



OXFORD ISLAMIC FINANCE – DAR AL ISTITHMAR

The Islamic Perspective on Derivatives

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This summary note represents the views and opinion of Mohammed A. Elgari with respect to derivatives prepared for Oxford Islamic Finance for its second Islamic Finance Round-Table. It provides an outline on the conception of risk and risk transfer, Islam's perspective on derivatives, why conventional derivatives are considered impermissible and what alternatives exist within the Islamic framework to serve as tools to manage risk. This summary note also provides a meaningful analysis of the key differentiating factors between Islamic risk management tools and conventional derivatives.

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1. What are derivatives?

Derivatives are exchange contracts, the main purpose of which is to transfer risks associated with an underlying asset for a specified price. There is no intrinsic asset of value in a derivatives contract. Instead, the derivative contract derives its value as a result of its value impact on another underlying asset. Derivatives were developed as tools to manage risks. Hedging is when these derivatives are used to mitigate risks and minimize the chances of a reduction of value of the underlying. However, derivatives are also used for speculative purposes, not to protect the value of the underlying assets, but to “profit” from the increase of value of the underlying assets.

2. What is risk?

The answer may be very obvious. However, to spell out the *Shari'ah* position on risk, and address our primary enquiry in a meaningful way, we must be sure that we are “on the same page” as to the meaning of risk. A simple definition of risk would be: the probability of something undesirable happening. In the context of finance and investment, undesirable means a reduction in the value of an asset, either by missing an expected profit or making an actual loss.

Risk are in the very nature of things. It is a fact of life that nothing in the future is certain. The question is, in the process of decision making are we required to ignore this fact of life and be “fatalistic” or is it that we need to take precautions and endeavour to reduce the probability of something undesirable happening? The answer is but too obvious. There is nothing in the *Shari'ah* that dictates on the believer to be reckless enough as to ignore risks around them. It is not contrary to basic Islamic belief, to reckon that God is the supreme power and eventually it is His will that will always prevail. Yet, His will remains supreme because even avoiding risk is happening within His glorious will. Risk by itself is neither necessary nor preferable for any transaction to be *Shari'ah* acceptable. In fact it is more in line with *Shari'ah* to avoid risk, provided this is done through *Shari'ah* acceptable means. At the time of the Prophet (PBUH), a Bedouin getting off his camel asked the Prophet (PBUH) as a true believer whether he should just rely on Allah and leave his camel there unleashed. The Prophet (PBUH) said that he must rely on Allah, but also you leash the camel. Hence, managing risk is not contrary to true belief.

3. On the concept of risk transfer

Individuals differ in their ability to absorb the consequence of an undesirable event therefore their preference for the amount of risk they want to carry differs. Life nevertheless will not deal you the cards you desire and people must take their chances. Hence, people needed to

redistribute risk in accordance to preference. However, no one would be willing to accept risks for free. For this, people invented all kinds of risk redistribution tools including insurance and derivatives.

In the beginning it was social solidarity, then insurance and finally derivatives. It is hard to imagine life without means for transferring risks. It is an established economic fact that risk sharing and intertemporal smoothing are essential elements of welfare in any society. It is also an established *Shari'ah* fact that the main objective of Islamic *Shari'ah* is the good and welfare of the Society. Therefore, it is unthinkable that *Shari'ah* will lack the ways and means to provide necessary facilities for Muslims' legitimate needs to manage risks in the realm of finance and investment. Our focus here is on the tools for risk transfer in the realm of commerce and economics. In particular we are concerned with derivatives as tools of risk transfer.

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

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

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

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

A creditor can reduce credit risk by paying a fee to a third party to issue a guarantee. This third party would be obliged to pay in case of default of the debtor. The Credit Default Swap works in a similar fashion.

There are four major types of derivatives. *Prima facie*, these derivatives are contrary to the *Shari'ah*. Certainly this is correct. However, this is correct only in form not in substance. If we believe that *Shari'ah* is capable of meeting the needs of the faithful and that managing risks is a legitimate need of people involved in commerce and economy, then *Shari'ah* must have tools

that can deliver the same capabilities of risk management, with the exception that they will be free from the negative effects of derivatives.

4. The bad name of derivatives

The word derivative has now become infamous due to its perceived role in the current crises. Derivatives contributed significantly in the process of “financialization of economy” where the financial sector dominated the whole economy and forced the real sector to change its way of doing business just to meet the requirements of the financial market. The real sector shrank in terms of growth rate and profits and contribution to the total income of the economy. In the United States, for example, the size of the derivative market reached \$56 trillion when the GDP itself is a mere \$14 trillion. GDP as percentage of financial turnover was 79.6% in 1956. In 2000 it was a mere 1.9%.

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

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

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

5. Superior tools for risk management

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

Call option

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

- a) That the option is not separated for a sale contract for the underlying asset thus absolutely not allowing growth of derivatives beyond the actual need of real transaction.
- b) No *Arboon* sale contract is to be entered into unless the seller actually owns the underlying asset and continues ownership for whole duration of the option. Thus not permitting “*Arboon*” to be traded separately.

Futures

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

Forward

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

Swap

A swap is also possible under Islamic banking, but in a different fashion. A stream of income that is fixed can be exchanged for a stream of income that is variable. This is done via a series of *Murabaha* sale contracts, the subject of which is a commodity but the price is bench-marked to an active index thus creating the variable stream (variable leg). Another *Murabaha* contract is executed for the whole duration of the swap and the profit rate is fixed (fixed leg). The

economic outcome is exactly like that of a conventional swap except that it never outgrows its need since it is tied to the exchange of real good or service.

Credit Default Swap

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

6. Summary Conclusion

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