especially.

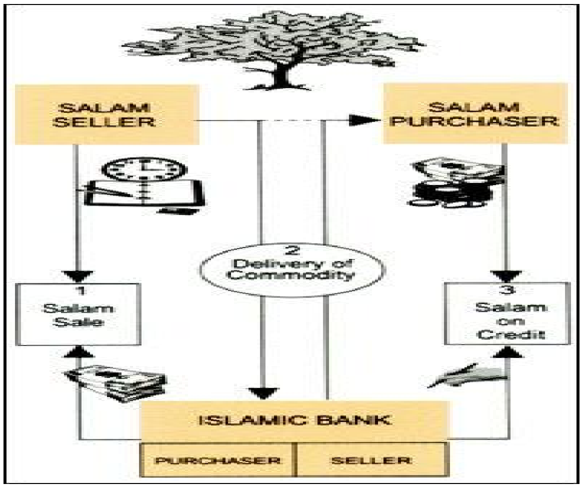
This is in accordance in Islam when we are in different opinion it is best to refer back to Al-Quran and hadith. Therefore, the implementation of gold dinar would probably be the catalyst for the reformation of the complexity of derivatives to the simplicity of derivatives. The next section will be touching on the instruments evolution from complexity to simplicity with the usage of gold dinar as currency.

Forward In Dinar Economy

Forward contracts are acceptable according to the shariah principles if it adhere to the contract of salam. Salam in the definition jurists a sale of a commodity whose delivery will be in a future date for a cash price, which means, it is a financial transaction in which price is advanced in cash to the seller who abides the delivery of commodity of determined specification on a definite due date. The deferred is the commodity sold and described (on liability) and the immediate is the price (Al Baraka Islamic Bank).

A detail operational salam contract implemented by al Baraka Islamic Bank registered in Bahrain is presented in diagram 1. The salam seller will enter into a salam sale with the bank whereby the bank will pay cash and the commodities will be delivered by the salam seller in the future to the bank or purchaser. The bank will enter into a second salam agreement with a buyer of the commodities requiring the buyer to pay cash during the contract if the commodities are to be delivered in the future or by deferred payment if the commodities are with the bankers.

The salam contract The salam contract is the same as forward contract because the goods will be delivered in the future. However the major difference between salam and conventional forward contract is that the price of the goods must be paid during the



contract. In addition, currency forward could not be done according to the salam contracts because currency or sarf must be exchanged immediately and could not be delayed. Therefore currency forward is unacceptable in Islam because the exchange of money for delivery in the future.

It is clear that the forward and salam contract could reduce the sellers and purchasers future price uncertainty by locking to an agreed price. In a matter of fact, it would be also the same as for a salam contract in a dinar economy because the operation would be the same using fiat or dinar. However a major impact could be seen from the main objective of the forward salam contract in the dinar economy will not to fix and reduce uncertainties in future price for the buyer and seller because gold price is constant and variation of price is minimum.

Unlike gold, the value of paper money fluctuates which increase the uncertainty in the future market price. Even though there will be a slight change in the price of goods denominated by gold but the differences are too small that the fees of entering forward salam would be higher whereby it would be more effective to ignore the small fluctuations rather than locking the price. Therefore the objective of hedging price fluctuation is out from the picture. *The new objective of using forward salam in dinar* *economy would be getting free interest capital sourcing from the price paid by buyer during the contract agreement in cash before the gods are delivered in the future instead hedging.*

Futures In Dinar Economy

Future is not acceptable from the point of Islamic ulama' and scholars because of two main reasons (Salehabadi and Mohamad Aram, 2002). Mufti Taqi Usmani, a prominent Islamic scholar prohibited the use of futures in an interview with Ghazanfar Adil in 1999 (International Journal of Islamic Financial Service, 1999). The first reason is the delivery of commodities and money will be done in the future not during the contract agreement. Therefore it is not a contract of spot exchange, deferred payment or salam sale which are permissible in Islam. While the second reason is because the future transactions are merely speculative and delivery of commodities and in the seller possession is not intended. Mohammed Obaidullah also prohibits financial futures and currency forward because it involve Riba (Mohammed Obaidullah, 2001)

Future transactions are settled off and no actual delivery is made except for about 1 percent from the total volume of transactions (Gitman & Joehnk, 2003). This is not in accordance from the shariah perspectives. Salehabadi and Mohamad Aram (2002) pointed out that future should not be considered as a sale and purchase contract or bay but fall into compromise (sulh) and (promise gift) ji'alah contract.

Sulh is an agreement to solve dispute or ulama's from Hambali's sect defines sulh as an agreement or contract to achieve agreement between two disputing parties (Wahbah al Zuhaili (a) pg 261, 1995). Even though it is not mentioned the details on how future should be considered as sulh by Salehabadi and Mohammad Aram, the operational of future according to sulh would fall into compromise with agreement under sale and purchase order (tempahan) category.

However, if this is the case then, salam sale must be one of the contract in future to effect sale and purchase. When the delivery date of the goods is due the sulh contract could be used whenever the seller or buyer disputes the agreement. Then the party who could not fulfill the contract has to offer a compromise to replace the agreed property that should be delivered with other properties such as money.

The other suggestion is to use Ji'alah which is not permissible from the Hanafi sect but is permissible from the point of view of Shafie, Maliki and Hambali sects based on Al-Quran, Surah Yusuf: 72 (Wahbah al Zuhaili (b), pg 788, 1995). In this case, the buyer will announce that if the seller could deliver the commodities then he will be paid for a certain amount of money. This is merely a promise from the buyer of commodities in future contract that he will pay the seller a gift. In this case it is not a bay contract therefore the buyer and seller in future contract will enter as seller and purchaser but as promisor (buyer) and doer (seller).

However, if the economy is using the Dinar monetary system, it is again stressed out that the gold is synonym with its constant due its nature. Therefore price fluctuation is minimal and the need for hedging with future is undesired.

Options In Dinar Economy

Options is a more complex financial derivative instrument, which give the buyer and seller the option to withdraw from the agreement of sale and purchase. Mufti Taqi Usmani prohibits options on the basis of the fee charge for the promise and not because of the promise (International Journal of Islamic Financial Service, 1999). The promise is permissible according to shariah perspective for call and put options.

It is a promise from a party to another party to buy or sell his property in a future date. The problem in options is the premium fee that is imposed on the promise, which make the contract invalid. Furthermore Salehabadi and Mohammad Aram (2002) did not suggest any alternative contract that is suitable for options.

Arboun or deposit is also suggested as a shariah compliance for call options. The buyer will pay a deposit for the call option and in the case of withdrawal; the deposit will be forfeited as a gift to the seller. If the buyer continue on the purchase then the deposit will treated as the purchase price. For the seller, there will be no option for not to sell. However arboun is a fasid according to Hanafi and void according to Shafie and Maliki because it is a form of deception, welcoming danger, and getting properties without replacement (Wahbah al-Zuhaili,(a) pg. 462, 1995). Kamali however approved the usage of arboun sale or charging fee in options based on hadiths and views of contemporary scholars such as Yusuf Qardawi and Mustafa al-Zarqa who has authenticated arboun.

Only Ahmad Bin Hambal approved the sale of arboun based on the hadith narrated by Zaid Ibnu Aslam. Ibnu Qudamah states that arboun must have time period in the contract to prevent gharar, conflict and uncertainty but Ahmad himself approved arboun without any time period stipulating the contract if both parties agreed to it.

In a discussion forum published in the International Journal of Islamic Financial Service, Muhammed Shahid Ebrahim and Tariqullah Khan approve the usage of option while Mahmoud El-Gamal has an opposite view on its permissibility (International Journal of Islamic Financial Service, 1999). Wahbah in his opinion states that arboun is permissible on the basis that it has been a customary and the hadiths from both oppositions are weak (Wahbah al-Zuhaili,(a) pg. 462, 1995).

Muhammad Ayub states that modern options could not be found in any Islamic fiqh law since the financial transactions during the classical theory of fiqh. Furthermore khiyar could only take place for exchange transactions, which has taken place not as options, which payment and delivery will take place in the future (Muhammad Ayub, 2003).

Indifference with future, options in Dinar economy also undesired due to the same reason because there is no need for withdrawal from the sale and purchase agreement when the market price today is almost the same as the market price 3 months, 6 months or 1 year in the future. When the price is stable then the need for capitalizing and reduction of loss from the market price difference due to time horizon is eliminated.

Conclusion

Futures and options are being urged to be reconsidered by the ulama' for hedging purposes and still unresolved. Forward contract are permissible using salam contract whereby the price will be paid in advance while the delivery of commodities will be deferred. However the sale of currency in forward is not permissible because the sale of currency could not be deferred. Future contract is to be reconsidered by using sulh or ji'alah contract and options have no clear direction of any possibility tying it to any permissible shariah contract. However, Arboun could be used as the alternative contract for options because it has become a customary of the society.

In the dinar economy, complexity of the financial system would be eliminated since there is no need for future and options except for forward or salam sale. Even the forward contract main objective will become getting capital from the price paid by the buyer in advance. This is due to the certainty in the future price of commodities and goods using gold as currency when the gold price is constant. This is true because the value of gold will be measured from its weight not from token value as fiat money. In view of the revisit of the gold Dinar, will make full use of classical fiqh rulings in the area of business dealings and transactions.

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