

Disentangling the Issue of Islamic Futures: An Academic Discourse

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Agenda



OVERVIEW

Brief introductory primer

- *Why derivatives?*
- *Why Islamic derivatives?*
- *Need for Innovation*



ANALYSIS

Critical Look

- *What are futures?*
- *What is Bay' Salam?*
- *What is Bay' Ististna'?*
- *Jo'ala?*
- *Link with Conventional Futures*



SOLUTION

Novelty Aspect of the Presentation

The audience will be primed with a brand new innovative concept of a hypothetical futures contract to elucidate the practical impediments towards designing Islamic Futures Contracts



OBJECTIVE

What I hope to achieve

- *Foster critical thinking*
- *Disentangle some intricacies of futures trading in Islamic Capital Market*



REVIEW

Assorting Juridical Stances on Derivatives

- *Collating Positions of the Fuqaha*
- *Defining Shari'ah Parameters*



Q&A

Interaction with Audience

Wrapping up the presentation with a Q&A session.

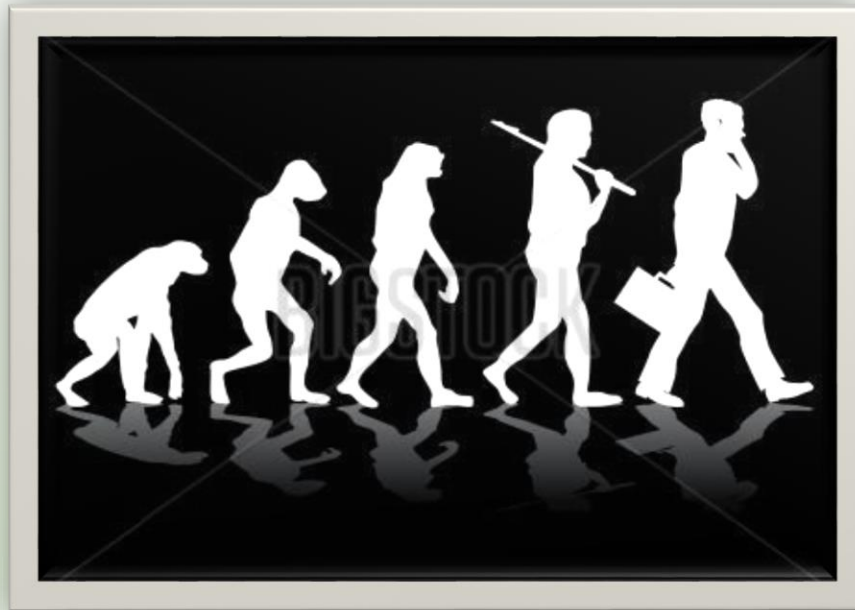
Evolution of Islamic Derivatives

Financial Engineering

- Limited growth
- Scholars' reservation concerning permissibility
- Off-market counterparty specific arrangements
 - Profit rate swap contracts (Fixed-vs-Float)

Features

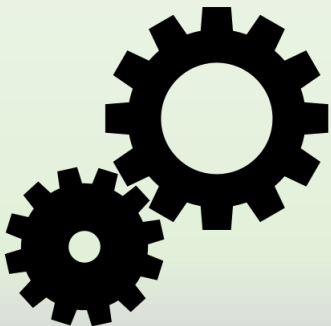
- Distinguishing traits:
 - Deferred transactions
 - Applicable to different situations
- Few instruments exist in Islamic Finance that qualify as a basis for forward/futures contract within Shari'ah framework
 1. Salam
 2. Istisna'
 3. Jo'ala



Bay' Salam

Definition

- 2 parties agree to carry out a sale of underlying asset
- Predetermined Future Date
- Predetermined Price
- Price is paid in FULL today
- Proof: (Qur'an: 2-282)



Features

- Comparable to forward contract
- Payment should be in cash form
- Useful for helping needy farmers and small businesses with working capital financing
- Due to full pre-payment, Salam is beneficial to seller
- Results in price lower than spot price

Futures vs. Salam

- Price behavior is anomalous to futures
- Futures price > Spot Price
- Carrying cost effect
- Lower Salam price = compensation afforded by seller to buyer
- Exchange traded futures conform to all traits except full pre-payment

Conditions

- Discouraged for food stuff or perishable goods
- Full payment at the moment of effecting sale
- Underlying asset must be standardizable
- Quantity, quality, maturity date and price have to be clearly enumerated

Remarks

- Salam is more customized than futures
- Resembles forwards more closely than futures
- Counterparty risk is one-sided
- Shari'ah allows buyer to require Rahn, in form of guarantee or mortgage

Salam (Continued)

Present Issues

- Since Salam involves transacting in underlying assets, financial institutions are reluctant to engage in Salam. They bypass this via some alternatives.



Parallel Salam

- Parallel with Seller
 - Bank enters into a Salam Contract
 - After a while, Bank enters into another Salam sale for same maturity date
 - Must be 2 independent contracts



Third Party Offset

- Bank enters a Salam contract
- Enters into a contract promising to sell the good to a third party on delivery date
- The 2nd contract is not a Salam
- Bank doesn't receive advance payment
- Transaction carried out on maturity date, based on a pre-agreed price



Merits

- Resale price is higher; resulting in profit
- Profit is justifiable due to time lapse
- Shorter the TTM, higher the resale price.



Notes

- The latter more closely resembles conventional futures
- Islamic Bank offsets an obligation but doesn't speculate
- Fuqaha are not in consensus regarding permissibility

Istisna' & Jo'ala

What is Istisna'?

- Comes from the root word sana' (manufacture)
- Underlying asset is a manufactured good
- Buyer contracts with manufacturer to make a produced good according to his specifications



Example

- X places an order with Y to manufacture 10,000 boxes of chocolate chip cookies @ MYR 2.50 per box
- Subject matter is non-existent at the time of contract
- X or Y can cancel contract before work begins but not after



Comparison

- Vs. Salam: contract can be cancelled unilaterally (before work)
- Vs. Salam: Price is not fully pre-paid
- Vs. Ijarah: Manufacturer uses own material



Legality

- Hanafi Jurists consider it impermissible based on Prophet's prohibition of selling what the seller doesn't have
- Zufar, Maalik, Shafi'i and Ahmad permit Istisna' but with stipulated conditions
- Hadeeth of manufacturing a ring for cupping (good and service)



Jo'ala

- Essentially an Istisna' contract but concerns services instead of manufactured product

Legitimacy of Futures

Issues

1. Sale Prior to Taking Possession (Qabd)
2. Debt Clearance Sale (Bay'al-Dayn bil Dayn)
3. Sell Not What is Not With You
4. Speculation



Fatwa of Omam Al-Haramaini Al-Juwaini

- *Futures trading is Halal if based on Dharurah and needs of Hajaat of Ummah*
- *SIF trading is Haram, since underlying stocks aren't all halaal*



Mufti Taqi Uthmani

- *Futures Transactions are not allowed*
 - *Reason 1: According to Shari'ah, sale or purchased can't be affected for a future date*
 - *Reason 2: In most futures transactions delivery or possession is not intended*



Syariah Advisory Council (MY)

- *Futures trading of commodities is approved as long as underlying asset is halaal*
- *Crude Palm Oil Futures contracts are permissible to trade*
- *KLCI SE based SIF is not permissible due to inclusion of non-halaal stocks*
 - *Implication is that index based futures will be halal for a halaal index*

Disentangling Issue #1 (Qabd)

'Abd Allah ibn 'Umar's Hadeeth

- *"He who buys foodstuff should not sell it till he has received it."*
- Ash-Shafi'i interpreted it to include not only perishable goods but literally anything subject to sale



Counter-point 1

Only a minority of futures contracts lead to physical delivery of the commodity (2% according to Kamali)



Counter-point 2

Majority of contracting parties of futures close out their position by entering offsetting transactions (cash settlement)



Points to Ponder

- *The issue of delivery is apparently settled*
- *Is it enough to overturn the fatawa of Fuqaha?*

Disentangling Issue #2 (Bay'al-Dayn bil Dayn)

- *Fuqaha have differed over definition of sale of debt for debt*



Counter-point 1

- *The rationale for disapproval of Bay'al-Dayn bil Dayn is the apprehension towards Gharar (uncertainty)*



Counter-point 2

- *In futures trading, offsetting transaction is a basic function of the clearing house*



Points to Ponder

- *Parties acknowledge and mutually agree upon their obligations*
- *Therefore, there exists no uncertainty with regards to contractual responsibilities*

Disentangling Issue #3 (Sell NOT What Is NOT With You)

- *“Do not sell that which you do not own”*
- Futures trading involves short selling which basically entails selling goods not yet owned



Counter-point 1

- *The hadeeth only applies to sale of specified and unique objects but not fungible goods with a ready market*
- *Purpose of hadeeth is to avoid gharar in deliverability*



Counter-point 2

- *Analogy drawn from permissibility of Bay' Salam*
- *Market place of Medina during Prophet's time was small and offered no assurance of regular supply of goods*



Points to Ponder

- *Clearing House guarantee functions as a shield*
- *Are these points still enough to overturn the ban of the scholars?*
- *Let's see how speculative points can be rebutted*

Disentangling Issue #4 (Speculation)

- *Speculation Promotes Volatility*
- *Represents transactions with no economic activity approved by Shari'ah (akin to Maysir)*
- *Concerned with Macro-level implications*



Counter-point 1

- *Without Speculation, futures market would be illiquid and ineffective*
- *All trading activities (even real business deals) include elements of speculation*
- *A little bit of speculation is healthy (Ref: Holbrook Working's T-Index)*



Counter-point 2

- *Over-emphasis on macro-issues shouldn't result in ignoring micro-level maslaha*



Points to Ponder

- *Both parties appear to have good arguments*
- *So should futures really be permissible or not?*

Re-entangling The Legality Debate

- *In recent times substantial effort has been exerted in legitimizing futures by comparing them to Salam and Istisna'*
- *These efforts have failed because:*
 - *In Salam, the price must always be on spot basis*
 - *In Istisna', although both 'Iwad can be deferred, object of sale is to be manufactured r constructed (tailor-made) rather than being a fungible/homogenous commodity*



'Innamal a'malu binniyat

- *It can be argued that the whole debate boils down to motive of contracting parties*
- *Imaam ash-Shafi'i said this hadeeth solves 70% of fiqh issues*
 - *While hedging and risk minimization have merit, speculation's repercussions have been extreme in recent times*



Present Modus Operandi

- *With today's intricate transactions and legal framework, it is practically **impossible** to ascertain the **niyyah** of the contracting parties*



Imtiaz's Conclusion

- *Keeping an open mind (hedging my bets)*
- *The issue is not black and white and requires extensive deliberation and research*

The Future of Futures

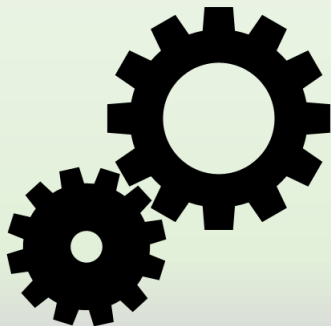
Before we venture into the topic of designing Islamic Futures, it is important to remind our audience that the proliferation of derivatives in recent times has been subject to heated debates, especially after the commodity and sub-prime bubbles burst.

“Derivatives are financial weapons of mass destruction, mainly due to opaque pricing and accounting policies in swaps, options and other complex products whose prices are not listed in exchanges...” (Warren Buffett)

“....that there is nothing wrong with financial engineering, but the poor uses of derivatives are to blame is akin to the argument against gun control that guns don’t kill people, people kill people... there will be misuse of financial instruments which they create for hedging, but which are in fact instruments of gambling..” (M El-Gamal)

Examples of some derivative-involving scandals:

- *Commodity boom of 2008 (food/oil)*
- *CDO and US Sub-prime crises*
- *Collapse of Baring Bank by Nick Leeson*
- *Futures trading losses incurred by Societe Generale (SocGen) in January 2008*



Designing Islamic Futures

Underlying Principle	Question to Ask
Shari'ah mandates man-made concoctions, not vice-versa	Why are we shoe-horning Islamic contracts into conventional instruments? Is Islamic Finance really that bankrupt?
Financial transactions should be intertwined with real economic activities	<ul style="list-style-type: none"> • Salam is a contract of exchange, with added elements of financing and hedging • The issue with futures is not so cut-and-dry
Risk itself is NOT a commodity	Shari'ah legitimizes risk only when its assumption leads to creation of economic value
Macro Maslaha shouldn't supersede Micro Maslaha	They ask you (O Muhammad) concerning alcoholic drink and gambling. Say: "In them is a great sin, and (some) benefit for men, but the sin of them is greater than their benefit." And they ask you what they ought to spend. Say: "That which is beyond your needs." Thus Allāh makes clear to you His Laws in order that you may give thought." (Al-Baqarah 2:219)

Designing Islamic Futures

Shari'ah Parameters

- *In order to design a Shari'ah compliant Islamic Future—assuming permissibility is granted by a religious council—I proffer the following building blocks revolving which the instrument should be designed.*



Purpose & Rationale

- *Must be devised purely for hedging a real risk or exposure*
- *Should be justifiable in terms of value creation. The burden on proof is on the proposing parties.*



Risk Management

- *Priority to non-synthetic hedging arrangements (natural or economic hedging)*
- *Enough caution to minimize room for opportunistic manipulation which results in unjust wealth transfer*



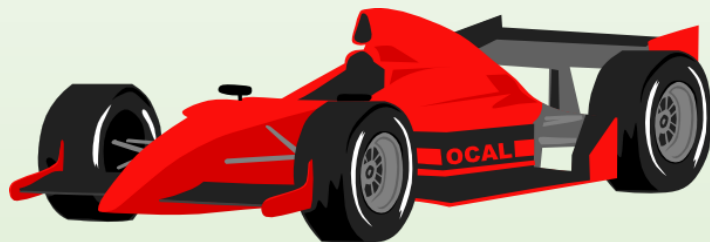
Quantum

- *The underlying concern **must be Shari'ah compliant***
- *Quantum of derivative transactions shouldn't eclipse underlying real economic exposure*

Hypothetical Future: F1F

F1F Contract

- *Formula 1 Future contract*
- *Sauber Petronas Racing Team (Now defunct)*



Indentures & Features

- *Exchange traded futures contract*
- *Underlying commodity – racing performance of Kimi Raikkonen*
- *Rationale: allowing investors and sponsors of Petronas Engineering to hedge their stake*



Quantum

- **Long** implications
 - *Gains if the racing team performs superior than past season*
 - *Typically consists of pure speculators*
- **Short** implications
 - *Benefits if Raikkonen underperforms in a Grand Prix season*
 - *Typically those directly invested with the racing team will use this as a hedging instrument*

Shari'ah Parameter Acid Test

Parameter	PASS/FAIL	Logic
Hedging	FAIL	No economic rationale is found for risk exposure opposite of Kimi Raikkonen's racing results
Value Addition	FAIL	Will it make Raikkonen a better driver?
Risk Aversion	PASS	Both in theory and practice, risk is diversified.
Manipulation	FAIL	<ul style="list-style-type: none"> • Substantial room for insider trading. • Very large Information Asymmetry
Subject Matter	50-50	<ul style="list-style-type: none"> • Racing is a dangerous sport; almost suicidal • No underlying commodity with usufruct • Potentially objectionable content
Leverage	FAIL	Since F1F is an ETF, its survival is impractical without high leverage
Marketability	PASS	Very eager to absorb an innovative derivative like F1F

Designing Islamic Futures

Cautious Approach

- *We agree with and appreciate the need for financial engineering*
- *We also acknowledge the time has come to think out of the box and let the Islamic Financial System graduate from its infant status*
- *However, caution is warranted*



Ethics & Morality

- *Products should serve a higher purpose and shouldn't be concocted as a means to inflate an institution's profit margin*



Transparency, Governance & Integrity

- *Most Islamic financial products today are copy-cats of their traditional counterparts, but **more complicated**.*
- *This is a worrisome trend.*

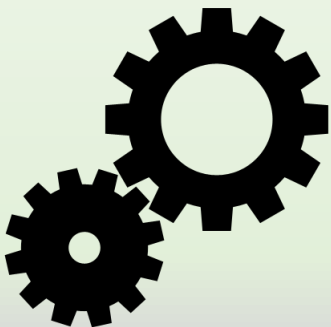


Address a Bona Fide Shari'ah based need

- *There is a tendency among ICM advocates that just because traditional finance has it, we must have the same product.*
- *This is not a sufficient reason to develop an Islamic product.*

Disentanglement

- **Problem: non-consensus of `ulama regarding validity of futures contracts**
- **Solution:**
 - Consolidation of myriad of conflicting views and their implications
 - Combining the resources of various religious councils worldwide to find a common ground which fosters flexible but fair rendition of a judgment that will afford Islamic Capital Markets to flourish
 - Scholars need also to be reminded that IFIs are not charity organizations. Their Maslahah should also be considered keeping in mind intense competition and need for survival.



Question & Answer



START

OVERVIEW

OBJECTIVE

ANALYSIS

REVIEW

SOLUTION

Q&A