OPTIONS FUTURES AND DERIVATIVES

By:
Dr. Mohamed A. Elgari Bineid
Associate Professor of Economics, King Abdulaziz University

Derivatives

Financial and Investment activities don’t depend only on primary exchange contracts, but also on derivatives. A derivative is an instrument produced (derived) from an already existing contractual relationship. The most important derivative securities are options. We have to firstly understand the meaning of derivatives. People engage in exchange contracts for a purpose (I want to have a car and you want to have money). Whenever this purpose is "contractible", i.e. can be made a subject of a contract, then we enter into a primary contract. Sometimes the subject can't be made a subject of a contract, then we opt for a derivative. A derivative doesn’t differ in its form from the primary contract. It differs in purpose. I can't make protection from the risk of price change a subject of a contract, so I opt for derivative, a contract whose subject is another one's obligation to sell or buy. My purpose is protection from risk; however, I contract on purchase or sale obligations.

Looked at from this angle, I believe there is a Shari'ah basis for many derivatives. Are options one of them?

Options

In contemporary financial transaction an option is itself a contract. Hence an investor can buy an option contract in the stock market. This means that he will pay a price to another party to acquire the “right” (not the obligation) to buy or sell an asset in the future for a pre-set price. The party that receives the price will be “obliged” to either buy (in case of put option) or sell (in the case of a call option) at the request of that buyer. An investor will opt to buy an option contract whenever she has expectations about the future market of the asset in question which are not that of the other party. Through the purchase of an option contract (i.e. right to buy or sell), an investor can benefit from his expectations, yet protect his investment from adverse outcomes if such expectations didn’t materialize. The option contract is independent of the future purchase or sale of the underlying asset.

Shari'ah does allow for many kinds of options. Some of them are there to guard against injustice between the two parties. For instance, if the buyer discovers that the seller didn’t reveal his true cost in a Murabaha transaction then he automatically will have an option to repeal the contract and has a right to receive back his money. He need not exercise this option if he is satisfied, still, with that price. But if he is not, the seller is obliged to return or compensate. The same thing will be true if buyer discovers damage in the purchased goods.

But Shari'ah also provides for generic options, where one party can hold the outcome of a contract in suspense for a specific and short period of time. Hence two parties may engage in a sale contract and then one of the two parties requests an “option” in that sale contract. Such option is not to "contract" or not "to contract" as the contract has been affected. It is rather the right to repeal the contract. Both “call” and “put” option can be included in any exchange contract. However, the option itself can not be separated from sale contract. Therefore, that option will not be separately priced. This is a major departure for the standard option pricing model. This means no market for options can be created in an Islamic environment.

Sale of Arboon

One of the contracts of sale that generated a lot of controversy because of its “optional” aspect is what called “sale of arboon”. This kind of sale is not permitted by all schools of jurisprudence in Islam. However, the Hanbali School does permit it, and most contemporary scholars will be inclined to this view. The Figh Academy of the OIC has taken a decision in permitting it. Sale of arboon is in fact a call option. In this type of contract the buyer pays only a small percentage of the price of the purchased good or asset, and holds the effect of the sale contract in suspense for a predetermined period of time. If he decides to complete the purchase, the balance will be paid to the seller. The interesting thing is that if he decides not to go ahead with the purchase, then the paid portion of the price will be kept by the seller as a consideration for giving him the option.

I was, probably, the first to discover the potential of this form of sale contract for risk management the Islamic way. In 1990 I wrote an article in the Journal of Islamic economics studies which became the basis for developing the first capital protected fund by the NCB, Jeddah.

Two problems remain without solution:

a) That a separate and independent option contract is not possible from Shari'ah point of view. The Figh Academy in deciding to disallow the standard final option realized upon an established rule in Shari'ah that pure rights and obligation can't be the subject of an exchange contract. This has been recently challenged by some Shari'ah scholars. It appears different types of rights and obligations were allowed to be the subject of an exchange contract by the classical Shari'ah jurisprudence. The task is to derive a rule out of these opinions.

b) While the Arboon sale may be used as substitute for a call option where a buyer reserves the right to repeal the contract, we also need a substitute for a put option where the seller has such right. Such option has been recently developed by the Shari'ah board of an institution that is to remain nameless now until the product is launched.

Futures:

The importance of futures is smoothing the inter-temporal price movement is well known. They are also a tool for risk management for both suppliers and those who need the goods in the future. The Salam sale contract is a Shari'ah based arrangement known since the time of the Prophet that serves the same purpose. However, a significant difference does exist. In Salam, the full price must be paid and not just a small portion of 1% or so. Therefore, it is difficult for non users to actually engage in this market. We all know that futures markets are the heaven of speculators. Only few contracts end up with an actual delivery. Not when the full price is paid. There is a movement, I sense, to try to show that may be Shari'ah is tolerant to "not paying the full price", hence we have a room for futures like contracts. I am against it. With the existence of options, people have sufficient tools to manage risk. Futures are tools for speculations.