Sustainability in Islamic Derivatives for Economic Development Vs. Conventional Derivatives

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Islamic financial instruments are sustainable because they are required until the contract is concluded, in contrast to conventional financial instruments which do not require the existence of the underlying asset. This paper aims to analyse Islamic derivatives such as bay al-salam, bay al-Istisna’ and arbun as alternatives to conventional derivatives. The other focus of the paper is the examination of some conventional derivative contracts such as options for the futures as well the extent to which they are legally permitted in Islamic law. Furthermore, there is a discussion on the views of Muslim jurists on fictitious contracts, and the extent to which the expression and intention of contracting parties affect the contract. The study adopts a qualitative research methodology in which classical and modern jurists’ views are analysed to discover Islamic and conventional derivatives contracts. This paper shows that conventional derivatives do not conform with the principles of Islamic law. Therefore, Islamic derivatives can be an alternative to conventional forms for the sustainability of economic development.

Keywords: Conventional derivatives, Islamic derivatives, bay al-salam, al-Istina’ and Arbun.

Introduction

There has been extensive discourse amongst experts regarding the vitality of derivatives in both conventional and Islamic perspectives. In derivative markets, the performance of market instruments depends on the performance of other instruments (Chance & Brooks, 2007). Regulation of the market allows the contracting parties whether to choose the exchange of
physical counter values. Derivative transactions can be conducted either in an organised or non-organised market (over the counter market). In other words, in derivative transactions, contracting parties can conclude a contract without any contractual instruments or underlying assets based on market performance. This is due to the fact that derivatives are instruments, which rely on the performance of other instruments, in order to be transacted in the market. A financial derivative is a contract, the value of which depends on the price of the underlying asset but which does not require any investment of principal amount. In addition, a financial derivative is a contract between two counterparties to exchange payments based on underlying prices. The transfer of ownership of the underlying assets and cash flows are unnecessary (Ridhwan, 2005).

Chance & Brooks, (2007) maintain, “…Derivatives are financial instruments the returns of which are derived from other financial instruments. That is, their performance depends on how other financial instruments perform.

Based on the above definition, derivatives are contracts regarding the movement of the prices of assets, in which one contracting party benefits at the expense of the other. Contracting parties conclude the contract without intending to exchange physical counter values. Therefore, derivatives are market instruments, which rely on other instruments in which the contractual instruments are unnecessary. Thus, contractual parties conclude a contract on an item which they do not own or which is not in their possession. As a result, derivative contracts are fictitious in which the intention of contracting parties to exchange counter values is absent.

Types of Conventional Derivatives

There are a number of derivative types. However, this paper shall focus on only two major types: options and futures.

Conventional Options

An option is an agreement that gives contracting parties rights but not obligations to conclude a contract in the future at a fixed price agreed upon previously. When the buyer has the option to purchase a contractual instrument, it is referred to as a ‘call-option’ and when the seller has option to sell a contractual instrument, it is called 'put-option.' Options instruments can be traded in organised and non-organised markets (Chance & Brooks, 2007). Therefore, a call-option is the buyer’s right to conclude or cancel the contract within the option period. On the other hand, a put-option is the seller’s right to conclude or cancel the contract within the option period.
(1) A call option is a right that is given to the purchaser to purchase an asset at a fixed price during a specific period of time. The purchaser pays an amount to the seller in advance, which is called a premium, before the sale contract is concluded. This amount is the price of option (Chance & Brooks, 2007). Without paying the premium, the purchaser does not have the right of option as this premium is not included in the price of the sold item when the contract is concluded by the parties.

(2) A put option is a seller’s right to sell an asset at a fixed price, agreed upon between the contracting parties up to a specific period of time. In put options, when the price of the asset is more than the exercise price, the put option is called “out of money.” In this case, the contract of put option is not going to be exercised. However, if the price of the asset is less than the exercise price, the put option is called “in the money.” In this case, it is advisable for the seller to exercise the contract of option before the expiration of the option date. Furthermore, when the price of the asset is equal to the exercise price, the put option is called “at the money,” and the contract of put option is going to be concluded by the parties (Chance & Brooks, 2007).

In summary, contractual rights options are given to contracting parties to conclude a contract when they realise that concluding the contract is in their favour. However, they are not obliged to conclude the contract in case the conclusion of contract is not in their favour.

**Conventional Futures**

Futures contracts are agreements between contracting parties to buy or sell a specific financial instrument, agreed upon in the future at a fixed price and at a specific period, which is called “expiration date” (Chen, 2019).

They are undertaken by contracting parties to buy or sell underlying assets, at a specific price on a specific date, in which the contracting parties are obliged to fulfil their commitments at the end of the period of time that is fixed in the contract (Adam Milton, 2019).

In view of the above, one can observe that futures are obligations on contracting parties to exercise the contract in the future. In addition, the difference between futures and options consists of the fact that options are rights rather than obligations, while futures are obligations and not rights. In other words, in futures contracts, the contracting parties are obliged to fulfil the contract at a mature period of time while in the options contracts, they are not obliged to exercise the contract until the period of options has lapsed.
Legality of Conventional Derivatives Contracts in Islamic Law

Since derivative contracts are fictitious, the purpose or motive of contracting parties varies from their expression. The paper will now examine the concept of fictitious contracts, *iradah al-zahiriyah* (effect of expression) and *iradah al-batiniyyah* (hidden intention) according to Islamic law before discussing derivatives contracts based on the perspective of Islamic law.

Fictitious Contract based on the perspective of Islamic law

Fictitious contract is where contracting parties make an offer and acceptance, but their intention to exchange counter values is absent (Saleem, 2012). In other words, in fictitious contracts contain the pillars of the contract, but the motive or purpose of contracting parties to conclude the contract is absent. The conclusion of the contract is not in conformity with the objective of Islamic law regarding the permissibility and purpose of the contract.

The Views of Muslim Jurists on Fictitious Contract

There are two opinions on expression and hidden intention of contracting parties, which are as follows:

(1) Hanafi and Shafi‘i jurists look into the expression of the contracting parties, without taking into consideration their purpose and motive towards the contract. They believe that the contracting parties’ hidden cause or motive does not affect the contract, unless it is expressed in the terms and conditions. They are also of the view that the contract is valid according to its expression, which contains the fundamental pillars of contract such as the offer, acceptance and subject matter. However, the contract may be regarded as offensive with respect to the *mukruh tahrir* (degree of prohibition) that may be involved because of the bad intention of contracting parties, that is not to exchange counter values (Al-Zuhaili, 1989).

In view of the above, one can note that Hanafi and Shafi‘i jurists do not examine the hidden intention of contracting parties, rather their expression. On the other hand, they take into consideration the intention of contracting parties because they say that it is forbidden to conclude a contract if the intention, motive, or purpose of the contracting parties is bad i.e. if the intention of contracting parties is not to exchange the counter values of the contract. As a result, Hanafi and Shafi‘i jurists believe that the contract is not valid if the contracting parties do not intend to exchange the counter values of the contract.

(2) Maliki and Hanbali examine the intention, purpose and motive of contracting parties to the contract. They maintain that the contract is void if the intention, motive, or purpose of the
contracting parties is impermissible, provided that one of the contracting parties is aware of this impermissible intention or motive, or he or she is able to know the impermissible intention or motive or purpose of the other party through indications and circumstances which denote that the other party’s intention or motive or purpose is not in conformity with Islamic law principles. According to them, the contract is void because it amounts to helping one to commit sin and an act of transgression which is not permissible in Islamic law (Al-Zuhaili, 1989).

In the foregoing section it was demonstrated that this group of jurists take into consideration the purpose and motive of contracting parties to conclude the contract. They are of the view that the contract is void if the purpose or motive or intention of contracting parties is unlawful, however the contract is valid if the purpose or motive or intention of the contracting parties is lawful.

In view of the arguments of jurists regarding fictitious contracts, it is obvious that the two groups do not permit fictitious contract. This is due to the fact that according to the first group, if bad intentions exist, then the contract will be considered as unlawful, while the second group argues that the contract is void if there is a bad intention which is known to any of the contracting parties. Therefore, there is no doubt that in any contract, at least one party would be aware of a bad intention. Logically speaking, it is not possible to conclude a contract on any subject matter, by any means of transaction if one party does not know the purpose or motive of the contract. Hence, one can say that a fictitious contract is not permissible in Islamic law and the contract is void when it is concluded for a fictitious purpose, whereas in the contemporary era, fictitious contracts are organised to be exercised by contracting parties. This means that both the contracting parties know the motive and purpose of the contract. Therefore, based on the opinions of the Muslim jurists, the contemporary organised fictitious contracts are not in conformity with Islamic law principles.

Legality of Conventional Options Contract in Islamic Law

There is no doubt that Islamic law permits all types of options in commercial transactions. The Prophet Sallahu Alaihi Wassalam (S.A.W.) said, contracting parties are an options as long as they are in the session of contract and do not separate (Al-'Asqalani, 2000). In another hadith, He says to one of his companions Habban bin Munqidh; “If you buy something, say no deception and I have the option for a period of three days (Al-Naisaburi, 2001). Despite the fact that option is permissible in Islamic law it is not however, permissible for a Muslim to sell what is not in his or her possession because the Prophet (S.A.W) said; “Do not sell what is not in your possession or what you do not own” (Al-Mubarakfuri, 2001).
In view of the foregoing, one can say that contract options are permissible in Islamic commercial transactions as this was recommended by the Prophet (S.A.W). On the other hand, he forbade the selling of what someone does not own. The question that may arise in this instance is whether options of contracts as practiced in contemporary stock markets are in accordance with Islamic law principles. In order to answer this question, there is a need to know the nature of contracts or transactions and the purpose or motive of contracting parties as well as the objective of Islamic law behind the permissibility of contracts.

**Legality of Conventional Options Contract in Islamic Law as Practiced in Stock Markets**

There is a lot of difference between options of contract that were permitted by the Prophet (S.A.W) and options of contract that are being conducted in the stock market. Based on the perspective of Islamic law, the right of options is not tradable and when there is option, the contract is concluded on the real asset which is in the possession of the seller. In the stock market, the right of options is tradable and the contract is concluded on a hypothetical asset which is not in the possession of the seller (Ridwan, 2005). The contracting parties conclude the contract on a notional asset (short sale). Therefore, there are no similarities between the options of contract allowed in Islamic law and the options of contract as practised in stock markets, especially in derivatives contracts. They are only similar in nomenclature but differ in their nature and structure.

**The Views of Contemporary Muslim Scholars on Selling Right of Option in the Stocks Markets**

Muslim scholars have two views on selling right of options in stock markets. The first view is that it is permissible for contracting parties to trade their rights of options in stock markets, while according to the second view, it is not permissible. An analysis of the two views is provided below:

Evidence for the first view, according to which it is allowed for contracting parties to trade their rights of options is established by analogy based on the fact that right of options in the sale of *Arbun* is permissible in the Hanbali schools. The Hanbali jurists affirm that since the sale of *Arbun* is permissible, sale of right of options is also permissible if it is free from any other illegal elements. Their position is supported with the analogy that since the right of options (option of contract) to option of condition, is permissible in Islamic law in a specific period of time, the trading right of options is also permissible in a specific period of time (Muhaydin, n.d.). They also support their claims with the hadith of the Prophet (S.A.W) which was narrated by al-Tirmizi stating: “Muslims can stand on their conditions with the exception of a condition that makes what is unlawful lawful or a condition that makes what is lawful unlawful” (Al-Mubarakfuri, 2001). They add that since the contracting parties have the right of
options in the above mentioned hadith, then it is permissible for each of the contracting parties to exercise their right towards each other (Ridwan, 2005).

A closer look at the abovementioned view reveals that the proof and analogy adduced regarding the sale of Arbun to sale of right of options as practiced in stocks markets show that there are some differences between the two contracts. Firstly, in the sale of Arbun, the premium paid to the seller is a part of the price of contract, in case the contract is concluded and the contract is real asset. On the other hand, in the stock market, the premium is excluded from the price of the contract and the contract is concluded on a notional asset as practised in the stock market. Furthermore, the hadith which they use to support their claim, is not in its proper place because the conditions which were mentioned in the hadith are not absolute. As mentioned in the hadith, if a condition will make what is lawful unlawful, and what is unlawful lawful, then it is not valid. In addition, the hadith is concluded on contract based on real asset, while the intention of contracting parties is to conclude a real contract and exchange counter values. However, in options of contracts as practiced in the stock market, a subject matter of contract does not exist because the contract is only notional, in order to get the benefit that derives from contractual instruments. The intention of contracting parties is not to conclude a contract on real assets and exchange counter values. It is to get what could be derived from the contractual instruments according to market movement. Therefore, their view is in total conflict with the sale of Arbun and the hadith, which they have used as proof. This is due to the fact that in Islamic law for a contract to be valid, intention and expression of contracting parties must be in accordance with the Shari’ah provisions. The expression of contracting parties must not differ from their intention and motive or purpose of the contract.

The second group of scholars express a view that, it is not permissible for contracting parties to transact rights of options, as practiced in the stock market. Their proof is that options of contracts in stock markets contain the sale of what is not in someone’s possession and the sale of what someone does not own, whereas in the stock market, the right of options is on notional (short sale) in which the subject matter of contract does not exist and the intention of contracting parties is not to exchange their counter values. It is to get the benefit derived from the contract according to the market’s pace without any real contractual instrument. Furthermore, they claim that there is conflict between options of contracts as practiced in the stock market and the objective of Islamic law in permitting the option of condition. This option is permissible in Islamic law because it favours the two parties and it also protects the maslahah (interest) of the contracting parties, unlike the options of contracts in the stock market which are at the expense of one of the contracting parties (Muhaydin, n.d.). In other words, the profit of one party in the stock market is at the loss of the other which means that it is only one party that is going to benefit from the contract. Hence, the contract is not in the benefit of both parties.
To summarise the above two views, the view that allows the selling right of options of contract as practised in the stocks market is not preferable. This is due to the difference between their proof and current options of contracts as practised in the stock market, because in Islamic law, one cannot sell what is not in his or her possession and contracts are not to be based on assumption. In addition, option of contract of condition, which is permissible in Islamic law is not tradable. It is a right given to a buyer to conclude a contract or to cancel it within a specific period of time whereas the options of contracts in the stock market are tradable. This means that it is not compulsory for the expression of contracting parties to be in conformity with their intention or purpose of contract. This on its own is regarded as fictitious contract, which is not allowed in Islamic law. As a result, selling rights of options as conducted in the stock market is not in accordance with Islamic law principles. Therefore, the preferable view is the one of the second group of scholars.

**Sustainable Islamic Derivatives as an Alternative to Conventional Derivatives**

In the view of Muslim jurists, not all conventional derivatives contracts are in compliance with the principles of Islamic law. They suggest Bay al-Salam, Bay al-Istisna’ and Bay al-‘Arbun as alternatives to conventional derivatives, so that Bay al-Salam and Bay al-Istisna’ can be an alternative to conventional future contracts, and Bay al-‘Arbun can also be alternatives to conventional options contract.

**Bay al-Salam and al-Bay al-Istisna’Contracts as an Alternative to Conventional Future Contracts**

*Bay al-Salam* is a sale contract in which the buyer pays the full amount of the asset in advance, which would be delivered in the future. This contract is subject to certain conditions to be fulfilled in order to be regarded as a valid contract; the most important conditions are for instance, full payment of the price of the asset must be made by the buyer at the time the Salam contract is concluded., due to the fact that in Salam contract, it is not permissible to delay both the price and the asset sold due to the fact that if the price of the sold item and the sold item itself are delayed, then the transaction would be tantamount to a sale of debt by a debt transaction which is not allowed in Islamic law. Hence, the underlying asset of Salam must be available in the market and its quantity and quality must be specified by the contracting parties. The maturity period and place of delivery must be clearly mentioned in the contract in order to avoid anything that may amount to conflict between the parties. The underlying asset must not be a unique and identified asset, and must not be an asset from a particular form of the asset. It has to be standardised and easily tradable in the market during the period of the contract of Salam (SC Malaysia, 2009), as Salam contract is permissible to facilitate the conditions of the seller and buyer, so if the contract is concluded on an asset which is difficult to find in the market, it will amount to making the situation difficult for the buyer, which is not permissible.
This *Salam* contract can be an alternative to conventional futures contract in order to manage the price risk. Thus, the price is paid in advance to assist needy farmers and small businesses with operational capital financing.

Furthermore, *Bay al-Istisna’*, which is a manufacturing contract, can also be an alternative to futures contract. *Istisna’* contract is a sale contract where the buyer requests the seller to manufacture an asset with an agreed price at the conclusion of the contract and deliver it in specific period of time. The unique feature of *Istisna’* contract is that both price and asset can be deferred, nothing is exchanged at the conclusion of the contract. It is an Islamic commercial transaction contract in which the contractual obligations of the contracting parties are performed in the future. At the maturity of the period, the buyer can pay the price of the manufactured asset partially, fully or by deferred instalments (SC, 2009).

Therefore, since conventional futures contracts are not in conformity with the principles of Islamic law, *Salam and Istitsta’* contracts, which are in accordance with the principles of Islamic law can be alternatives to conventional futures contracts.

**Bay Al-‘Arbun as an Alternative to Conventional Option Contracts**

The Malaysian Securities Commission defines *Bay al-‘Arbun* as “an amount of money that the customer pays for a purchase ordered by the Institution after concluding the *Murabahah* sale contract, with the provision that if the sale contract is completed during a prescribed period, the amount will be counted as part of the price for the sold item. In case the customer fails to execute the sale contract, the Institution may retain the whole amount” (SC, 2009).

*Bay al-‘Arbun* resembles an options contract in the sense that both contracts attempt to manage the price risk. Thus, *Bay al-‘Arbun* is to reserve the sold item for the buyer against a nominal amount that is paid to the seller in advance, on the condition that if the bargain continues, the amount that is paid in advance will be a part of the price of the sold item. If the bargain is cancelled, the seller has the right to keep the advance amount that is paid to him or her. In this *‘Arbun* contract the buyer has right of option during the specific period agreed upon by the contracting parties to abide with the contract if he or she discovers that the contract is in his or her favour or withdraws from the contract if it is not. As a result, *Bay al-‘Arbun* comprised an option contract which is exchanged with money in case the buyer refrains from the contract so that the seller can manage the risk of pace of the market price. In the *‘Arbun* contract, the buyer is entitled to a binding offer from the seller, while the buyer has right to accept or reject the offer during the specific period of the offer agreed upon in relation to the *‘Arbun* (SC, 2009).

As a result, *‘Arbun* contract is similar to a call option contract where the buyer has the right to buy shares or refrain from buying in relation to losing the premium that is paid in advance to
the seller. However, in the Bay al- ‘Arbun sale contract, the premium that is paid in advance to the seller is part of the price of the sold item if the contract is concluded, while in the call option, the premium is not a part of the price of sold item in case the contracting parties conclude the contract (SC, 2009). Therefore, Bay al-‘Arbun can be an alternative to the conventional option contract which is not in accordance with the principles of Islamic law.

Research Findings

This paper has argued that in Islamic derivatives markets, contracts are concluded based on real assets whereas in conventional derivatives markets, they are concluded on notional assets which are not in existence while contracts are concluded. Thus, conventional derivatives contracts are fictitious in which the parties’ motive or intention is not to exchange the counter values of the contract. The motive and intention of contracting parties are different from the contract’s purpose. Furthermore, according to conventional law perspective, futures contracts are binding for contracting parties within the period prescribed in the contract while options are not binding for parties to conclude the contract.

As a result, Islamic derivatives which are sustainable instruments can be an alternative to conventional derivatives. This is due to the fact that conventional derivatives contracts are fictitious in which the contracts are concluded based on the movement of market prices, rather than the real assets which are transacted in the markets. According to the perspective of Islamic law, any contract in which the motive and intention of the contracting parties are not in conformity with the purpose and effect of the contract which are to exchange the counter values of the contract and transfer of ownership of the contractual instruments, is not valid.

In summary, Islamic derivatives are sustainable instruments for economic development and movement of efficient markets in which the real instruments are transacted, and the intention of the contracting parties is to exchange counter values of the contract while concluding them. In contrast, in conventional derivatives markets, the intention of contracting parties to exchange contractual instruments is absent.

Conclusion and Suggestions

The paper has outlined Conventional and Islamic derivatives. Conventional derivatives contracts are concluded on notional assets which are unnecessary while contracts are concluded, whereas Islamic derivatives contracts are concluded based on corporeal assets which exists while contracts are concluded. For example, in Salam contract which can be an alternative to future contracts, the price of the subject is fully paid in cash at the conclusion of the contract, which is concluded on the tangible asset of the subject matter, while in
conventional future contracts both the price and subject matter are delayed at the time the contract is concluded. Similarly, the *Arbun* contract can be an alternative to option contracts. There is a great difference between options of contract that is permitted by the Islamic law and options of contract that are being conducted in the stock market. Based on the perspective of Islamic law, the right of options is not tradable and when there is an option the contract is concluded on the real asset which is in the possession of the seller whereas in stock markets, right of options is tradable and the contract is concluded based on a hypothetical asset which is not in the possession of the seller.

As a result, the researcher suggests that *bay al-Salam, Bay al-Istisna’* and *Bay al-Arbun* to be financial derivatives for both conventional and Islamic derivatives market for the above mentioned reasons as well as to conduct empirical study on the topic to have a better understanding of Islamic and conventional derivatives.
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