SHARI'AH POSITION ON DERIVATIVES

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

What are derivatives?

Derivatives are exchange contracts. The main purpose of which is to transfer risks for a price which are not by themselves of much value but because of their impact on another thing called the underlying. Derivatives were developed as tools to manage risks. Hedging is when these derivatives are used to mitigate risks and found off possible causes of reduction of value of the underlying. However, derivatives are also used not protect the value but to "profit" and increase the value the underlying assets. This is what is customary called speculation.

What is risk?

The answer may be very obvious. However, to spell out Shari'ah position on risk, and address our main enquire in a meaningful way, without making sure we are "on the same page" as to the meaning of risk.

A simple definition of risk would be: the probability of something undesirable happening. In the context of finance and investment undesirable means a reduction in the value of an asset, either by missing an expected profit or making an actual loss.

Risk is in the very nature of things. It is a fact of life that anything in the future is not certain. The question is, in the process of decision making are we required to ignore this fact of life and be "fatalistic" or is that we need to take precautions and endeavor to reduce the probability of something undesirable happening? The answer is but too obvious. There is nothing in Shari'ah that dictates on the believer to be reckless enough as to ignore risks around them. It is not contrary to basic Islamic belief, to reckon that God is the supreme power and eventually it is His will that will always prevail. Yet, His will remain supreme because even avoiding risk is happening within His glorious will. Risk by itself is neither necessary nor preferable for any transaction to be Shari'ah acceptable. In fact it is more in line with Shari'ah to avoid risk, provided this is done through Shari'ah acceptable means. At the time of the Prophet (PBUH) a Bedouin getting off his camel asked the Prophet (PBUH) as a true believer should I just rely on Allah and leave my camel here unleashed. The Prophet (PBHU) said no you rely on Allah but also you leash your camel. Hence, managing risk is not contrary to true belief.

On the concept of transfer of risk:

Individuals differ in their ability to absorb the consequence of an undesirable event therefore their preference for the amount of risk they want to carry, differ. Life nevertheless will not deal you the cards you desire but must have your chances. Hence, people needed to redistribute risk in accordance to preference. However, no one would be willing to accept risks for free. For this, people invented all kinds of risk redistribution tools including insurance and derivatives.

In the beginning it was social solidarity, then insurance and finally derivatives. It is hard to imagine life without means for transferring risks.

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* fact that the main objective of Islamic *Shari'ah* is the good and welfare of the Society. Therefore, it is unthinkable that *Shari'ah* will lack the ways and means to provide necessary facility for Muslims' legitimate needs to manage risks in the realm of finance and investment.

Our focus here is on the tools for risk transfer in the realm of commerce and economics. In particular we are concerned with derivatives as tools of risk transfer.

Risks faced by any investor or merchant are basically in the form of "loss", or reduction in the value of assets due to changes in market conditions. For example, an investor holding company share faces the risk of price reduction thus absorbing a capital loss in his investment. He can shift this risk by buying a put option thus paying a fee to someone to undertake to purchase the same at a set price hence, if, 6 months later, the price goes down, he has the right to sell at the agreed upon price which is higher than the reduced price. If he wants to invest and expect to make a profit because price of such shares is expected to go up, but he is not certain they will. Rather than taking that risk he can buy a call option thus paying a fee for a third party to undertake to sell him these shares at an agreed upon price.

Buying an option doesn't oblige him to purchase or sell the shares. Only if his expectations turned out to be correct he would exercise and make this purchase at the lower price and then sell and make the profit.

A processor of raw material faces the risk of price fluctuation of the finished good. He can mitigate by entering into a future contract thus selling his product today for a delivery in a future date and locking in a specific price thus protecting itself for the future.

A company whose income is fixed while its obligation is variable can enter into an interest rate swap thus exercising a fixed cash flow for a variable one thus mitigating the risk of asset liability mismatch.

A creditor can reduce credit risk by paying a fee to a third party to issue a guarantee who would be obliged to pay in case of default of the debtor, not exactly the same but quite similar to a CDS.

There are 4 major derivatives around. On the face of it all these derivatives are contrary to Shari'ah. Certainly this is correct. However, this is correct only in form not of substance. If we believe that Shari'ah is capable of meeting the needs of the faithful and that managing risks is a legitimate need of people involved in commerce and economy, then Shari'ah must have tools that can deliver the same capabilities of risk management except they are free from the ill effects.

The bad name of derivatives:

The name derivatives are now infamous due to their perceived role in the current crises. Derivatives contributed significantly in the process of “financialization of economy” where the financial sector dominated over the whole economy and forced the real sector to change its way of doing business just to meet the requirements of the financial market. The real sector shrinks in terms of rate of growth and profits and contribution to the total income. In the United States for example the size of the derivative market reached $56 trillion when the GDP itself is a mere $14 trillion.

GDP as percentage of financial turnover was 79.6% in 1956. In 2000 it was a mere 1.9%.

As derivatives are no longer tools for risk management but for pure speculation, they can grow indefinitely and bring havoc to the stability of the whole economy.

One example would be sufficient to illuminate this point Credit default swaps or CDS is a useful tool where an issuer guarantees payment by borrower to lender thus reducing the credit risk. Originally it was designed to reduce the credit risk of certain debt papers thus improving their investment grade. Naturally, creditors need CDS's because they want to make sure the risk of lending to a specific borrower is reduced. Then, it got out of hand when some one who is not a creditor to any one purchases a CDS. So if I buy a CDS to mitigate the risk of me holding GE bonds, when GE defaults on payment I would be covered thus reducing the risk of holding GE bonds. However, when CDS are traded in the open market, they become a tool for speculation since they will be purchased by someone who doesn't hold GE bonds but stands to profit if GE defaults on its payment, by receiving money GE don't owe to him.

This contributed significantly to the current crises. There are those who say it only happened because the US regulators "slept on the wheel". This could be the case. However, a system that provided for risk management tools with a built in checks that never permit them to become "chips in a casino" in certainly superior to any regulation based system. We claim that Shari'ah succeeded in being so.

<u>Superior tools for risk management.</u>

All the above mentioned tools of risk management have an equivalent in Shari'ah that deliver the same economic effect yet assuring stability of the system because they have a built in ability to limit their growth to the needs of real transactions. They can never be themselves subject for trade.

Call option:

The Arboon sale contract, in which a sale contract is affected with a condition of revocation by purchaser works exactly like a call option. The down payment can be retained by seller thus working as a fee for the option. Two important features must be highlighted:

a) That the option is not separated for a sale contract for the underlying asset thus absolutely not allowing growth of derivatives beyond the actual need of real transaction.

b) No Arboon sale contract is to be entered into unless seller actually owns the underlying asset and continue owning for whole duration of the option. Thus not permitting “Arboon” to be traded separately.

Futures:

Salam contract which include the sale of a well described commodity not necessarily owned by the seller at the time works exactly like futures except that the full price of the underlying must be paid. This again guarantees that Salam contracts are not used for speculative purposes. Only then who want to hedge an actual risk enter into.

Forward:

In Islamic banking the “Waad” (promise to exchange) is used for managing exchange risks. A merchant who faces such exchange risk can enter into agreement with a bank whereby, the bank undertakes to enter into an exchange contract at a rate agreed upon between the two parties today. Thus that merchant can exercise if the prevailing price in the market when his payment is due is higher than the said price. The bank will receive a fee for this commitment. But the Waad itself is not subject to sale. Therefore, Waad can never grow unchecked.

Swap:

A swap is also possible under Islamic banking, but in a different fashion. A stream of income that is fixed can be exchanged for a stream of income that is variable. This is done via a series of sale contract the subject of which is a commodity but the price is bench marked to an active index thus creating the variable stream. And another one time Murabaha for a fixed profit rate for the whole duration of the transaction (say one year). The economic outcome is exactly like that of a conventional swap except that it never outgrows its need since it is tied to the exchange of real good or service.

CDS

A guarantee granted by a highly rated institution to secure a debt would be permissible from Shari'ah point of view even on a large scale such as a securitization transaction. However, the guarantor has the right of recourse to the indebted. Hence, it will never happen that a non-creditor will just purchase a guarantee (i.e. a CDS) for speculative purposes, for he has to show the indebtedness of the guaranteed to him. Hence, though fee based, a guarantee will never grow independent from the real sector.

The point we are trying to show is the common thread in all already known contracts as well new ones guided by Shari'ah rules. They are financial products but all tied up to real goods and services. The economy in the Islamic eye is not finance, it is the real effort to produce goods and service and create jobs. Finance must remain subordinate.