Future Trading - Islamic Perspective

Mohamed A. Elgari, Ph.D.

Director

Center For Research in Islamic Economics
King Abdul Aziz University
Jeddah, Saudi Arabia

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CONTENTS

I- The meaning of future trading.

II- Future's trading impact on the economy.

III- Relevant *Shari'ah* injunctions to future trading.

IV- *Shari'ah* objections on the conventional forms of futures trading.

V- Towards a *Shari'ah* acceptable forms of futures trading.

VI- Conclusion.

Introduction:

Marvelous innovations in our modern life are not confined to genetic engineering, technological design and medicine. Some of the most important revelations that reshaped our lives are taking place in the sphere of finance. Individuals and firms have always resorted to financial innovations to reduce cost, circumvent government regulations and to manage risks. No one dare say that Muslims should ignore new advances in medicine and technology, or that the forces of modernization in our generation should be halted. By the same token, we must not be left out in the pursuit to renovate the system of economy. It is part of our Islamic belief that our *Shari'ah* is capable of accommodating all our legitimate needs. If we fail to catch up with others, it is because of lack of effort on our part.

I- The meaning of future trading:

Transactions involving bridging of present to future are not new. Forward contracts we known to may centuries.

Forward contracts are agreements in which sellers agree to deliver specific commodities to buyers sometime in the future. At the time of contract seller and buyer agree on the quality and quantity of the commodity sold. Both parties will then know in advance the price and when these commodities will be delivered. Hence they need not negotiate price at the time of delivery. Forward contracts are not confined to grains and foodstuffs, but they are prevalent in all sectors of the economy, in rents, charge cards, real estate lease, newspaper subscriptions,... etc.

Futures contracts are quite similar to forward, except that they are standardized. Quantity, quality, delivery, location, are all standard. Price is the only variable which is decided through the forces of supply and demand. Unlike forward contracts, futures are traded in organized markets.

More importantly, however, is the fact that, unlike forward, futures contracts virtually eliminate default risk. This is done by using two devices:

a) Futures contracts traded in organized markets are "marked to market". The change in the value of the future contract is paid or received at the end of each day. It leaves nothing to chance. Forward contracts have only one single payment at maturity.

b) Organized markets for futures contracts have a clearing mechanism. The clearing house which is an essential part of each organized market is responsible for settling all trading accounts. Hence it acts as a third party to all contractors, acting as buyer to every seller, and seller to every buyer. Therefore all obligations are actually carried by the clearing house. No direct relationship between buyer and seller will exist. This means that every transaction is guaranteed by the clearing house and sellers and buyers take the risk of the house not each other. Default is effectively eliminated.

II- Futures contracts impact on the economy:

Every business (agricultural, industrial, goods or services), faces variety of risks. However, risk is like matter, it is indestructible, it only changes nature. It is not possible to avoid risk. However, it is important for any agent to recognize the existence and nature of risk and to consciously take the size of risks he wants to take. Hence, for every market player attempting to minimize risk, there must be another willing to assume such risk. Futures contracts are means for the transfer of risks. Those who accept to avoid certain type of risk risks are called hedgers. Those who assume such a risk, for profit, are called speculators. However, these are not two distinguishable groups of people. The only difference between hedgers and speculators is the fact that the latter have no commercial interest in the commodities sold. Such will not be a material difference that can be the basis of policy or special procedures toward each group. Only at the time of delivery it becomes possible to distinguish albeit not very precisely, between the two groups.

Clearly, the availability of a mechanism to transfer risks is quite valuable to individual agents. However, this effect of futures trading is not confined to such agents. The existence of

an organized program to exchange risks will have an important impact on the economy at large. In fact, risk sharing and intertemporal smoothing are too important determinants of welfare in any society. Lack of opportunities for risk sharing is a major constraint of the attainment of such welfare

The main consequences of futures market are as follows:

a) Futures contracts make the market more liquid, bridging the gap between present and future and providing information about the impact of current events on future prices.

b) Future's market provide hedgers financial protection against price volatility for commercial firms.

c) Futures can be used to control risk and to adjust risk expositor of a portfolio to new economic information.

d) With the existence of futures contract, the market can absorb greater volume of transactions without adverse effect on current or future commodity prices. Yet future's market can embody substantial amount of new economic information to the point that it is sometimes called a "price discovery market", (Patrick Catina P.5)

III- Relevant *Shari'ah* injunctions on Futures Trading:

It is claimed that futures contracts are not recent discoveries but go back to the 16th century (Donald Chew P.151). It is a fact, however, that futures have been traced on the Chicago Board of Trade since 1865. Their importance, however, is quite contemporary. Therefore, our classical jurists didn't address the subject of futures contracts directly. However, there are a number of *Shari'ah* injunctions that are relevant to the subject at hand. They are mainly:

a) ***Bai* and *Sarf***

Sale contracts may involve the exchange of money for goods (*Bai*) or involve the exchange of money for money (*sarf).* For the second category of contracts it is an established rule in *Shari'ah* that such exchange must be spot. Neither the sold currency nor the price (the other currency) are to be differed. Such rule is based on authentic narrations from the Prophet (PBUH), and therefore is not a subject for re-interpretation.

b) *Salam* contract and deferred payment sale:

Shari'ah dsoes recognise the need for inter-temporal transactions. Exchange contract in *Shari'ah* can be spot, in this case both price and items sold are instantaneously exchanged. They can be forward, in this case the price or item sold is differed for future delivery. *Al-bai bilthaman al-ajil* is an example of deferred payment sale, while the *Salam* contract is an example of a sale contract where the goods are differed.

However, it remains that both, *Al-Bai bil-thaman al-ajil* the differed payment sale and the *Salam* contract are a far cry from the modern futures transactions. An exchange contract in *Shari'ah* is an agreement where two parties exchange a price for a priced item (good or service). The contract itself must always be spot, i.e. creating rights and obligations immediately and resulting in a complete or partial delivery of the object of the contract. It is therefor not permitted to engage in contracts that only create mutual obligations that are to be disposed of in the future.

c) Contracts in suspense:

A contract is definitive when the offer and acceptance are both categorical and the contract is validly concluded. A contract is suspensive when the offer and acceptance are kept in suspense i.e. for future effect. The latter is not permitted in *Shari'ah,* particularly in sale contracts. Hire contracts, to majority of scholars, may be suspensive.

Contracts in suspense, are relevant to futures because in the latter there is only offer and acceptance but no contract is concluded. Effectively futures are quite similar to sale contract in suspense

d) Exchanging debt for debt:

Debt obligations (such as receivers) are not to be sold except in very restrictive cases where it does not lead to usurious transactions, one sure case is when the debt obligation is not money but commodity. Debt is sold in deferred payment (i.e. for debt is beyond the pale..

IV- *Shari'ah* objections on conventional future contract:

If we focus specifically on the form of contemporary futures contract, we can identify certain flaws that can be summarized as follows:

1) A commodity bought for future delivery has to be, if it is to be acceptable from *Shari'ah* point of view, on *Salam* basis. In this case, and as part of requirements of *Salam,* full price must be paid immediately
at the time of contracting[1]. This is based on an authentic narration from the Prophet (P.B.U.H) and hence is not subject to re-interpretation. An essential part of the futures program, as practiced in organized markets, is that sellers and buyers only pay a small percentage of the total price. Even then such percentage is paid to the clearing house and not to the counterpart. Therefore, a futures contract will not be accepted on *Salam* basis.

One may say why do we insist on *Salam.* The point is that when the sold item in a sale contract is not identified but only described, it becomes a "debt obligation " on the seller, similar to any other debt. Such sale contract must be on *Salam* basis, for *Salam* is the exchange of money (price) for a well described (but not definite) item. Had the sold item been in existence at the time of sale and can be exacted by the parties like one's car

or a house, the buyer will then take the risk of that item not the credit risk of the seller. It should be apparent, therefore, that we have no alternative but to apply the rules of *Salam* on futures if they are to be acceptable from *Shari'ah* point of view.

2) Even if the futures contract can be adopted into the *Salam* model of sale (i.e. parties consented to pay full price at time of contracting) there remains another problem. To the majority of jurists a commodity bought on *Salam* basis can't be disposed of by sale before actual delivery. When a forward (or future for that matter) contract is effected, buyer must wait until delivery to be able to sell same. This is not what happens in futures market. Commodities, in the organized futures markets, are bought and sold several times before actual delivery, otherwise the market will fail to provide liquidity, which is an essential part of the mechanism. . But from *Shari'ah* perspective, even in standard sale contracts, it is not permitted that the buyer sells before actual receipt of the purchased items.

These two objections fly in the face of conventional futures and makes it almost impossible to accept conventional futures contract.

V: Towards a *Shari'ah* acceptable futures trading:

It is an established economic fact that risk sharing and intertemporal smoothing are essential elements of welfare in any society. It is also an established *Shari'ah's* fact that the main objective of Islamic *Shari'ah* is the good and welfare of the Moslem society. Therefore, it is unthinkable that *Shari'ah* will lack the ways and means to provide necessary facility for Muslims' legitimate needs in the realm of finance and investment.

We know already that all the modes of partnership in *Shari'ah* are geared toward risk participation. Not only that risk sharing is the most important element in the idea of *Mudarabah* and *Musharakah,* but also that when the form of contract of such partnership is altered to shield one partner from risk, the contract becomes null and void for it no longer serves the basic purpose which is risk/reward sharing. In fact the main reason for prohibition of interest is the fact that loan contract shifts commercial risk of the profit generating venture to the borrower. Hence, the other party deserves to get no share of such profit which is essentially a reward for risk taking.

However, it is one thing to say that risk sharing is a legitimate objective, but another to say that risk *per se* can be the subject of an exchange contract. Speculators have no commercial interest in the commodities being exchanged in futures markets. Rather, they make money out of "purchase" and "sale" of risk. Unlike the need for hedging against risks, speculation is a deplorable activity. The point is how can we distinguish hedgers who have a legitimate need, and speculators?. Unfortunately, there is no practical way for such end.

Intertemporal smoothing is a legitimate objective. It is a built-in component in every contract that bridges present to future.

Shari'ah doesn't lack such a facility. As a matter of fact *Salam* itself is an intertemporal smoothing device.

Furthermore, one major effect of future's trading is creating the means whereby relevant and useful economic information is internalized into the market mechanism. This is not only in line with *Shari'ah* but it a requirement for all exchange contracts.

It is because of this a number of contracts become void or prohibited when they are made a means to conceal information from the other party.

Having said all that, is it sufficient to say that conventional futures contract is not permissible from *Shari'ah* point of view? The answer is negative. We must venture into developing a *Shari'ah* acceptable form of futures contract.

At this stage, however, we can only set the foundation for future research tasks and set the agenda for other works to follow.

Firstly: The need for hedging risks is a legitimate one from *Shari'ah* point of view. Efforts to design new instruments for this purpose that are in line with *Shari'ah* requirements should be encouraged.

Secondly: Such legitimate needs are found in the realm of production of real assets and services. Therefore, interest rate, currency, and stock index futures have no place in an Islamically valid futures market.

Thirdly: We have always assumed that a futures contract is actually a sale contract. Therefore, we have insisted that it should be abided by the *Shari'ah* acceptable rules for such contracts. However, there are those who think that the futures is not actually a sale contract but a promise to buy and sell. In his "International Investments", 3rd edition, Bruno Solnik described futures as "simply a commitment to buy or sell" (P.398). This area must be explored from *Shari'ah* point of view.

Certainly a binding commitment is a contract. The fact of the matter is that such commitment is not binding. Neither buyer nor seller are obliged to receive or deliver. He is only required to compensate the other party for any damage caused by such commitment, i.e. the difference in price. This perspective actually takes the whole matter to a different chapter in the jurisprudence of contracts. In a momentous decision, the Islamic Jurisprudence Academy of OIC, a distinction between such contract and a binding promise to buy (or sell) was established. Based on the Malki school of thought, a promise to purchase is not a purchase contract. Yet it creates an obligation on the promising party to compensate the other for any loss caused by not honoring one's promise. The profit generated would be that of the compensation.

Fourthly: Building a model of futures trading on the basis of the *Salam* contract should not be excluded all together. As for the requirement in the *Salam* contract to pay the full price when the contract is transacted, this will clearly reduce the possibilities for speculators and hedgers. As for liquidity, some classical jurists differentiated between food and non-food items in the case of *Salam*. To the majority of the Maliki scholars, sale of *Salam* based goods before actual receipt is acceptable for non-food items. These possibilities must be explored.

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