ISLAMIC JUSTIFICATION OF DERIVATIVE INSTRUMENTS

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This article outlines the key necessary elements of options and futures contracts for Iranian economy and it briefly addresses the jurisprudential justification of these financial instruments from the Islamic point of view.The new financial instruments that recently came into the investment vocabulary are complicated and will be explicitly analyzed. The first part of the article includes the Islamic justification of futures contracts and the other part seeks to provide Islamic justification of options contrcts.

1. Islamic Justification of Futures Contracts

Crude oil revenues are crucial to Iranian Economic development. Approximately 80% of national foreign currency income is generated through oil exportation. Fluctuation of crude oil prices in the world markets has been rather high for example while the price were at $9.39 in Dec1998 it went to $24.44 in Dec 1999 and as of $30 in 2000, it stands that so producers should protect themselves against this volatility to better plan for strategic development, and pay for day-to-day expenses. As of yet, Iran has not taken advantages of financial vehicles to at least reduce the negative effect of price and at best profit from it. One of these instruments is futures contract for hedging. Some of other oil producing countries has been successful in implementing these mechanisms to a point that they could profit more from selling their oil than the average on-going market prices.

A case in point is Mexico. It has not only been able to protect itself from the price drops but also earned $1.5 billion more than the market prices in 1991.Hedging is utilized to minimize the risk of price increase for consumer of petroleum by-products as well.

Since government has exclusive right on oil in Iran (and there is no private competitive market domestically), effectively it is in the sole oil player from the Iranian side internationally. It can follow the following policies, using derivative instruments:

1.Lock-in government's income from selling crude oil.

2.Lock-in government's expenditure for reducing expenses.

3.Take advantages of price fluctuations in the market, in order to increase the average selling price of oil and reduce the average buying price of petroleum by-products.

4. Using different strategies for hedging such as straddle before OPEC meetings.

5.Become an active player in the market to affect prices in short-term and within the pricing cycles.

6. Marketing the crude oil in the futures markets.

On the surface there seems to be some conflicts between principles on which futures and options are based on sharia(Islamic code). In this article we will try to shed light on futures objectives and give possible solutions to resolve the fore mentioned issue.

Islamic scholars state that futures transactions are not permissible for two reasons:

1.It is a well-recognized principle of *Sharia* that a sale or a purchase cannot be effective in a future date. There is a *hadith* (saying quoted) from Prophet Mohammad (pbuh) that such transactions are not permissible. At this point it will be crucial to mention that there four types of business transactions three of which are permissible under Islamic law as follows:

1.Spot

2.Deferred

3.Salam

4.Future

In spot or cash trading both commodity and money changed simultaneously and immediately. In the deferred transaction the commodity is delivered but money payment is deferred. Salam is a form of business dealing in which money is paid but commodity will be delivered later in a future date. These three types are Islamically accepted. The forth type is futures transaction in which delivery of money and commodity as well are to be done in a future date are as it appears not an accepted type dealing.

2.A second reasoning goes as follows. In most of the futures transactions delivery of commodity or their possession is not intended. In most cases, these transactions are closed with settlement of difference in prices, more precisely it is used for speculation purpose, and speculation being some sort of gambling as it is perceived, and therefore, forbidden in Islam.

Hence based on these reasoning a futures transaction is not allowed under Islamic *Sharia.* All being said however we believe that is not the end of discussion and the book is not closed on the future of futures contracts, if we do comparative study with undetermined concluding contracts in Islam and also with determined concluding contracts.

1.Comparative study with undetermined concluding contracts.

The futures contract is an obligation to a future transaction and so it is not a bai (sales or purchase) that is effective in a future date, and hence we must make such distinction between the two. Therefore since futures contracts are obligations to a future sales and purchase, it can not be the subject of argument in a bai framework (that is affected by the future date).

2.Comparative study with compromise (solh)

Compromise contract is a form of contract that two parties agrees on delivery of money and commodity in the future date.

Imam Khomeini as a grand Ayatollah and distinguished faghih (Islamic science scholar) has a sentence to the effect that futures transaction that is not permissible in the bai framework is permissible in the compromise framework, however, because we define the futures contracts as those that two parties compromise on a future transaction, seller agrees to deliver the commodity in a future date to the buyer and buyer agrees to pay money to the seller at that time. And as such futures contracts in the form of solh are permissible.

3.Comparative study with jo-aleh

Jo-aleh is a form of contract in which buyer announce that if seller deliver the commodity at a determined time in the future, he/she will deliver the money to him/her. Accordingly the futures transaction in the framework of jo-aleh is therefore permissible.

Futures contracts are not applied only for speculation. They are used for hedging risk. Iran can enter into the market for hedging not for speculation. In this way the second problem of futures contracts can be easily solved.

2. Islamic Justification of Options Contracts

Somewhere around a century ago new financial terms came into official being in Chicago when Chicago board of trade formed the futures markets. Later on and as market gets more sophisticated, more complex terminologies like futures contracts, options, swaps and other derivatives are added to investment vocabularies.

However as many Asian latecomers got to utilize these instruments to safeguard their earnings or even increase them substantially, Iranian governments were either not interested in, or not informed about such vehicles. Therefore there was no specific law or regulation to cover such issues, that is up to recently, for, according to the third 5-year national socio-economic plan, Government agencies which deal in exports and /or imports must have a use of the above mentioned instruments. Nevertheless, Iran must go through a few stages in anticipation of an eventual entry into the futures markets as follows:

1.Preliminary descriptive analysis of these instruments from the Islamic perspective.

2.Opinion polling of *foghaha*(Islamic scholars) to obtain their *fatva*(religious decree).

3.Provided that *fatvas* are permissive, rules and regulations will be drawn up in the form of bills and legislations to be passed by *majles* (Islamic Consultative Assembly, i.e. parliament) and if passed through *majles,* it then needs to be confirmed by *showra-ye-negahban(*Guardians council),a council of Islamic scholars whose job is to ensure no law is passed and enacted if it is in contradiction with *sharia(*Islamic code)or constitution.

4.Upon enactments, the economic council, a body that oversees major economic related decision makings should give a go ahead by issuing permits to appropriate government institutions such as oil ministry or ministry of commerce to get into the futures market business.

Future priorities:

At the moment, one can envisage three areas in where Iran can get into futures markets:

1.Exporting mineral commodities mostly crude oil.

2.Importing essential commodities such as wheat, sugar, and so forth.

3.Investing in stocks internationally. Clearly, if active in futures markets, it can maximize the revenue generated through oil Production and minimize the cost of wheat, sugar and other essential commodities and hence maximize total investment.

Authors believe, utilization of future instruments are of urgency because:

1.National budgeting and as a result national development programs can be planned and implemented with a higher degree of precision.

2.Safe guarding against negative effects of price fluctuation either in oil (such as a major producer and exporter) or in wheat and sugar (as a major importer and consumer).

Now in practical terms the following path should be persuade:

1.Feasibility of options and futures contracts from Islamic point of view.

2.Comprehensive study of options and futures contracts mechanism for choosing

appropriate ones to Iranian circumstances.

3.Set up: Including organizing, staffing of experts, training etc. of an agency to handle options& futures contracts and transactions.

Feasibility of options from the Islamic point of view

Appropriateness of financial instruments is not determined by socio-economic, political or business environment only, from an Islamic perspective, in fact there is a set framework of what's right and what's not by Quran and prophet Mohammad style of life. These principles or frameworks are prohibition of Reba (usury), speculation and avoidance from an array of forbidden activities. Having said that, many investment vehicles and instruments are explicitly accepted such as transactions in spot market, leasing, selling contracts and many others. Derivatives are one of these financial instruments and option is one of the derivatives.

Now the question is: if options are permitted under Islamic law?

To find the answer we will compare option contracts with three permissible contracts under Islam, however, let's review a difficulty that Islamic scholars raise on premium of option. When a person promises to another that he will sell or buy some specified amount of commodities at the determined price and date, from Islamic point of view and principles of *sharia* it is a permissible contract but this promise cannot be subjected to an exchange of a fee.

We will make an attempt to find a solution to this problematic dilemma by comparing this sort of transaction to what we called them three acceptable class of transaction as follows:

1:Comparative study of insurance and option:

First of all in a sense option is similar to insurance because of presence of a seller and a buyer and a premium in the case of option and insurer, insured and insurance premium in the other case.

Secondly transfer of risk from insured to insurer is exchange for a fee in insurance transactions and transfer of risk from buyer to seller in exchange for premium.

Thirdly insurer compensates damages and seller of option compensates losses.

Nevertheless, there are some differences between insurance and options as follow:

a: The subject of insurance is physical assets and in the case of option it is physical and financial assets. Although in futures option for commodity, the subject of the option is futures contract that is called underlying asset.

b: There is no transfer a damage can happen whereas in the case of option, when holder wants to exercise his/her right, he/she dose so independent transaction which makes option more powerful than insurance from the Islamic point of view.

c: Damage payment is in cash in insurance but in option there is partly commodity and partly cash reimbursement.

So by doing this comparative study, we can then conclude that option transaction Seem to be permissible under Islamic law provided *Ulama* (Islamic scholars) accept this reasoning.

2. Comparative study of bai-al-urbun with option:

Bai-al-urbun refers to a sort of transaction through which a person who wants to purchase commodity in future, will pay percentage of cost at present time and at determined date if he purchase the commodity he pays the remaining cost at the time of settlement. If he dose not purchase the commodity, he cannot get back the initial payment because he did not fulfill his promise.

This sort of transaction was customary among Arabs in early Islamic era. Imam Ali, the first imam of shia sect of Islam and son-in-law of prophet Mohammad who is respected by other Muslims, permitted this form of transaction and therefore it seems that call option is permitted.

3.Comparative study of financial right with option:

Option is financial right and according to the Imam Khomeini's idea (Grand Ayatollah) this right is transferable and it could be the subject of transaction.

Conclusion

Islamic scholars will accept those transactions from that are not contradictory to Islamic code-*sharia* and acceptable to common sense and technical reasoning of people of wisdom. Futures markets in principle is fitted into logic and hence permissible. Perhaps that's one of the reasons why some institutions such as ministries of Oil and Energy in Iran are putting extra efforts to find practical ways to get into it.

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