# Conventional futures: derivatives in Islamic law of contract



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## Abstract

**Purpose** – This paper aims to compare and contrast the concept of conventional futures contract from the Islamic law of contract perspectives. The underlying theory and practice of Islamic finance is based on the principles of Islamic law of contract. Although the necessity of derivative instruments such as the case with futures contract is essential for developments in Islamic finance, the permissibility of using these instruments still remains a debatable issue.

**Design/methodology/approach** – The paper discusses arguments for and against using derivative instruments as in futures, for example, in light with the Qur'an and Sunnah (the Prophet's traditions), as well as the views of classical scholars, jurists and contemporary researchers. Arguments for and against are analysed systematically to derive a logical conclusion.

**Findings** – The study finds that majority scholars consider futures contracts as non-compliant with the Islamic law due to the fact that selling something that does not exist, deferment in the both counter values, gharar or ambiguity and excessive risk taking, pure speculation and sale of one debt for another.

**Research limitations/implications** – The study focuses narrowly on conventional futures contract. Analysing other financial derivative contracts could be a future research endeavour.

**Practical implications** – The study has so far found the verdict of impermissibility of conventional futures contract in its current form as has been argued by majority scholars in the premise that they do not comply with the Islamic law. Policymakers and industry practitioners need to take this opinion of majority scholars while developing new Islamic financial derivatives.

**Originality/value** – To the best of the author's knowledge, the present research is the first attempt so far that explained the validity of conventional futures by analysing arguments of classical and contemporary jurists, scholars and researchers.

**Keywords** Derivatives, Futures contract, Gharar, Islamic law of contract, Maysir, Speculation, Sale of debt

**Paper type** General review

## 1. Introduction

Conventional futures are derivatives, values of which derive from other financial products. A futures contract is essentially a standardised forward contract, is an agreement between a buyer and seller to deliver a specified asset at a certain time in the future for a certain price. Trading volume of futures contracts is often much larger than underlying assets, and this is due to the presence of the elements of speculating activities and *maysir* or games of chance in derivatives. Some researchers asserted that those who participate in futures contracts do

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not enter into them for risk protecting, rather for speculating and in fact, hardly 1 or 2 per cent of traded derivatives instruments are settled by actual delivery of the underlying assets, while the rest were ended through cash settlement, not including real sale.

The speculation and gambling pictures in futures contracts also reflected in the huge trading volume of derivatives relative to the gross domestic products (GDP) of the world, where the trading volume of derivatives all over the world in the parallel market as at the end of 2012 amounted to more than $1.270 quadrillion, and in the organised market more than $52tn (Jobst, 2013). Meanwhile, the GDP volume of the world as at the end of 2012 was only at $71.9tn. This amount is equivalent to almost 18 times the value of the GDP of all countries in the world.

There are some derivative instruments which are considered by Muslim scholars as clearly *haram* (unlawful) due to the flaws in underlying assets or the contract itself. However, there are other derivatives which are based on equity instruments and *halal* (lawful) objects which deserve much attention to the scholars. Although conservatism can be a favourable position in *`ibadat* or ritual matters, it might have costly consequences in matters related to *mùamalat* (commercial transactions), for example, for thriving Islamic finance. It is even of immense importance in the modern day highly competitive and complicated international business environment where denial of the use of a flexible and powerful array of instruments could place them at a disadvantageous position. Therefore, it is of paramount necessity to consider social welfare dimension in evaluating the permissibility of derivatives like futures contract (Obiyathullah, 1999).

Research on derivatives from Islamic legal perspective is found to be in the state of infancy. However, because of its complexity and speculative nature, it has not been a mesmerising topic to be openly discussed by Muslim academicians. Futures contracts are being urged to be reconsidered by the scholars for hedging purposes, and they still remain unresolved. Although the issue has been addressed by a number of institutions, such as Jeddah-based Islamic Fiqh Academy of Organisation of Islamic Conference (OIC) in different seminars and workshops; the Permanent Research Committee of the Board of Great Scholars in Saudi Arabia; and the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), the outcomes of these discussions have been to urge the prohibition of derivatives (U. Chapra; M. T. Usmani; M. A. Khan; M. F. Khan, M. Mahmassani; A. Y. Sulayman; and others). However, these judgements should not be considered the final *Sharī`ah* ruling on the issue because certain shortcomings have been associated with these resolutions (H. Kamali; al-Qadir; M. Din Azzam, al-Khatib, Obiyathullah and others). Consequently, *Sharī`ah* Advisory Council of Securities Commission of Malaysian 1997 has resolved that commodity futures like Crude Pulm Oil (CPO) futures are *Sharī`ah* compliant and also allowed composite index futures and single stock futures. Therefore, fresh discussion on the issue is of paramount importance. Reaching to a solution is possible given the flexibility adaptability of Islamic law, on one hand, and the broader sphere of the concept of freedom of contract, on the other, in particular, as it has been pointed out by a recent International Monetary Fund (IMF) working paper (Sole and Jobst, 2012).

The qualitative research design selected involves a rigorous literature research. Data for our study have been collected from various sources, namely, classical books, contemporary books, academic journals and mainstream articles. Inductive and descriptive method is used for data analysis. It is found that there is no exact analogous of futures contracts in the Islamic commercial law. Fundamental difference in opinions among classical and contemporary scholars arises due to four broad issues in futures contracts:

- non-existence of the subject matter;
- sale prior to taking possession;

- *bay' al-kali bi al-kali* or the exchange of a delayed counter value for another delayed counter value; and
- speculation.

In the following section, we discuss the classical jurists' opinion regarding these matters. According to major classical and contemporary jurists' arguments, it can be concluded that conventional futures contracts are not compatible with Islamic commercial law.

This study is divided into a number of sections and subsections. Section 1 discusses the introduction of the study, while Section 2 outlines the definition and scope of conventional futures. Section 3 elucidates general principle of contract in *Sharīʿah*. Section 4 provides comprehensive analysis of contract and pillars of contract in Islamic law. Section 5 puts arguments against conventional futures. Section 6 gives arguments for conventional futures. Section 7 concludes the study with the summary and policy recommendations in line with its objectives and for further research.

## 2. Conventional futures: concepts and scopes as derivative instruments

Derivatives are financial assets whose values are dependent on underlying asset or known variables. One of the key derivative instruments is futures contract. A futures contract which is essentially a standardised forward contract (Hull, 2007), is an agreement between a buyer and seller to deliver a specified asset at a certain time in the future for a certain consideration or price (Saunders and Cornett, 2007). The price is competitively determined by "open outcry" on the trading floor or through a computer-based market. The contract, if taken to maturity, is fulfilled by a cash payment of price and actual delivery of the item on the delivery date based on the settlement price for that date.

Although futures can be divided into two types such as financial futures and commodity futures, generically, financial futures are not different from commodity futures except for the underlying assets of both differ from each other. For example, a particular commodity like metals, vegetables and so on are traded in commodity futures, whereas in financial futures, diverse financial instruments such as equity shares, debentures, bonds, treasury securities and currencies are traded. Futures contracts were developed to overcome the problems of double co-incidence, unfair forward price and country party risks (Bacha, 2001).

In today's competitive and complicated business environment, futures contract plays a vital role and important instrument for managing or hedging against risk in financial markets due to price volatility. Hull (2007) states that many participants in futures markets are hedgers. They want to use futures contracts to reduce a particular risk which they face. At present, these contracts are actively traded all over the world.

Futures contracts are normally traded on an organised exchange (Saunders and Cornett, 2007). The exchange sets up certain standardised features of the contract. As the counterparties do not necessarily know each other, the exchange provides a mechanism that gives a guarantee to both parties that the contract would be honoured. The main role of exchange is to avert or minimise the risk it bears, which is the potential default risk. This exchange achieves by two processes, one is known as "margining" and the other as "marking to market". The exchange requires each party to deposit initial deposits, known as initial margins; when losses occur, it will require the party whose position is losing to pay up as the losses occur. This is known as a "margin call". "Marking to market" means that the gain or loss in each contract position resulting from changes in the price of the futures (or option) contracts at the end of each trading day is added or subtracted from each account balance (Khan, 1996). Another unique feature of futures is the ability of the buyers and sellers to reverse out of their positions before delivery or maturity. Therefore, in commodity

futures, physical delivery hardly ever takes place, as compared to forward contracts where delivery does take place.

Two largest futures exchanges in the USA are the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME). The largest exchanges in Europe are the London International Financial Futures and Options Exchange (LIFFE) and Eurex. Other large exchanges include the Tokyo International Financial Futures Exchange (TIFFE), the Singapore International Monetary Exchange (SIMEX) and the Sydney Futures Exchange (SFE).

Danila and Jeffers (2009) identified the following main advantages of futures contracts:

- the futures contracts need less initial costs than other similar instruments, only need to deposit guarantee or margin an underlying asset of greater value;
- the future markets can be used as instruments to cover the risks derived from the fluctuations of cash prices before expiration;
- the existence of an organised exchange and standardised contracting terms gives liquidity and possibility of closing positions on a date before the expiration; and
- participants assume less risk of insolvency; the clearinghouse guarantees the liquidation of the contract.

Though futures contracts have been able to overcome the problems of forward contracts, there are three inadequacies that stimulated the search for further product innovation. First, while futures enabled easy hedging by locking in the price at which one could buy or sell, being locked-in also means that one could not benefit from subsequent favourable price movements. Second, participants cannot handle contingent liabilities. Third, as futures are standardised, there does not exist futures contracts for all the instruments nor for all the merchandise, and they might not cover exactly all the cash positions (Obiyathullah, 1999).

## 3. General principles of contract in *Sharī ah*

Islam is a rules-based religion (Askari *et al.*, 2015). The Qur'an and the Sunnah are the sources of all rules required for every sphere of human life, from cradle to death. The Qur'an mentions the following verse in several places "Obey Allah and His Messenger" [1]. In Islamic law and jurisprudence, contracts are the backbones of everyday human transactions, civil, commercial or of any sort. Consequently, the underlying principles of contracts are derived from the Qur'an and the Sunnah about the Qur'an sates about fulfilling the contract and covenants (عقد) in numerous places. For example, "O you who believe! Fulfil (your) obligations" (Al-Maidah, 1); "And fulfil (every) covenant. Verily, the covenant will be questioned about" (Al-Isra, 34);

> And fulfil the covenant of Allah when you have covenanted, and break not the oaths after you have confirmed them –and indeed you have appointed Allah your surety. Verily! Allah knows what you do (Al-Nahl, 91);
>
> Except for the idolaters with whom you have a treaty, and who have not subsequently failed you in aught, nor have supported anyone against you. So, fulfil their treaty to them for the end of their term. Surely Allah loves the pious (Al-Tawbah).

These verses indicate the sanctity of a various obligations, including, social, political, commercial and not to mention spiritual. Therefore, the word '*aqd* establishes the foundation of contract and attendant liabilities (Mohammed, 1988).

According to Islamic Law, the word *'aqd* literally means to tie between two ends of something either physically or morally. Generally, it covers everything a person commits himself to do which includes unilateral and bilateral action such as agreements, commercial arrangements, legal transactions, documents or deeds (Razali, 2010).

Al-Zuhayli (2003) defines *'aqd* as the meeting of offer and acceptance in conformity with the formality prescribed by the *Sharī'ah* (Al-Zuhayli, 2003). Razali (2010) states that the term *'aqd* in general refers to a legal transaction which involves a bilateral declaration, namely, the offer and acceptance. The *'aqd* is a legal transaction which creates a new legal situation (Niyazi, 1990).

Fixed formality is not required to form contract in Islam. Qudamah (1984) made a significant statement that Allah permitted sale but did not specify the manner in which it was to be concluded. Niyazi (1990) supported this idea and emphasised that there is no fixed formalities in contract under Islamic law. He further added that what under Islamic law, the fundamental proof of consent by each party is required as in any other legal system. Consent is discovered by the use of the *'ijab* or offer and *qabul* or acceptance methodology. The offer and acceptance must meet at the same time and the same majlis or meeting (Niyazi, 1990).

After giving clear evidence from the Qur'an and various definitions by Islamic jurists, we can decisively state that contract is not an alien concept in Islamic law. Mansuri (2006) distinguishes most important general principles of commercial contracts and transactions, which we are going to briefly discuss in the subsequent section.

### *3.1 Need for parties' consent in the contract*

The consent of the contracting parties should be the key pillar in any contract under Islamic law. In other words, mutual agreement is considered the basis of a contract. In Islamic law, such concept is based on the ruling appeared in the Qur'an such as its verse which states: "O you who believe! Squander not your wealth among yourselves in worthless dealings but let there be trade by mutual consent" [2]. And it is also referred to in several traditions of the Prophet (pbuh) such as "The trade should be concluded by mutual consent, and is unlawful for a person to take his brother's property unless by the pleasure of his soul". In another tradition, the Prophet (pbuh) is reported to have said: "The contract of sale is valid only by mutual consent" [2].

### *3.2 Need for gharar-free contract*

The Arabic word *gharar* is a fairly broad concept that literally means deceit, risk, fraud, uncertainty or hazard that might lead to destruction or loss. The Hanafi scholars have defined *gharar* as "something which its consequence is undetermined." While the scholars Shafi'i school of thought have described it as "something which in its manner and its consequence is hidden". According to Al-Sarakshi, "anything that the end result is hidden or the risk is equally uncommon, whether it exists or not." Therefore, *gharar* in Islam refers to any transaction of probable objects whose existence or description are not certain, due to lack of information and knowledge of the ultimate outcome of the contract or the nature and quality of the subject matter of it.

Prohibition of *gharar* is another important principle that governs all contracts and transactions in Islamic law of contracts. Risk is inherent in business: no one can predict whether there will be a profit or a loss at the end of the year. But *gharar* does not refer to this. A contract is presumed to suffer from *gharar* if it involves:

- a thing whose quantum is unknown;
- a thing about which is not known whether it exists or not;

- a thing that is not within the knowledge of the parties;
- the parties are unaware whether a sale will take place or not (Mansuri, 2006).

There is no specific evidence from the Qur'an which connotes *gharar*. However, Allah mentions: "Eat not your property among yourselves unjustly by falsehood and deception" [4].

There are several traditions where the Prophet (pbuh) strictly prohibit *gharar*. For instance, Ahmad and "Ibn Majah narrated on the authority of Abu Said Al Khudriy: The Prophet (pbuh)has forbidden the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to their distribution, the purchase of charities prior to their receipt and the purchase of the catch of a diver. The tradition refers:

> Oh Prophet of Allah! A man comes to me and asks me to sell him what is not with me, so I sell him [what he wants] and then buy the goods for him in the market [and deliver]'. And the Prophet (pbuh)said: 'sell not what is not with you [5].

### *3.3 The contract needs to be free of riba*

*Riba* is derived from the derivative word "rabawa" it denotes certain meanings, such as to increase; to grow; to grow up, and to exceed. In the specific sense, *riba* is generally translated into English as usury or interest, but in fact it has a much broader sense under the *Sharī'ah* (Haqqi, 2009).

One of the key principles that governs transactions in Islamic law of contract is the prohibition of *riba*. It is unanimously agreed upon that *riba* is excess in return of which no reward or equivalent counter value is paid. In other words, all unjust enrichment is considered as *riba*. On *riba*, the direct Quranic references are to be found in four chapters. These verses are an ascending scale which starts with a mere judgment of value, followed by an implicit prohibition, then a limited one and finally, a total and conclusive prohibition (Al-Rum, 30:39; Al-Nisa, 4:161; Ali-Imran, 3:130 and Al-Baqarah, 2:275-9).

Moreover, the detailed varieties of usurious transactions as well as such prohibitions have been explained and elaborated by the Sunnah. For example, the Messenger of Allah (pbuh) has cursed the one who accepts *riba*, the one who pays it, the one who records it, and the two witnesses of it, saying they were all alike [6]. It is also reported that the Prophet (pbuh) has said to the effect: "(Exchange) gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, measure for measure and hand to hand. If the (exchanged) articles belong to different genera, the exchange is without restraint provided it takes place in a hand to hand transaction [7]".

### *3.4 The requirements of the contract being free from qimar and maysir (gambling and games of chance)*

Islam has also categorically prohibited all forms of *qimar* and *maysir*. *Qimar* comprises every form of increase or money gaining of which depends entirely on luck on chance. For instance, acquiring income as an outcome of lottery or lucky draw. On the other hand, *maysir* refers to the easy acquisition of wealth by chance, whether it deprives the others' right. There is no difference of opinion between the scholars regarding the prohibition of gambling. In the Qur'an, Allah clearly prohibits gambling in its following verses:

- "They ask you concerning wine and gambling. Say: "In them is great sin, and some profits for men; but the sin is greater than the profits" [8].

- "O ye who believe! Intoxicants and gambling, (dedication of) stones and (divination by) arrows are an abomination of Satan's handiwork: eschew such (abomination) that you may prosper [9]".

*3.5 The contract should be void of deception and cheating*

Deception and cheating have been stoutly condemned in the Qur'an and the Sunnah. Deception includes a number of practices, such us giving short measures and short weight, false bidding to raise price of an item, false swearing, hiding defects in sale and so on [4]. Referring to this prohibition Allah says in the Qur'an:

> Woe to those that deal in fraud. Those who, when they have to receive by measure, exact full measure. But when they have to give by measure or weight to man, give less than due. Do they not think they will be called to account on a Mighty Day? [10]

*3.6 Two mutually inconsistent contracts are not permissible*

If there are more than one contract, they must be congruent with each other. The Prophet (pbuh) has prohibited two mutually inconsistent contracts. For example, the sale the sale of two commodities for two prices, the contingent sale and the sale of single object for two prices (Nawawi, 2009).

*3.7 A contract should not be contrary to maqasid Sharī ah*

Any transaction or contract that offends or jeopardises any of the objectives ("*Maqasid*") of *Sharī ah* is automatically invalid. *Maqasid Sharī ah* is alternately referred as "*huquq*Allah" (rights of Allah) in Islamic Law [11]. The objectives of *Sharī ah* or "*huquq* Allah" have been mentioned in several verses of the Qur'an. For instance:

> In the law of equality, there is saving of life to you, o man of understanding [12].

*3.8 Entitlement of profit upon liability for risk*

Another principle that governs contract and commercial transactions is principle of liability for loss and entitlement to profit. This principle provides that a person is entitled to profit only when he bears the risk of loss. This principle operates in a number of contracts, such as contract of partnership, sale or hire. The Islamic legal maxim*al gunmubil gurm*, or "with profit comes liability or risk". provides the rationale and the principle of profit and loss sharing in various types of contracts including *musharkah (*partnership) contract.

*3.9 What is not explicitly prohibited is permissible*

In *mu1mamalt* or Islamic commercial transactions, everything that is not prohibited is permissible. This rule has been emphasised in a number of verses in the Qur'an. Allah ordains:

> Say, Who has forbidden the adornment of Allah which He has produced for His servants and the good [lawful] things of provision? Say, they are for those who believe during the worldly life [but] exclusively for them on the Day of Resurrection. Thus do we detail the verses for a people who know? [13]

Having analysed the governing principles of Islamic law of contract, we can conclude that Islam is a complete code of life and it provides governing principles for every aspects of life

including commercial transactions. In the following section, we will attempt to discuss the pillars of contract in Islamic law.

## 4. *`Aqd* and the fundamental pillars of Islamic law of contract

The discussion of the theory of contract constitutes the cornerstone of Islamic commercial law. Contract is the essential mode of acquisition of ownership transferred from a party to another. Therefore, it deals with the types of contracts to effect the transfer and their legal impact with the function of meeting the needs of the society with regard to dealings and transactions (Securities Commission Malaysia, 2009).

The word *`aqd* (pl. *uqud*) in Arabic language originally means: tying tightly, as in tying a rope. In the dictionary of *Lisan al-'Arab*, it is defined as "*aqd al ahd*" to mean 'make a covenant' and "*aqd al yamin*" to mean "give an oath". Therefore, '*aqd* carries the meaning of covenant and fulfillment. The word *`aqd* or contract in Islamic jurisprudential usage means an engagement and agreement between two persons in a legally accepted, impactful and binding manner.

An expression of the matching between a positive offer/proposal made by one of the parties and the acceptance of the other party in a way which has an impact on the subject matter of the contract (Kharofa, 1997).

In its technical sense, contract has been defined as the obligation which is the result of an offer given by one party and the acceptance given by the other party, in a way where its legal effect is expressed on the thing contracted upon.

According to *Majallat al-ahkam al-`adliyyah* (Civil Code of the Ottoman Empire promulgated in 1876), contracting is the connection of an offer with an acceptance in a lawful manner which marks its effect on the subject of that connection. It is further explained that as a result of this connection, both parties are under an obligation to one another.

From the above definition of the contract, we can say that Islamic contract law requires certain conditions to be fulfilled to be valid. Fundamental pillars of contract include:

- *sigha*(statement or a form);
- two contracting parties; and
- the subject matter of contract (Securities Commission Malaysia, 2009).

Allah emphasises the requirements of mutual consent in all trades and transactions and prohibits explicitly taking the property of others without their consent by illegal means.

As quoted earlier Allah's command: "O you who believe! Eat not up your property among yourselves in vanities: but let there be amongst you traffic and trade by mutual good-will: nor kill (or destroy) yourselves: for verily Allah has been to you Most Merciful [14]." In other statement, Allah also blamed the Jews for taking others' property in a wrongful way [15].

The sanctity of property ownership and requirement of consent in transferring the property to another party in the form of a contract is further supported by the Sunnah of the Prophet (pbuh). The Prophet (pbuh)is reported to have said "the property of a Muslim is prohibited (from being acquired by others) unless by his free will" [15].

### *4.1 Sigha or the statement*

The significance of the *sigha* or statement is supported by majority Muslim jurists as it utters the mutual consent of both parties involved in a contract. In absence of this the contract is considered void (Haqqi, 2000).

*Sigha* is created through valid *ijab* (offer)and *qabul* (acceptance). The offer made by the first party to the contract is called *ijab* because it gives and confirms the freedom of acceptance to the second party. If the second party agrees, then his/her statement is called *qabul*. The coming together of *ijab* and *qabul* makes up the contract (Haqqi, 2000).

Offer and acceptance can be performed in various ways. Such as by words, gesture or indication and by conduct. The acceptance must be made to correspond with the offer/proposal. It is compulsory that the acceptance must conform to the offer in all its details irrespective of whether such conformity is expressed or implied. If this conformity does not exist, there will be no consent. This conformity could either be explicit or implicit (Arzim Associates Chartered Accountants and Chartered Islamic Finance Professionals, 2007).

An offer must be made in the same meeting before departing any of the contracting parties. The doctrine of *majlis* or session of contract states that for offer being conformed to the acceptance, both parties should be present in the same session (Arzim Associates Chartered Accountants and Chartered Islamic Finance Professionals, 2007).

There are different opinions among scholars whether a contract is obligatory instantaneously following an offer and acceptance, or parties are allowed to delay for further thinking about it until the end of the session. Majority of scholars (except for Hanafis and Malikis) uphold that both parties are endorsed to rethink and delay until end of the session. This view could be supported by a *hadith* which narrates: "Both seller and purchaser have the choice (to revoke the contract) unless they have separated from each other" (Arzim Associates Chartered Accountants and Chartered Islamic Finance Professionals, 2007).

### *4.2 Contracting parties*

Legal capacity of both the contracting parties is the second most important requirement that is obligatory to have a valid Islamic contract. The parties who have the legal capability to enter into a contract must have the following attributes: puberty, sanity and maturity (Securities Commission Malaysia, 2009).

In the Quran, Allah says:

> And test the orphans until they attain puberty; then if you find in them maturity of intellect, make over to them their property [16].

The sanity of both contracting parties is a must in Islamic law of contract. The capacity for the parties to make the contract is when he/she attains full mental growth and maturity. Puberty is considered as a standard criterion [17]. However, reaching puberty alone is not sufficient evidence that a person has obtained capacity of doing business independently. Moreover, one must possess maturity of action to conduct not only financial matters but also religious matters or ritual worship (*`ibadat*) [17].

### *4.3 Subject matter*

Subject matter is another significant pillar of contract in Islamic law without which no contract can be performed. Subject matter can be in the form of goods or property. The following conditions of the subject matter are to be met in Islamic law of contract:

- legality or suitability;
- precise determination of the subject matter;
- existence of subject matter; and
- certainty of delivery [17]

First, the subject of sale must have the value. The goods must have a clear material value, which is verified by the market. Goods without real value cannot be subject of sale or purchase. In addition, the subject matter must be permissible article from the *Sharī'ah* point of view. Legitimacy of subject matter also entails the ownership (i.e. it must be possessed). Lastly, legality of subject matter also requires that there should be no hindrance of rights attained to it. The subject of sale should not be a thing used for intentions that are supported by the tenets of *Sharī'ah* (Securities Commission Malaysia, 2009).

Besides, the subject matter must be accurately determined by both parties. All scholars generally agree that both parties must know in details the particulars about subject matter. The general principle in Islamic contract law is that the subject matter must be exactly determined in relation to its nature, quantity and value. Likewise, if the subject matter is an obligation or performance, it must be precisely determined at the time of the contract or else the contract will be invalid (Securities Commission Malaysia, 2009).

The subject must be specifically known and identified to the buyer. If the goods are not specified and agreed on up-front, the sale is null and void, as the goods may differ from goods agreed at the initial point of agreement. If the goods are not agreed on initially upon entering the contract, there is likelihood of gambling and cheating. The quantity and attributes of the subject matter must be also precisely known and agreed upon together with the certainty of the timing for completion and delivery of the contractual obligations. The price of the subject must be definite and becomes a necessary condition to the validity of the sale contract. If the price is uncertain, the sale is null and void (Ayub, 2009).

Islamic contract law also upholds that the subject matter for transactions should be in actual existence at the time of contract and should be competent of being obtained and delivered to a prospective buyer in the future. The subject must exist at the time of sale. If subject matter does not exist at the time of sale, it cannot be transferred and its non-existence makes the contract void (Securities Commission Malaysia, 2009).

The subject must be in the full ownership. If something is not fully owned, the contract that takes place becomes void. In addition, the subject must be in physical possession of the owner when he/she transfers it to another person (Securities Commission Malaysia, 2009).

Further requirements in Islamic contract law in this regard are that the sale must be instant and absolute. The sale of goods at a future date or event is void except for exceptional conditions that are allowed in Islamic law of contracts as is the case of *salam* or *istisnàa* transactions (Securities Commission Malaysia, 2009).

The common rule related to deliverability is that the subject matter must exist at the time of contract and must be owned and in possession by the seller before it can be transacted. The delivery of the subject of sale must be certain, not depending on a possibility or chance (Securities Commission Malaysia, 2009).

Having discussed the general principles of transactions and fundamental pillars of Islam, it is now pertinent that to be compliant with Islamic law of contracts; any financial products these principles must be adhered to. If there is any discrepancy, the contract is generally considered as void. In the following section, we would like to discuss on why the majority of jurists argue against the motion of the use of futures contract.

## 5. Arguments against conventional futures in Islamic law of contract

### *5.1 Sale of that which is not owned*

According to classical jurist Imam Ahmad bin Hanbal, a seller's possession of the subject matter of sale is compulsory; however, the *salam* sale is the only exception where the ownership is not a prerequisite. Imam Shafi' takes the view that one might sell what one does not own provided that it is not a specific object, because the delivery of a specific item

cannot be guaranteed if the seller does not own it. On the contrary, Imam Malik has drawn a distinction between commutative and non-commutative contracts (such as charitable contracts), and concluded that the existence of the subject-matter is a requirement in only commutative contracts (Al-Zuhayli, 2003). Ibn Taymiyyah claims that the sale of a non-existent object is unlawful if it involves gambling and misappropriation of the people's property, but it is otherwise lawful. The same view is held by Ibn al-Qayyim who states that evidence is found neither in the Qur'an nor in the *Sunnah* nor in the statements of any of his disciples putting a ban on the sale of a non-existent object. There is no doubt that the jurists of various schools of thought have invalidated the sale of non-existent object for the fear of its involving uncertainty (*gharar*). On the other hand, some jurists such as Ibn Taymiyyah claim, as has been stated above, that it is not an issue of existence or non-existence of something which determines the legality or otherwise of its sale. Instead, the effective cause (*`illah*) of prohibition is its involving *gharar*; it comes about when a thing cannot be delivered whether it is existent or non-existent (Kunhibava and Shanmugam, 2010). The conventional *fiqh* equates, in all probability, the sale of non-existent object with *gharar* because the markets were very small in the early stage of the advent of the Prophet Muhammad (pbuh), but this is no longer the case.

The *Mejelle*, the Ottoman Civil Code, Article 197 provides that the "the thing sold must be in existence". Article 205 further provides that "the sale of a thing which is not in existence is considered void" (Tyser et al, 2001).

Futures contracts include that is not owned or possessed, due to the fact that this type of sale leads to *gharar*. Dawabah (2007) and Obaidullah (2002), stated these contracts contain sale of underlying assets that does not exist on their ground and is not possessed by the seller as well.

Ibn Qudamah (1401H) and Al-San`ani (1353H) prohibited sale of commodities that are not owned by the sellers in Islamic law (Injadat, 2014). Al-Shwasi (*n*.d) and Ibn Abedin (*n*.d) considered this sale as void for the lack of ownership (Injadat, 2014). Imam Shafii also considered this as a contract which involves *gharar* (Al-Mazni, 1321H) (Injadat, 2014). Moreover, this sale is also considered as *al-ma'adum* (non-existent) sale where futures contracts concerning things are basically invalid on the account of non-existent items (Injadat, 2014). In this regard, Mahmassani has stated that all contracts, except for *salam* and *istisnà*, for selling future goods are invalid under the *Sharī'ah* because it contains the state of non-existence. In the case of *salam*, or even *istisnā'* contracts, only one counter-value is deferred at the time of sale which is allowed under the *Sharī'ah*. However, non-existence of both counter-values, in the case of futures contracts, amounts to *gharar* or unwarranted risk-taking due to uncertainty about the prospects for fulfilment [18].

Islamic *Fiqh* Academy of the OIC also agrees with the opinion of Mahmassani. During its 7th session in 1412 H (9-14 May 1992), the Islamic *Fiqh* Academy made the following resolution (OIC Islamic Fiqh Academy, 2000):

> [. . .] where the contract provides for the delivery of described and secured merchandise at some future date, and payment of its price on delivery. It also stipulates that it shall end with the actual delivery and receipt of the merchandise. Thus, contract is not permissible because of the deferment of the two elements of the exchange. It may be amended to meet the well-known conditions of 'salam' (advance payment). If it does so, it shall be permissible.

The aforementioned opinions are based on a number of *ahadith* and the views held by the majority jurists. According to Al-Zuhayli, top scholars from all the schools of Islamic jurisprudence have agreed that the sale of non-existent goods, and goods that might cease to exist, is invalid: e.g. the sale of fruits and plants, before they appear (Mansuri, 2006):

> [. . .] sale of pearls in shells, milk in udder, wool of the back of sheep, and a book before it is printed (Mansuri, 2006).

Examples of *ahadith* that prohibit the sale of non-existent goods are:

- Jabir narrated that the Messenger of Allah (pbuh) forbade the selling of fruits until they ripen [19].
- Abu Bakhtari reported that I have asked Ibn Abbas about the selling of dates. He replied: "The Prophet (pbuh) forbade the sale of dates until they became fit for eating and could be weighed." A man asked about what to be weighed? Another man sitting beside Ibn Abbas replied that it is until they are estimated [20]. Ibn Abbas reported that the messenger of Allah (pbuh) prohibited the sale of fruit before its quality is known, the sale of wool on the back of sheep, and the sale of milk in an udder [20].

### *5.2 Sale prior to taking possession (qabd)*

In conventional futures transactions, the majority of buyers and sellers reverse their positions before delivery or maturity of the contract. This means that for futures, physical delivery hardly ever takes place.

The word *qabd* denotes taking and holding something in one's hands (Kamali, 1996). In its juristic application, "*qabd*" refers to lawful custody and ownership in a proprietary capacity, even if it does not entail the material operation of holding (Kamali, 2007). The seller has obligation to bring the goods sold, and the buyer needs to pay the price.

Almost all jurists are of the opinion that one cannot sell foodstuffs before taking possession (Muhammad, 2000). According to Imam Shafi'i, it is not allowed to sell anything, moveable or otherwise, before taking possession. Imam Abu Hanifah invalidates the sale of a moveable thing before possessing it, but possession is not a requirement in the sale of real property, assuming that the fear of destruction and loss, which seems to be the *raison d'etre* of the prohibition, is absent in this case (Al-Zuhayli, 2003). The Hanafi jurists further uphold that a valid sale can be concluded prior to taking possession, but it will fall into abeyance until the *qabd* (holding physical possession) comes about. *Qabd* is therefore not a prerequisite of a valid contract, and it is lawful to postpone it to a future date. In case of currency exchange, it is however, a *sine qua non* for a valid contract (Qudamah, 2004). Imam Malik takes the view that the *ahadith* apply to foodstuffs only, but this requirement is applicable to such transactions that entail exchange of values, not to loans and gifts (Al-Kandhalwi, 2014). Thus, a person who buys foodstuffs may pass them on to someone as gift or loan even before possessing them. Ibn Hazm has confined the applicability of this decree to one item only, namely, wheat. According to him, everything could lawfully be sold before possessing it, except wheat (Ibn Hazm, 1988).

Futures contracts include selling items prior to taking possession (Khan, 1996). The lack of real possession (sale prior to taking possession) does not make these contracts valid (Usmani, 1996). Current futures contracts are prohibited because the contracts include selling item prior to taking possession. At its 7th session held in 1412 H (9-14 May 1992), No. 63/1/7, the OIC Islamic *Fiqh* Academy opined as follows:

> [. . .] the contract provides for the delivery of described and secured merchandise at some future date, and payment of its price on delivery. Th contract, however, does not stipulate that it shall end with the actual delivery and receipt of the merchandise, and thus it may be terminated by an opposite contract. This type of contract is the most prevalent in the commodity markets. It is not

> at all permissible" [... moreover] it is not permissible to sell a merchandise purchased under 'salam' terms with advance payment unless the merchandise has already been received.

All leading Jurists agree that selling items prior to taking possession is prohibited sale (Al-Shafii, 1321H; Al Sarkhasi, 1986; Kunhibava and Shanmugam, 2010). When elaborating this decree, Muslim scholars have relied on the authority of the following *ahadith* (plural of *hadith*, i.e. the Prophetic traditions).

- Hakim b. Hazzam relates that he asked the Prophet (pbuh) that a man comes to me and asks me to sell him something that I do not have. Should I sell it to him and then go and acquire it for him from the marketplace? The Prophet (pbuh) replied: "Do not sell what you do not have." [Sunan al Tirmidhi (1232), Sunan Abu-Dawud (3503), Sunnn al-Nasa'i(4611), and Sunan Ibn Majah (2187)] [21].
- Ibn Abbās narrated that the Messenger of Allah (pbuh) said: "He who purchases food should not sell until he takes possession of it." Ibn Abbās said that every sale is subjected to this condition [22].
- Abu Hurairah asked Marwān if he has legalised interest. Marwān replied in negative. Then Abu Hurairah asked him if he has legalised selling promissory notes, whereas the Messenger of Allāh (pbuh) forbade selling foodstuff unless received by the seller. Marwān then addressed the people and forbade selling such notes. Sulayman stated that he saw the guards taking them away from the hands of people [23].

> In addition, the delivery of the item (underlying assets) in sales contracts is required, and if the seller is unable to deliver it, the transaction would entail excessive risks and gambling [23].

*5.3 Bay` al Kali bil Kali (sale of a debt for a debt)*

*Bayʿal-kali bi al-kali*also known as*bayʿal-dayn bi al-dayn* has generally been found to be prohibited in Islamic law [24].

The deferment of both final payment and the delivery of the object or commodity is subject to another criticism for conventional futures contracts (Salehabadi and Aram, 2002). This is due to the fact that these contracts include *bayʿal-kali bi al-kali(bayʿal-dayn bi al-dayn)*, i.e. sale of debt where both parties – seller and buyer – agree to defer both price payment and delivery of item in future dates.

According to Imam Malik, *bay` al-kali bi al-kali* is illicit. The Hanbali jurists prohibit such transaction when the two commodities are different, whereas the Shafi jurists forbid it even though the commodities are identical in terms of genus and quantity. Qudamah (2004) also maintains that *bay' al-dayn* is unanimously impermissible. He cites Ibn al-Munzir's assertion that there is a complete agreement among the jurists about the illegitimacy of *bay' al-dayn*. Imam Ahmad bin Hanbal is also reported to have said the same (Al-Shawkani, *n*.d.). Any increase or decrease from one side is tantamount to *riba*, and as such can never be allowed in the *Sharìah*. Gilani (2020) argues that *bay' al-kali bi al-kali* is prohibited because it might precipitate untold disputes at the time of payment. Ibn Rushd (*n*.d.) also deems *bay' al-dayn* forbidden in the light of the *hadith*. On the other hand, Ibn al-Qayyim holds the view that not all forms of *bay' al-dayn* are prohibited. The prohibited form is that which involves the sale or exchange of one deferred debt for another. He further explains that there is neither explicit nor implicit text in the *Sharìah* to proscribe it. On the contrary, the principles of the *Sharìah* signify its permissibility. To Ibn Taymiyyah, the Prophet (pbuh) did not prohibit the payment of one debt in exchange for another debt when both are established and

substantiated, especially when this process does not involve any third party, and is restricted to the debtor only. The Maliki jurists also upheld the permissibility of certain types of *bay al-dayn*, especially when the debts involved therein do not arise from the exchange of foodstuffs, and the transaction does not contain the element of *gharar* (Al-Zuhayli, 2003).

The consensus of Muslim scholars prohibited *bay' al-kali bil kali* (Ibn Taymiyah1385H; Ibn al-Qayyim,1973; Ibn Qudamah,1401H; Ibn Rushd, n.d; Al-Dharir, 1967; Kunhibava and Shanmugam, 2010). This general prohibition has been prescribed to futures. In this aspect, it is concluded that the sale of futures contracts, where the parties can offset their transactions by selling the "debts" owed them to other parties before the delivery of the underlying asset, will amount to a sale of a debt, and as such it is prohibited. The prohibition of *bay' al-dayn* is a logical consequence of the prohibition of *riba* [23]. Ibn Taymiyah and Ibn al-Qayyim considered *bay' al-kali bil kali* (or *bay' al-daynbildayn*) as a means to *riba*, and thus not a valid legal benefit, and leads to conflict between parties, also to an excessive risk (*gharar)* [24].

*5.4 A fake sale, gharar and maysir*

Futures are generally considered as paper transaction not a genuine sale to make speculative profit. According to al-Zarqa, any contract that includes *suwari* contract (in form only, but not in substance) which does not intend to deliver item and price is considered null and void (Injadat, 2014). This fully applies to conventional futures contracts where many of these contracts are not intended to be settled by delivery or by making real possession or even real ownership; thus, it is a fake contract.

Instead, it is considered a type of prohibited speculation activity aimed to exploiting price fluctuations to achieve capital gains (Gupta, 2005). The reason can be traced to leverage features in derivatives contract, where the buyer and the seller are required to deposit only a fraction of the contract value. This enables them (speculators) to enter into more contracts than spot market. This causes the market to be more liquid, consequently increasing the speculative volume in derivatives market.

As a result, International Islamic Fiqh Academy (1992) and Islamic Fiqh Academy of Muslim World league (1984) indicated that these contracts are forbidden because the ultimate goal of that is just to pay and receive price differences between sellers and buyers, which is considered as gambling and is, therefore, impermissible in Islamic law [23].

*5.5 Sale of al-a'ayan (assigned items)*

The consensus of Muslim scholars prohibits selling of *al-a'ayan* on credit sale. It is not permissible to sell *al-a'ayan* on credit, for technical considerations in Islamic *fiqh* (Al-Sulayman, 2005). For example, it is not accepted to sell an assigned car (this car) on credit, but it is accepted to sell a car inclusive of characteristics of such and such on credit sale. Additionally, stocks trading on credit sale (futures on stocks) is prohibited because the stocks are *a'ayan*, which is not permitted for selling on deferment basis, and the postponement of delivery of stocks has no valid purpose (Al-Sulayman, 2005).

*5.6 Sharìah non-compliant underlying assets*

Futures contracts conducted on prohibited underlying assets are definitely considered as impermissible as underlying asset is interest rate. And when underlying assets are hypothetical such as futures and forward index, they are prohibited and are considered as a form of gambling (International Islamic Fiqh Academy, 1992). The prohibition occurs on these contracts also when the underlying assets are money (currencies), such as futures and forward currencies contracts, as currencies are not considered as a commodity for selling

and buying rather, it is a method for trading (i.e. medium of exchange) (Danila and Jeffers, 2009). The currencies must be traded on spot rather than on deferment basis so it is not accepted in futures and forward contracts. Currencies should only be traded hand to hand on spot basis, not on deferment basis (Sole and Jobst, 2012).

Furthermore, International Islamic Fiqh Academy (1992) and Islamic Fiqh Academy of Muslim World league (1984) consider deferring currencies are prohibited because it is a practice of *riba al-nasi'ah*. Conventional futures contracts are used for speculation and gambling purposes (Obaidullah, 2001). Where many of these contracts are not intended to be settled by delivery or by making real possession or even real ownership and thus, are fake but not genuine contracts (El-Gamal, 2006).

Trading volume of futures contracts is often much larger than underlying assets, and this is due to its involvement with speculating activities and practice of gambling in derivatives (Obiyathullah, 1999). Al-Suwailem (2006) stated that based on the office of the comptroller of currency (OCC), only 2.7 per cent of derivatives transactions used by end users for hedging ended by actual delivery while the majority, 97.3 per cent, is used for speculation by speculators and dealers which ended by cash settlement. Some researchers asserted that those who participate in future contracts are not for risk protecting rather, for speculating and in fact, hardly 1 or 2 per cent percent of traded derivatives instruments are settled by actual delivery of the underlying assets, while the rest were ended through cash settlements, not including the real sale (Injadat, 2014; International Islamic Fiqh Academy, 1992).

The speculation and gambling pictures in futures contracts also reflected in the huge trading volume of derivatives relative for the GDP of the world, where the trading volume of derivatives all over the world in the parallel market at end of 2012 amounted to more than $1.270 quadrillion and in the organised market more than $52tn. Meanwhile, the GDP volume of the world at end of 2012 was only at $71.9tn, and this amount is equivalent to almost 18 times the value of the GDP of all countries in the world (Injadat, 2014).

### *5.7 Offsetting sales and purchases*

Another criticism is the availability of offsetting sales and purchases in the futures markets as a whole. Where, the sale of underlying asset in *Salam* contract prior to possessing is prohibited (El-Gamal, 2006).

Reasoned that the repeated sale of the same underlying asset in the chain while none of the participants took possession will add burden to the customers by adding the extra profit of repeated sale to the commodities' price and the burden of having to pay this extra profit is passed to the customers [25].

International Islamic Fiqh Academy (1992) stated that futures contracts are different from *salam* contracts, where the price in futures contracts is deferred to expiration date, while in *salam* contracts, the price paid during the contract session or can be delayed until three days further. El-Gari (1993) indicates that commodity futures contracts include selling prior to taking possession which is not the case in *salam* contract.

## 6. Arguments in favour of futures contracts

Futures contracts have important role in risk management and hedging. Contrary to mainstream view of majority Muslim jurists regarding the impressibility of futures and forwards contracts some contemporary Muslim jurists such as Kamali (2007) and El-Gari opine that futures contracts are permissible if they do not violate a decisive principle, and void of *riba* and gambling, and do not include the elements of excessive *gharar*. In the subsequent section, major arguments in favour of futures contracts are discussed.

*6.1 Arguments against the criticism of sale of items that are not owned by the seller*

The first criticism pertaining to *gharar* results from the prohibition of selling items that are not owned by the seller. The well-known *hadith* of Prophet Mohammad (pbuh) that prohibits of selling items that are not owned by the seller applies only to the sale of underlying assets in rem (*bay' al-a'ayan*), not to fungible goods (Kamali, 2007). Further, Ibn Al-Qayyim (*n*.d) concluded the *hadith* is related to a specific item, not for described goods. The similar view is held by Ibn AlQayyim (*n*.d) and Ibn Taymiyah (1398H). They assert that the *hadith* is related to sale of what is not in existence and what the seller is unable to deliver (Kamali, 2007). The *hadith* that prohibits selling items that are not owned by the seller applies only to sales that include specific objects and not to fungible goods, and the futures contracts normally proceed over fungible goods (Kamali, 1999).

*6.2 Arguments against the criticism of selling prior to taking in possession*

With regards to selling items prior to taking them in possession, some Muslim scholars have differing opinions on the possession of other items. This is where they do not require the possession of non-food stuff. Ibn Rushd (*n*.d.) holds the view that selling non-food items before taking possession is acceptable [26]. The *illah* (causality) of prohibited sale of objects is not owned by the seller, and selling prior to taking possession is *gharar* (probability of future disputes) due to the seller's inability or failure to deliver underlying assets. However, if the seller can ensure the delivery, then the existence or possession of the subject matter is no longer an issue, and the reason for prohibition is the inability to deliver (Injadat, 2014). Furthermore, selling those non-existent items whose existence is certain in future is permissible (Mansuri, 2006).

There is clear sanctity of the sale of goods or financial securities before taking possession, for the presence of interest and excessive risks; however, if there is no interest and excessive risks, then it becomes permissible as the case is in *salam* contract, but it is better to take possession on the commodities (financial securities) before the sale. Apart from that, the food is excluded from that must be possessed before selling, but if the food is of preserved-type, then it can be sold before taking possession (Hattab, 2007).

*6.3 Arguments against the criticism of Bay`al-kali bi al-kali*

With regards to the deferring of delivery of price payment and underlying asset, some Muslim Islamic finance experts accept that deferring. Deferring both price and subject matter is accepted in the forward markets for the underlying commodities only, while for financial securities, it is impermissible (Ahmad, 1995). However, Hamoud (1976) stated deferring both in exchange is accepted based on *mùawadah*. The contracts which include selling debt for debt is due to the needs of traders and industrialists. Thus, based on *hajah* (need) and *darurah* (necessity), they can be used as soon as they retain the legal standards. Deferring is acceptable as long as it does not include foodstuff assets or is void of any forms of *gharar* (Mansuri, 2006).

Those contemporary scholars of Islamic finance who accepted deferring (postponement) in both price and item, they agreed on that subject to the fulfillment of certain conditions (Al-Suwailem, 2020). In fact, the reason for this flexibility is that there will be no available room for speculation in price differences, unlike the futures and forwards contracts, as the products cannot be easily found in the market place (Injadat, 2014). A part from that, there is no conclusive proof in the *Sunnah* on prohibition of sale of debts. Al-Albani (*n*.) stated the *hadith* of *bay' al-kali bil kali* as weak [27]. The *hadith* that refers to the prohibition of selling debt by debt is weak, and as such cannot be used as inference for prohibition. Albeit, for the

contract and its effects, it is right but the obligation to be contacted urgently, no evidence is available to support that.

Some contracts that involve deferring for both price and item were accepted by the scholars. This includes supply and *bay` al-istisnà* contracts, where supply contract is permitted (Al-Masri, 2007). International Islamic Fiqh Academy concluded that *bay` al-istisnà* contract is Islamically permissible contract and can be used to defer price payment (Al-Masri, 2007).

*6.4 Arguments against the criticism of bay`al-àayan*

With reference to futures and forwards as a form of *al-a'ayan*sales, Fdad (2000) mentions the consensus of Muslim scholars' acceptance of the sale of *al-àyan al-gha'ibah* (absent sale) as soon as underlying items are fully described, not of *al-ma'adum* sale, as well as owned by seller at contracting period. In fact, plethora of scholars have allowed *al-a'ayan* sales, although many of them stipulated granting the buyer right to perform the contract after seeing the underlying items [28].

There are some levels of needs for speculation activities for the purposes of market enhancing even though many Muslim jurists' outlaw speculation. Al-Amine (2013) stated that some financial and economic experts believe that speculation has good reflection with regard to allocation of resources, decreasing price fluctuations in markets, restoring equilibrium between demand and supply and minimising periodic gluts and shortages; this creates efficiency in the market (Al-Amine, 2013).

*6.5 Arguments against the criticism of offsetting transaction*

In the matter of offsetting transaction, the perception that speculation causes the offsetting of transaction which adds burden to the customers is misleading. Instead, it is improper to assume that everyone in the chain of sale makes profit when in fact people can make profits and also can make losses, and also some people may need to resort to a reverse transaction before taking delivery on the same point [29]. Apart from that, the validity of offsetting must be based on the notion of *ibahah* or permissibility, which means that the reverse trade must not include any contravention of Islamic law to be considered lawful (Kamali, 2005).

*6.6 Futures contracts are akin to bay` al-sifah (sale of description)*

Forward contracts are in line with *bay' al-* where the sale of item that is not present at the time of contracting is very well described and is to be delivered at a later date, and as such the sale is lawful by Hanafi, Maliki and Hanbalijurists (Kamali, 2007). On the other hand, other Muslim scholars see forwards and futures contracts as being similar to *bay' salam* and *bay' istisna*, which are valid Islamic contracts and accepted by the jurists of all Islamic schools of thought.

*6.7 Futures contracts in the form of tafahum (mutual understanding)*

Khomeini (*n*.d) stated that, because we define the futures contracts as those that two parties settle on a future transaction, seller agrees to deliver the commodity in a future date to the buyer and buyer agrees to pay the price to the seller at that future time, and as such, those futures contracts are in the form of *tafahum* and are permissible (Injadat, 2014). Apart from that, futures contracts are permitted if they are adjusted according to the Islamic rules, especially as these contracts reallocate risks, and collect and distribute information about the future course of prices in the spot market to achieve price stability in future (Salehabadi and Aram, 2002).

*6.8 Futures contracts are acceptable under the notion of darurah (necessity)*

Apart from all that have been discussed above, Bacha (2001) considers futures trading is permissible in Islam based on *darurah* and need, where some futures contracts should be applied in Malaysia's derivatives market. Further, based on Shariah Advisory Council (SAC) of Securities Commission, Malaysia's ruling about futures trading of commodities is that it is acceptable as long as the underlying asset is not prohibited.

The SAC of Securities Commission, Malaysia has approved single stock futures (SSF) as a *Shariah*-compliant instrument, provided that the underlying stocks of the SSF are *Shariah*-compliant. The SSFs were approved by the SAC on the basis that the instruments are free of elements pertaining to *muqamarah* (gambling), *bay` màdum* (buying and selling something which does not exist), *jahalah* (ignorance) and *gharar* (uncertainty). Also, provided the instrument is traded in clear quantities and pricing is based on market's real demand and supply (Securities Commission, 2007).

## 7. Conclusion, policy implication and recommendations

Conventional futures contracts are widely used financial derivatives around the world for hedging purposes. Researchers argue that only 1 or 2 per cent of traded derivatives instruments are settled by actual delivery of the underlying assets, while the rest were ended through cash settlement, not including real sale. The speculation and gambling pictures in futures contracts are also reflected in the huge trading volume of derivatives relative to the real GDP. Nevertheless, certain features of futures contract raise questions whether it is permissible under Islamic law of contract. Islam is a complete code of life and every sphere of a believer's life is dominated by rules and principles referred in the Qur'an and the Sunnah of Prophet Muhammad (pbuh) of which financial transactions are not an exception. One of the fundamental concepts in financial transactions from Islamic legal perspective is contract. Contracting is the connection of an offer with an acceptance in a lawful manner which marks its effect on the subject of that connection. It is further explained that as a result of this connection, both parties are under a legal obligation to one another. There are generally accepted principles in *Shariah* for contract being valid. For instance, contract must be devoid of *riba*, *gharar*, *qimar*, *maysir*, *jahala*, fraud and cheating. Most importantly, contract must not contradict with *maqasidal-Shariah*. In addition to the above given general principles, all contract must have three fundamental pillars, namely, two contracting parties, subject matter and offer and acceptance.

At the same time, majority of the classical scholars argue that conventional futures are not permissible under Islamic law because of its inclusion of some features, such as sale that does not own, delay in both counter values, sale of one debt for another, excessive risks and uncertainty, speculation and gambling. Contemporary scholars have differing opinion regarding permissibility of conventional futures. In their recent study, Sakti *et al.* (2016) use qualitative method for understanding *Shariah* scholars' perception and experience on Islamic derivatives and found that conventional derivatives cannot be used in Islamic finance due to hedging or risk mitigation. Moreover, existing Islamic derivative instruments are similar to *bay' al-kali' bi al-kali* which is prohibited by Islamic law, also, instruments based on *wàad* (promise) contracts are found problematic (Usmani, 1996; Obaidullah, 2001; Wisham *et al.*, 2011). However, a group of contemporary scholars argue in favour of using futures contract for risk management (Kamali, 2002; Jobst, 2013; Al-Amine, 2013; Dusuki, 2008). Many contemporary jurists have provided evidence from the Qur'an and the Sunnah and also arguments from classical jurists to support their views. On the other hand, many scholars have attempted to justify the permissibility of futures contracts based on the notions of *istihsan* (juristic preference), *maslaha* (public interest) and *darurah* (necessity). They argued that the current financial world is too complicated, and *ahadith* which

opponents of futures contracts provide were meant to be for different purposes and circumstances. Moreover, many leading Islamic institutions have already issued resolutions by giving their opinions. It is found that futures contracts are considered *Sharìah* compliant only in Malaysia and approved by SAC of Securities Commission. On the other hand, both the OIC Fiqh Academy and Islamic Fiqh Academy have resolved that futures contracts are not permissible under the tenets of Islamic law. Despite the Fiqh Academy, SAC, European Council for Fatwa and Research and AAOIFI endorsed their resolution based on their own independent *ijtihad*, it can be concluded that majority of scholars reject the permissibility of futures contract. Even though arguments in favour of futures provided by Mohammad Hashim Kamali and others are quite persuasive. Nevertheless, counter arguments provided by scholars such as Usmani, Khan and others seem to outweigh the previous verdicts.

Given the above discussion, it is safe to assume that conventional futures contracts in its current form do not comply with the tenets of Islamic law. However, Islamic futures can be operated under some contracts such as *Salam, Istisnà* and *Jòalah* which put producers and farmers on more ease. Such contracts provide more liquidity to farmers/producers. Also, the market can be in safe from pure speculation because such market is less attractive for speculators. As most of the Islamic countries so far do not have a futures market, they can take start from the experiment at the modest level by introducing futures market on the basis of a single commodity. Consequently, following are the necessary recommendations to be compliant with the principles of Islamic law of contract.

- First, futures contracts must not include any prohibited elements such as *riba*, *gharar* and *maysir*.
- Second, the intention of such contracts must be embedded with the practice of genuine buying and selling (i.e. involved in economic activities) and all transactions must be on delivery basis and not on the basis of cash, intended for hedging purposes.
- Third, ownership and possession of underlying assets before entering into futures contracts that include something default or unreal is not acceptable.
- Fourth, futures contracts do not include currencies assets to avoid *riba,* and they are only traded on spot market hand to hand.
- Fifth, futures contracts must be conducted on *halal* products or on assets trading of which are allowed in Islamic law.
- Sixth, the contracts do not include deferring both items (price and subject matter) and offsetting contract before expiration date is not allowed. Last but not the least, the clearinghouse must be included in all transactions as guarantee to all parties in an attempt to eliminate *gharar* resulting from counterparties' risks and ensure the delivery of underlying assets.

The key requirements for initiating the futures trading are that the commodities should be properly standardised and graded with respect to their quality. Countries heavily depend on agriculture-based economies such as Bangladesh, Pakistan, Malaysia, Indonesia and Egypt, as they have plenty of scope to take necessary initiatives to start up futures markets on Islamic course to boost their production sector with pure speculation activities in the economy. For these countries, rice and cotton can be good starting commodities for *salam*-based futures markets, because these commodities are fairly standardised and have been properly graded. However, for giving practical shape to such institutions needs a proper workout. The first step that is required for the development of *salam*-based future market is the development of appropriate framework that can support the operations of this market according to underlying principles of *Sharìah*.

## Notes

1. The Quran 8:1
2. The Quran 4:29
3. The Qur'an 2:188
4. Sunan Abu Dawud, No. 3503
5. Muslim, Sahih, vol. III, p.1218, *hadith* no. 1597; al-Bukhari, Muhammad ibn Ismail, (1407/1987), 1st ed., vol. III – al-Shaikh Qasim al-Rifai(ed.), Beirut: Dar al-Qalam, pp. 128-9, hadith no. 337.
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