OPTIONS FUTURES AND DERIVATIVES

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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. Securities 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 protection from the risk of price a subject of a contract, so I opt for derivative, a contract whose subject is another one's obligation to sell or buy.

Looked at from this angle, I believe there is a Shari'ah basis from many derivatives.

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.

Islamic model of Financial Intermediation

The function of banks is financial intermediation. While experts may differ on the history of banking, there is no question that the importance of financial intermediation had been recognized even by ancient societies. It is because of this, we find that people in antiquity had always had arrangements to carry out such function. It was the temples at the time of the Pharaohs and the chapels at the time of Hamorabi that arranged for financial intermediation. The Greeks did have an even more advanced arrangement for financial intermediation.

What gave rise to financial intermediation is the fact that human societies, since time immemorial had been divided to two groups. One with more resources that it needs now and the other needs more resources now that it owns today. People discovered very early that the welfare of both groups will be significantly improved if a process of transferring resources from the first to the second group was initiated. Because every individual in society is prone to be in the first or the second, it is quite advantages to everyone to participate in this process.[1]

At the dawn of the middle ages, a social movement towards division of labor and specialization took place. It included the institutionalization of many activities which used be rendered as part of the religious or social relationships.

An institution for financial intermediation was born. It is at this epoch that the bank as we know it was born.

It was quite natural that such institution is built on the same arrangement which was the basis of financial intermediation in almost all historical stages that is the Loan Contract.

[1] Clearly this is not a line dividing society to rich and poor as all the members of both groups are well-off. In fact, members of the shortage group are mostly the rich who want to invest.

The bank is, therefore, based on a borrower-lender relationship with its sources of funds and users of such funds.

Matching assets and liabilities

In both asset and liability sides of the bank's balance sheet, this borrower-lender relationship is easily recognizable. The term "loan" is never used in the realign of banks relations with its sources of funds. This, however, doesn't hide the legal and actual fact that all bank deposits are loans; the borrower is the bank and the lender is the bank client. But why didn't savers go directly to borrowers and cut the cost of the middle man. The answer relates to the cost of information. An institution that specializes in credit analysis and risk management is more efficient in monitoring the risk involved in lending because of its ability to gather information less costly.

The Shari'ah basis for Islamic banking in Malaysia

Islamic banking started in Malaysia in 1981 when Bank Islam Malaysia Berhad was established BIMB was licensed under a special gazetteer to the banking law in that country. The success of BIMB was exceptional. It is because of this in less than ten years almost every bank in Malaysia was offering Islamic banking services after being granted a special permit to open Islamic window. This created an active “Islamic” money and capital markets and specialized financial services of underwriting and brokerage. Despite the phenomenal progress in such a short time, the Malaysia model of Islamic Banking remains, in the eyes of non-Malaysian Islamic bankers, an anomaly deviating from the basic Shari'ah “rules of the game”.

The problem of communication:

Without saying that the so called Islamic bankers are correct or wrong in their judgment over the practices in Malaysia, we feel there is a serious lack of communication between the two groups. Language is an obstacle. In particular, when it comes to reviewing the rulings of Shari'ah boards which is always recorded in Malay. The purpose of this paper is, therefore, not to cast a judgment, but to initiate a process through which views

are exchanged in a discourse that may lead to the betterment of the idea of Islamic banking in general. Certainly the Malaysian experiment is too important to be ignored by the rest of the world of Islam. And by the same token, there is so much that the Malaysian can learn from a more than two decades of Islamic banking in the rest of the world.

It is not the intention of this writer, therefore, to neither criticize the Malaysian way nor to legitimize practices that are questionable from Shari'ah point of view. Being involved to some extent with some of the Malaysian banking institutions, I feel especially obliged to contribute to the understanding of the Malaysian model.

The Foundation of the Malaysian Model:

The back bone of the Malaysian Islamic banking is the Murabaha and Al-Bai Bilthaman Al-Ajil. Both are sale contracts were the bank acquire tangible assets such as real estate, equipments, auto...etc., and sell them to bank clients on differed payment basis. The only difference is that Murabaha term is always 90 days or less. While Al-Bai Bilthaman Al-Ajal is longer in term. Except for the fact that they are both called Murabaha in the Jargon of Islamic banking. There is nothing

unique in both; Islamic banks everywhere practice these modes of finance. What is different, however, is what happens after a sale contract is concluded. The financial assets that created through this transaction remain in the books of the bank. It is the consensus of the Shari'ah scholars everywhere (save Malaysia) that transfer of such assets through sale constitutes what is called “Bai Al-Dain” (sale of debt) which is not permitted in Shari'ah. The Malaysians have different views.

There is no denying the ability to liquidate debts by discounting commercial paper, Sale of receivables and debt securitization, gives the financial institution a great deal of ability to maximize profiting, by concentrating on its corporate advantage i.e. risk management. Nevertheless, classical as well as contemporary scholars believe permitting the sale of debt will render the prohibition of usury (interest) meaningless.

Once three parties are involved in the debt transaction, this makes it similar to extending a loan at interest by the one who becomes the owner of these notes. Shari'ah does allow disposing of a loan before maturity. However, the permitted modes of such disposition involve only the debtor or creditor.

The Malaysian’s however, think that a debt arising from pure monetary transaction such as lending at interest differs from financial obligation that involve the exchange of real assets and goods. When a debt is created through a Murabaha transaction, it is believed that such debt may be subject to discounting. Shari'ah only prohibited discounting of debt that arise from lending. While some classical scholars distinguish between the two types of debt, such distinction never comes in this context.