

What Shariah Experts Say

FUTURES, OPTIONS AND SWAPS

Should Islamic financial institutions have the freedom to dabble in derivatives, like their conventional counterparts? According to one view derivatives add value and are justifiable on efficiency grounds. At the same time, the Shariah does not perhaps explicitly forbid such contracts, as these are of recent origin. A variety of strategies are employed by conventional banks for risk reduction, hedging and speculation, involving forwards/futures, options, and swaps. In order to get a definite view on the permissibility or otherwise of such contractual mechanisms we formulated a few questions and sought the opinion of Justice Mufti Taqi Usmani, an eminent jurist of our times. Our questions and Justice Usmani's comments and answers are reproduced below. The kind cooperation of Brother Ghazanfar Adil, Director General, Institute of Islamic Banking and Insurance, London in facilitating this exchange of views with Justice Taqi Usmani is gratefully acknowledged.

1. Question: (Futures/ Forward Contracts)

- i) Two individuals, A and B enter into a contract on 1st January, 1996 under which A would sell a stock of company X at a price of \$100 to B after an expiry of six months. B has an obligation to purchase at this price irrespective of the market price on 30th June 1996. Is this contract permissible in Shariah?
- ii) Can this contract or the rights and obligations of A and B be transferred by either of them to a third party C?
- iii) If the object of transaction is any commodity, or gold, silver or currency and not stocks, as in the case above, in what way is the validity or otherwise of the contract affected? It may be noted that the non-transferability of rights and obligations severely limits the possibility of speculation on Futures Exchanges.

A commonly held belief is that Futures contracts are prohibited when they are used for speculation. Does this imply that Futures contracts are permissible when these are used for hedging?

Comments by Mufti Taqi Usmani:

- i) This is an example of a Futures transaction. The Futures transaction as in vogue in stock and commodities markets today are not permissible for two reasons. Firstly, it is a well recognised principle of the Shariah that sale or purchase cannot be affected for a future date. Therefore, all Forward and Futures transactions are invalid in Shariah. Secondly because in most of the Futures transactions, delivery of the commodities or their possession is not intended. In most cases, the transactions end up with the settlements of difference of prices only, which is not allowed in the Shariah.
- ii) As Futures are not permissible, no rights or obligations can emanate therefrom. Therefore the question of transferring these rights and obligations does not arise.

iii) Futures transactions as explained above, are totally impermissible regardless of their subject matter. Similarly, it makes no difference whether these contracts are entered into for the purpose of speculation or for the purpose of hedging.

2. Question: (Options)

i) Two individuals, A and B enter into a contract on 1st January, 1996 under which A grants a right to B without any obligation on B's part. Under the contract B gets a right to purchase a stock of company X from A any time on or before 30th June, 1996 at a price of \$100, irrespective of the market price on the day of purchase. B, however, does not have any obligation to purchase. A accepts a consideration of \$5 from B for granting him this right without obligations. This is known as a "call" option in stocks.

ii) A and B enter into a contract on 1st January, 1996 under which A grants a right to B without any obligation on B's part. Under the Contract, B gets a right to sell a stock of company X to A any time on or before 30th June 1996 at a price of \$100 irrespective of the market price on the day of sale. However, B does not have any obligation to sell. A accepts a consideration of \$5 from B for granting him this right without obligation. This is known as a "put" option in stocks.

iii) A and B enter into a contract on 1st January 1996 by which A sells 100 stocks of company X to B at a price \$100 per stock. The transaction is settled with exchange of cash for the shares. A also grants a right to B, under which B can sell back the stocks to A on the expiry of six months, that is June 30, 1996 at a price of \$120 per stock. This right, however is canceled if the price of the stocks increase beyond \$120 and remains at that level for 21 consecutive days before 30th June 1996.

Unlike the previous two instances of transactions in pure options, the above is a case of option as an additional feature of an equity sale and purchase.

iv) If the object of transaction is any commodity, or gold, or silver, or currency and not stock as in the above three cases, in what way is the validity or otherwise of the contract affected?

v) Is the validity of the above contracts affected with an added provision that B can now transfer this contract to a third party C?

Comments by Mufti Taqi Usmani

i), ii), iv) & v) : According to the principles of the Shariah, an option is a promise to sell or purchase a thing on a specific price within a specified period. Such a promise in itself is permissible and is normally binding on the promisor. However this promise cannot be the subject matter of a sale or purchase. Therefore, the promisor cannot charge the promisee a fee for making such a promise.

Since the options transactions as in vogue in the options market are based on charging fees on these promises, they are not valid according to the Shariah. This ruling applies to all kinds to options, no matter whether they are call options or put options. Similarly, it makes no difference if the subject matter of the option sale is a commodity, gold, silver or a currency; and as the contract is invalid ab-initio, the same cannot be transferred.

iii) This contract has two aspects. Firstly, if the option of selling back the stocks to A has been made a pre-condition for the original sale transaction, the whole transaction will be invalid because, according to Shariah, a sale transaction cannot accept such a condition. Secondly, if the option is an independent promise without being a precondition for the original sale, no fee can be charged for such a promise as mentioned earlier. Although a complementary promise of this kind is permissible in the Shariah, it cannot serve the purpose of the option market.

3. Question: (Swaps)

Two banks enter into an agreement to exchange deposits for a period of six months in different currencies on 1st January 1996 at the prevailing exchange rates. Bank A exchanges Rupees 30 million with Bank B for US dollars one million and the Rupee-Dollar exchange rate prevailing on the date is 30:1. During these six months, each bank utilizes the deposits it received at its own risk.

At the end of six months, Bank A pays back one million dollars to Bank B and receives Rupees 30 million from it, irrespective of the Rupee-Dollar rate prevailing on June 30, 1996. For example, the Rupee-Dollar exchange rate might have become 35:1 or 25:1 on June 30, 1996. Is this contract Islamically permissible?

Comments by Mufti Taqi Usmani:

It is one of the principles of the Shariah that two financial transactions cannot be tied together in the sense that entering into one transaction is made a precondition to entering into the second. Keeping this principle in view, the Swap transaction referred to above is not permissible because the deposit of one million dollars has been made a precondition for accepting the deposit of 30 million rupees.

Since both the parties will use the deposits for their own benefit, they are termed in Shariah as loans (Qardh) and not as trust (Wade'ah). Therefore, advancing one loan has been made a precondition for receiving another which means that two financial transactions are tied together. This is my first hand opinion about this transaction. However it needs further study and research.

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