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Session IV

Other Islamic Finance Instruments

Islamic Derivatives

- Derivatives have invoked mixed response from the Shariah scholars whose tendency in holding them as prohibited due to the violation of basic requirements in contract.

- The general key arguments against the use of derivatives contain the following concerns:
  - the valuation of derivatives based on the sale of a non-existent asset or an asset which is not in the possession *(qabd)* of the seller, negating the *hadith* 'sell not what is not with you', Sharjah principles require sellers to actually own the reference asset at the inception of a transaction;
  - mutual deferment on both sides of the bargain, which reduces contingency risk but turns a derivative contract into a sale of one debt for another; and
  - excessive uncertainty or speculation that verges on gambling, resulting in zero-sum payoffs for both sides of the bargain.

Islamic Derivatives: Forward & Futures

- The main issue in the Shariah compliance of a forward or futures contract is the deferment of both the price and asset to a future date.

- to defer both price and asset to a future date may be a bit problematic due to the issue of *gharar*. This type of deferment is usually allowed as an exception to the general rule when there is a need for such a contract, for example, in the case of *istisna`*

Islamic Derivatives: Forward & Futures

- Majma‘ al-Fiqh ruled that to defer both the counter-values in the trading of commodities (forward contract) is not permissible, but recommended that such commodity trading follow *salam* rules in order to be permissible.

- However, in reality, the buyer in a forward or futures contract does not pay the price of the asset at the time of the contract, hence violates salam rule

Islamic Derivatives: Forward & Futures

- The Shariah Advisory Council of the Malaysian Securities Commission (SAC) has resolved that futures contract on crude palm oil is permissible.

- Later, the SAC also resolved that the mechanism for stock index futures contract does not contradict Sharjah principles as long as the index component is made up of Shariah compliant securities.

Islamic Derivatives: Forward & Futures

- To the contrary, it should be noted here that Majma' al-Fiqh al Islamiy ruled that index trading is not permissible because the subject matter is not real *(khayali)* and does not exist.

- Another prominent scholar who does not approve of futures trading is Mufti Taqi Usmani. He argues that futures contracts are invalid because:
  - it is against the Shariah principle that purchase or sale cannot be affected for a future date; and
  - in most futures transactions delivery of the commodities or their possession is not intended, and in most cases the transactions end up with the settlement of the difference in price only, which is not allowed in the Shariah.

Islamic Derivatives: Options

- SAC passed a resolution allowing the use of call warrants, provided that the underlying shares of the warrants in question are Sharjah compliant.

- The main reasons given for permitting call warrants are:
  - it fulfils the features of mal (property) according to Islamic jurisprudence as outlined in the *haq maliy* and *hak tomalluk* principles;
  - *haq maliy* can be traded if it complies with Islamic principles and conditions of buying and selling.

Islamic Derivatives: Options

- *Majma'* al *Fiqh* argued that the subject matter of conventional options are not *mal* (property), nor manfa'ah (usufruct), nor *haq maliy (*financial right) that may be recovered/waived, thus, ruling it as not permissible from the Shariah point of view

- Mufti Taqi Usmani was posed with a question about a sale of stock attached with put options. He responded that while an option contract when viewed as a promise is acceptable, charging fees and trading them are not. He also found that a sale of stock with a put option to resell the stock to the issuer at a future date is unacceptable since a pre-condition is placed on the original sale of stock

Alternatives Islamic Derivatives Products: Salam

- This is similar to the conventional futures contract. However, the big difference is that, in a *salam* sale the buyer pays the entire amount in full at the time the contract was initiated. The contract also stipulates that the payment must be in cash form.

- *Bai' salam* contracts are subject to several conditions, of these the important ones are as follows:
  - full payment by the buyer at the time of effecting the sale;
  - the underlying asset must be standardisable, easily quantifiable and of determinate quality;
  - the *salam* contract cannot be based on a uniquely identified underlying asset; this means that the underlying commodity cannot be based on a commodity from a particular farm or field, as by definition such an underlying asset would not be standardisable;
  - the quantity, quality, maturity date and place of delivery must be clearly enumerated in the *salam* agreement;
  - the underlying asset or commodity must be available and traded in the markets through the period of contract.

Alternatives Islamic Derivatives Products: Salam

- Other types of *salam* may also be applied in the islarnic derivatives markets.
  - A parallel *salam* with the original seller.
  - An offsetting transacting by the financial institutions with a third party.
- SAC passed the resolution permitting 'short selling' based on salam contract
- However, application of *bai' salam*, to foreign currency is not allowed according to a majority of contemporary scholars. There seems to be no Shariah-compatible mechanism that allows hedging against future volatility of exchange rates.

Alternatives Islamic Derivatives Products: Salam

- The rationale of financial options resembles the concept of *urbun* in the sense that both manage price risks.

- *Urbun* sale refers to a sale contract in which the buyer reserves a commodity, pays a small part of the price and agrees to forfeit the paid portion of the whole price when the buyer fails to turn up on a particular date for taking the goods and payment of the remaining price.

Alternatives Islamic Derivatives Products: Salam

- The basic elements that this definition encompasses are:
  - *urbun* takes place after effecting a sole contract;
  - the sold item is defined; and
  - the effective date of the *urbun* must be defined.

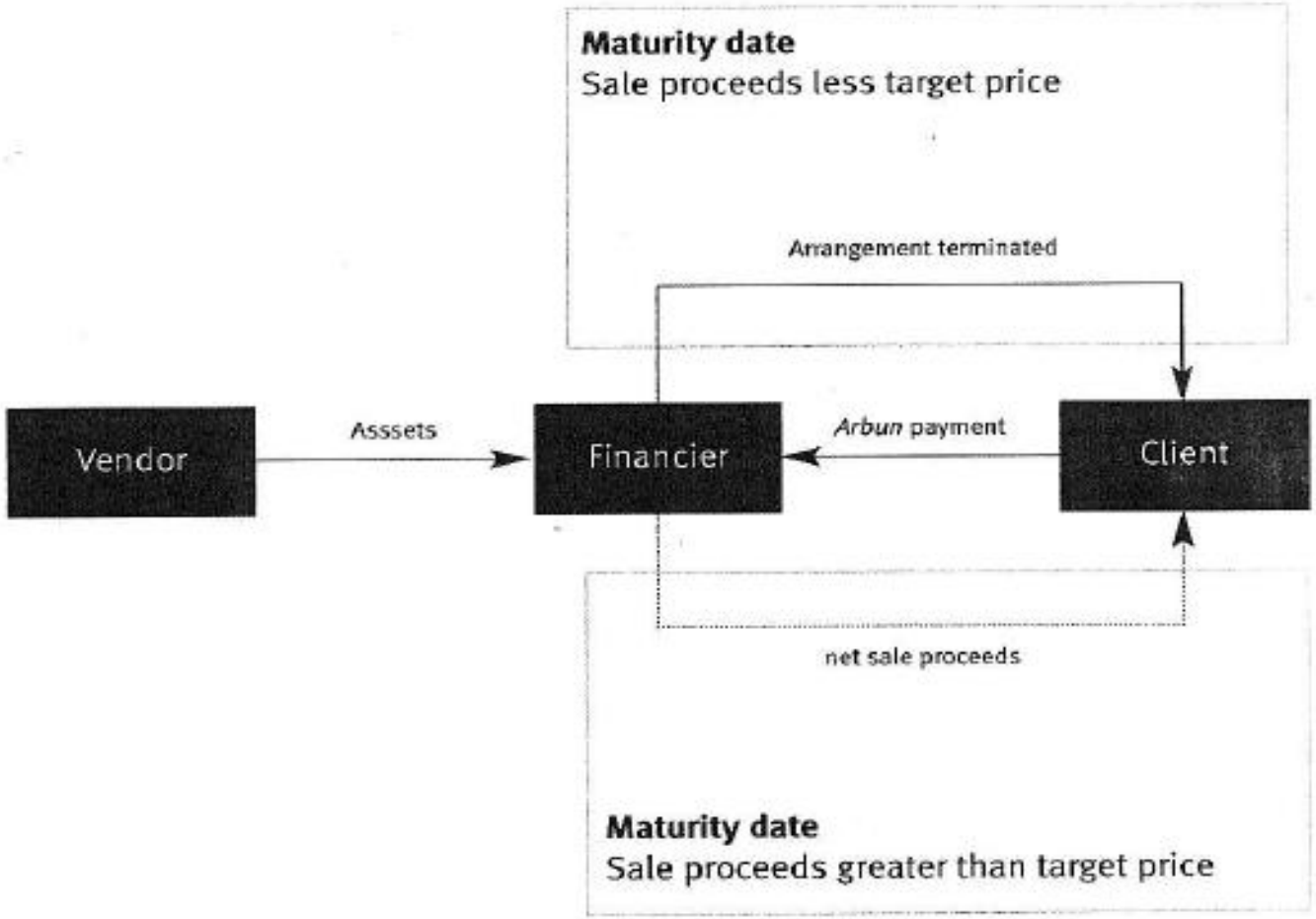
Alternatives Islamic Derivatives Products: Urbun

- The *urbun* sale entitles the buyer to gain a binding offer from the seller while the buyer is at discretion to accept or reject the offer within the period of offer in consideration for the *urbun*.

Alternatives Islamic Derivatives Products: Urbun

- Under an *Urbun* arrangement, the following happens:
  - The client contracts to buy assets from a financier for an agreed price (the target price) for delivery on an agreed later date
  - The client makes a partial payment (for example, 20 per cent) of the purchase price immediately by way of a deposit.
  - The client is entitled not to complete the purchase of the assets, but if the client elects not to complete the purchase they forfeit the deposit.
  - If, on the maturity date, the target price is less than the market price, the assets are purchased by the client and resold by the financier as agent of the client. The sale proceeds are distributed to the client net of the outstanding purchase price.
  - If, on the maturity date, the target price is greater than the market price, the contract is terminated and the client forfeits the deposit.

Alternatives Islamic Derivatives Products: Urbun

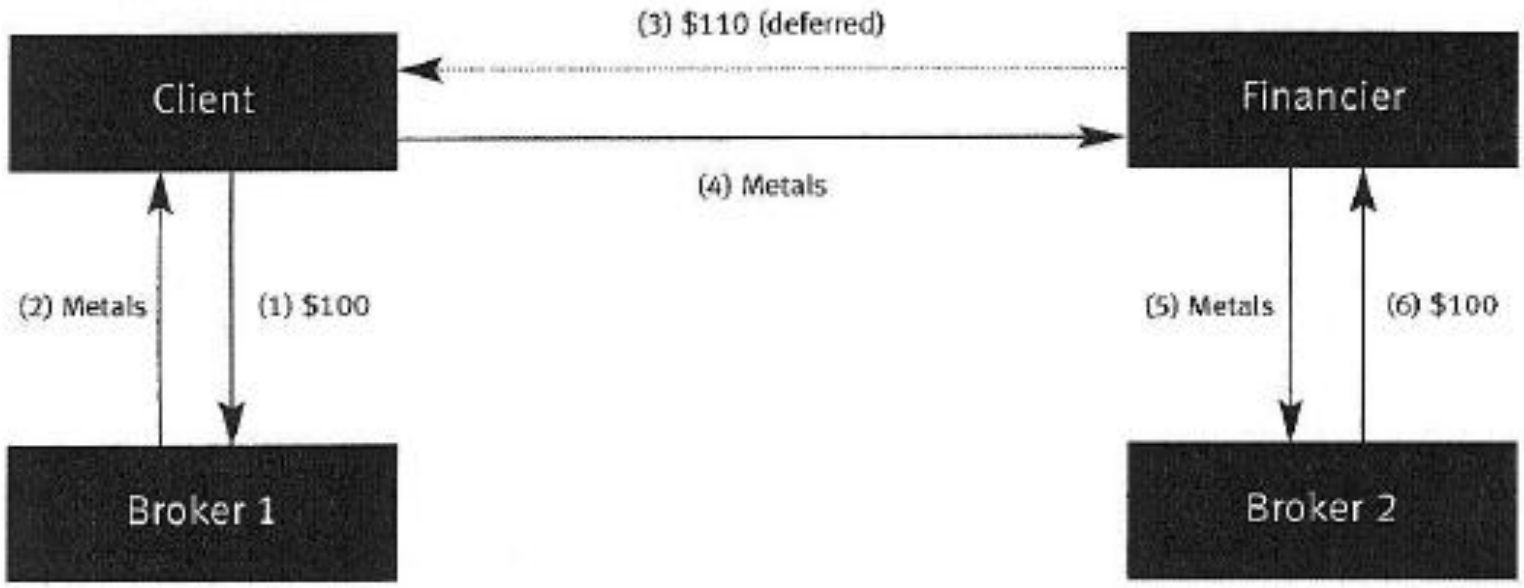


Alternatives Islamic Derivatives Products: Urbun

- This is similar to the call option where the option holder is entitled to buy shares or refrain from doing so against losing the paid premium.

- However, unlike *urban* where the premium paid is considered part of the purchase price, in call option, the premium paid is not part of the purchase price.

Structured Products: LME Murabahah



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Wallahua'lam

Thank you