FINANCIAL DERIVATIVES: A CRITICAL STUDY IN LIGHT OF ISLAMIC LEGISLATION

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Abstract:

This article examines financial derivatives to determine their Shari'ah status and propose compliant alternatives, by employing descriptive, analytical, and deductive approaches.

The study concluded that suitable alternatives must involve tradable underlying assets that achieve the same economic objectives. From this perspective, Ijarah Sukuk are proposed to replace futures and interest rate swaps. Additionally, Mugharasah, Musaqat, and Muzara'ah Sukuk—considering holders as landowners—are suggested for options contracts. Moreover, Istisna'a and the unilateral promise to sell are proposed to replace forward contracts. Finally, the study advocates the rectification of currency swaps through Sarf and Muqassah rules.

Keywords: Derivatives; Futures; Options; Swaps; Shari'ah-compliant alternatives.

1. Introduction:

Financial transactions have known significant development throughout history, evolving from the basic system of barter, based on the exchange of tangible goods, to the emergence of currencies that became a standard to measure the value of commodities and a tool to conclude contracts.

As economic activities expanded, financial operations became increasingly sophisticated, especially with the shift from the tangible to the virtual aspect of both commodities and currencies. Due to this considerable evolution, numerous transactions emerged leading to innovative instruments such as financial derivatives which refer to contracts whose value is derived from some underlying assets. Initially designed for risk hedging, derivatives trade have, however, become a subject of speculation and an easy means of generating wealth, substantially boosting financial markets.

Nevertheless, these financial instruments necessitates a careful evaluation from Islamic perspective; although the general principle of financial dealings is permissibility, it is essential to examine the nature of these tools and their trading to ensure Shari'ah compliance.

Research Problem:

The main issue of this study arises from the rapid expansion of financial derivatives and their prevalence in modern markets, requiring a deep jurisprudential analysis in order to answer the following questions:

- What is the fundamental essence of financial derivatives, and what is their status under Shari'ah principles?
- What Shari'ah-compliant alternatives may be proposed to benefit from these instruments?

Research Objectives and Importance:

This research aims to provide a comprehensive Shari'ah-based evaluation of financial derivatives to suggest Islamic alternatives that fulfill the need for risk management without violating Islamic principles.

The importance of this research manifests in its attempt to bridge the gap between the modern financial engineering and Islamic jurisprudence principles. Accordingly, the study contributes to contemporary jurisprudence by providing analysis of the latest financial instruments. Moreover, it presents a guide for Islamic monetary institutions and regulatory bodies to develop Shari'ah-compliant hedging instruments.

Literature Review and Research Gap:

Despite their relative recency, derivatives attracted considerable scholarly attention. However, academic studies dedicated to Shari'ah-based evaluation remain less prevalent. In this regard, the following examples illustrate research concerning the Islamic viewpoint on derivatives:

1. **Al-Istifada min 'Uqud al-Khiyarat al-Maliya fi al-Sina'a al-Maliya al-Islamiya [Utilizing Financial Options Contracts in the Islamic Financial Industry]**, submitted by Abd al-Karim Ahmed Guendouz, Majallat al-Abhath al-Iqtisadiya [Journal of Economic Research] Saad Dahlab University, issue 06, June 2012.

This study tackled the options as a risk-hedging instrument, with an emphasis on their pricing models, as well as the Islamic judgment of dealing with them. It concluded that the Islamic alternatives are limited due to the complexity of this contracts.

2. **The Reality of Legitimacy Alternatives of Financial Derivatives in Light of the Islamic Financial Engineering Products**, prepared by Atrous Sabrina and Atrous Souhila, Majallat Milaaf lil-buhuth wa al-dirassat [Milaaf Journal for Research and Studies], No.02, December 2015.

In this article, the concept of financial engineering was discussed within an Islamic framework, it also defined derivatives and their alternatives.

3. **Al-Mujazafa wa al-Mushtaqat al-Maliya bayna al-Waqi' al-Amali wa al-Takyif al-Shar'i [Risk Taking and Financial Derivatives between Reality and Shari'ah characterization]**, presented by Mounira Bebas, Majallat al-Iqtisad al-Jadid [Journal of New Economy], No.15, 2016.

The paper clarified the notion of risk-taking and its correlation with financial derivatives, and proposed some shari'ah-compliant alternatives.

4. **Shari'ah Regulators for Islamic Financial Engineering Products**, by Ahmed Kacimi and Rachid Zerguat, Journal of Contemporary Business and Economics Studies, University of Ibn Khaldoun,Vol.01, No.02, July 2018.

This research examined derivatives and suggested some Shari'ah-compliant alternatives, like Sukuk and parallel contracts.

While previous studies have contributed to simplifying the concept of financial derivatives and their rulings, they-despite their undeniable value-still require further depth in analyzing the relevant jurisprudential foundations. This analytical gap often results in proposing Shari'ah alternatives, such as earnest money and parallel transactions, which bear no functional resemblance to the actual mechanisms of derivatives.

The original contribution of the present research lies in its focus on the Islamic perspective by incorporating Shari'ah rules, specifically by concentrating on the jurisprudential causes of invalidity in financial derivatives, in order to propose the most appropriate alternative for each specific type. Accordingly, this paper is structured into two parts; the first provides an overview of financial derivatives, while the second explores the Islamic vision regarding their trading.

Research Methodology:

The methodological framework of this study is based on a descriptive approach to define the technical nature of the transactions under study, in addition to the analytical method which was applied to breakdown transactions to their operational stages in order to analyze them. Furthermore, the research adopted a deductive approach to determine the Islamic ruling of dealing with derivatives and ultimately propose an Islamic framework for these financial instruments.

2. CONCEPTUAL FRAMEWORK OF FINANCIAL DERIVATIVES:

Financial derivatives are instruments linked to a particular underlying asset, indicator, or commodity, from which they derive their value.[1] These contracts owe their designation to their connection with underlying assets that typically involve inherent risks, including interest rate risk, foreign exchange risk, equity and commodity price risks, all of which can be traded in financial markets independently. Hence; these tools are primarily utilized for risk management and hedging, in addition to other purposes such as speculation and arbitrage.[2]

Historically, derivatives were traded primarily in over-the-counter markets until the early 1970s, when the establishment of specialized exchanges provided a remarkable impetus to the development of the financial derivatives markets.[3]

The following section explores the primary categories of financial derivatives, namely forwards, futures, options, and swaps, analyzing their operational frameworks and characteristics.

2.1 Forward Contracts:

A forward contract is an agreement to buy or sell an asset at a specific future date for a certain price. These contracts are basically traded in the over-the-counter (OTC) market, typically between financial institutions or between an institution and its corporate clients.[4] In such agreement, one of the parties assumes a long position, and agrees to buy the underlying asset. Conversely, the other party takes a short position and agrees to sell the same asset as stipulated.[5]

The analysis of forward contracts reveals the following key components:

Parties: This contract binds a seller and a purchaser, for instance, a wheat farmer hedging against price drops, and a pasta factory owner securing future supplies.

Delivery Price (k): A fixed amount agreed upon at inception, and remains unchanged until maturity.

Spot Price (S_T): The actual market price at maturity, used to determine the payoff for each party.

Timeline: Comprising the inception date, the duration of the contract, and the execution date (maturity).

Forward contracts are considered a tool for hedging against price volatility.[6] For instance, a farmer seeking to sell his wheat crop in six months might fear a price drop at harvest time; consequently, he enters into a forward contract and takes a short position to sell the product at an agreed price. Meanwhile, a factory owner takes a long position to purchase the crop at the predetermined date and the agreed-upon price.

At inception, the contract basically has zero value. However, as the price of wheat changes during the life of the forward contract, the market value of each party's risk exposure will change.[7]

At maturity, two potential scenarios arise:

First Scenario: A Decrease in Wheat Prices: If the spot price at maturity is lower than the delivery price, the farmer has successfully hedged against price volatility, and locked in the higher contractual price, thereby avoiding the loss he would have otherwise incurred in the open market. On the other hand, the purchaser suffers a loss.

Second Scenario: An Increase in Wheat Prices: If the spot price at maturity is higher than the delivery price, the purchaser benefits from the forward contract, as he will be able to buy the commodity at a price lower than the current market rate.[8]

The aforementioned price scenarios illustrate how a forward contract generates shifting financial obligations. Any change in the spot price creates a creditor position for one party and a liability for the other. Consequently, The debtor/creditor relationship may change, in both magnitude and direction, during the life of a forward contract.[9]

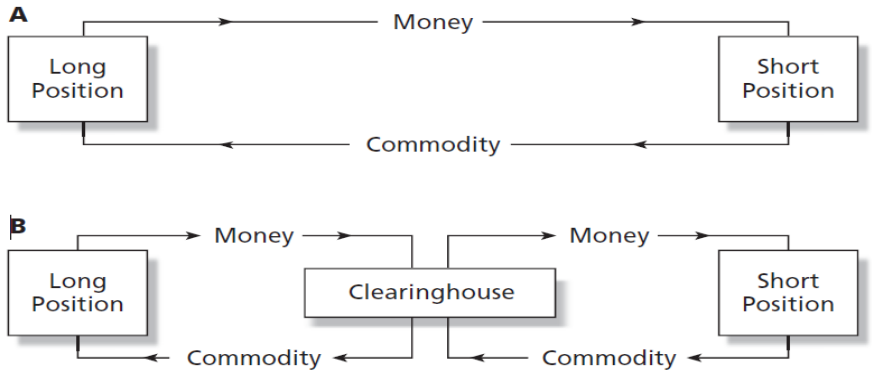
It should be noted that forward contracts may be settled by payment rather than the actual delivery of the underlying assets.[10] In this case, the payoff from a long position is (ST – K) where K is the delivery price and ST is the spot. Similarly, the payoff from a short position is (K – ST).[11]

In conclusion, at inception, a forward contract represents a neutral exchange of risk. However, as market prices move, a dynamic debtor-creditor relationship arises, creating a two-sided credit risk.[12] Thus, the

purchaser either receives or makes a payment at maturity, depending on the price movement of the underlying asset.[13] Hence, forward contracts can be a way to create wealth besides being a financial hedging tool.

2.2 Futures Contracts:

Figure1:Panel A, trading without clearinghouse.
Panel B, trading with a clearinghouse.



Source: Zvi Bodie, Alex Kane, Alan J. Marcus, Investments, McGraw-Hill Education, 2014, p (793).

Futures contracts represent a binding agreement between two parties to buy or sell an underlying asset at a specified future date and price.[14] In this regard, futures are similar to forward contracts.[15] However, they essentially differ in that they are traded on organized exchanges which standardize the contracts by pre-defining their characteristics, including the quantity and quality of the assets, in addition to the delivery date and location. [16]

A futures contract is based on two primary positions: a party that commits to purchasing and takes a long position, and a party that commits to selling and takes a short position. These parties are referred to as buyer and seller as a legal description of their respective positions, given that the contract does not represent an immediate sale but rather a mutual commitment to execute at maturity.[17]

Since the counterparties do not necessarily know one another, the clearing house stands between them,[18] and becomes the seller to every buyer and the buyer to every seller, as shown in **Figure1**.

To guarantee this commitment, both parties are required to deposit a sum of money known as the Initial Margin, which typically represents 5% to 15% of the contract's total value, ensuring the counterparties' ability to fulfill their obligations. In contrast, no initial cash flow occurs at inception.

Futures contracts encompass a diverse range of assets, which can be broadly classified into four primary categories: agricultural commodities, metals and minerals (including energy), foreign currencies, and financial instruments.[19]

Unlike forward contracts, where the gain is conveyed through a single payment at maturity, any change in the value of a futures contract is realized and settled daily. If, for instance, the price of the underlying asset rises the day following the inception, the long position gains a positive value. The latter is credited to the account at the end of the day. Consequently, futures contract is "marked-to-market" and "cash-settled" daily. This mechanism aligns with Fischer Black's description of a futures contract as a series of forward contracts in which each day, yesterday's contract is settled and today's contract is written.[20]

Futures contracts serve as essential investment vehicles for two primary market participants:

- **Hedgers:** They utilize futures to protect themselves against price movements. For example, a firm planning to sell oil may anticipate market volatility and seek to protect its revenue by entering a short position in oil futures. Hedgers face two strategic choices:

First Choice: Holding to Maturity: At maturity, the futures price converges to the spot price. Consequently; risk is virtually eliminated.

Second Choice: Early Liquidation: If the hedger chooses to close his position before maturity, he bears basis risk, as the gains or losses on the futures contract may not perfectly offset the price changes of the physical asset.[21] Yet, he can hedge his exposure by entering a reversing trade. To illustrate this point, a contract to buy a certain amount of grain at a specific location upon a fixed date can be offset through entering a contract to sell the same amount of grain at the same location on the same date. This enables financial settlement of contracts through the purchase of inverse

contracts.[22] This process is facilitated by the clearinghouse and results in a zero net position, effectively eliminating the obligation to fulfill the contract at maturity.

- **Speculators:** They aim to profit from price fluctuations. If they anticipate a price increase, they take a long position; conversely, they exploit expected declines by taking a short position. These gains are added to, or losses deducted from, their margin account at the end of every day.[23]

In summary, futures contracts are standardized forward agreements traded on organized exchanges, serving as pivotal financial instruments for both hedging and speculation. These contracts are characterized by a daily settlement mechanism (Marked-to-Market), where the clearinghouse acts as the central counterparty between the buyer and the seller, both of whom are required to maintain an initial margin to ensure the fulfillment of their obligations.

2.3 Options:

An option is a financial derivative that gives the holder the right (but not the obligation) to buy or sell an asset by a certain date for a predetermined price.[24] This transaction involves the following parties:[25]

- **Option Holder:** The purchaser who acquires the right but not the obligation to buy or sell an asset. The holder is said to be in the Long Position.
- **Option Writer:** The counterparty to the option holder, who occupies the Short Position of the contract. Writers of options are required to maintain a margin account with their brokers.[26]

For every option, there is both a buyer and a seller.[27] Never the less, the seller has the obligation to perform, in contrast to the buyer.[28]

On the other hand, the operational framework of an option contract consists of several key components:

- **Option Premium:** The up-front price paid by the holder to the writer when they enter into the Option contract. This amount serves as compensation for the writer's exposure to potential future liabilities. From

another perspective, this payment represents the cost of entry for the holder to ensure a non-negative terminal payoff.[29]

- **The Underlying Item:** Options are written on a wide variety of underlying items, including equities, commodities, currencies, and interest rates. They can be written on financial instruments as well.[30]

- **The Strike Price or the Exercise Price:** The agreed-upon contract price at which the asset will be bought or sold.

- **Expiration Date:** The specified deadline for execution, according to which options are categorized into two kinds:

First Kind: European Options: These can only be exercised on the expiration date.

Second Kind: American Options: These can be exercised at any time prior to the expiration date.[31]

Furthermore, there are two main classes of options: a call option, which grant the holder the right to buy an asset, and a put option, which provide the right to sell it, at a specified price until a predetermined date.

For a call option, the seller receives a payment from the buyer and gives the buyer the option of buying a particular commodity from the seller at a certain price. Similarly, the seller of a put option receives a payment from the buyer. The buyer then has the right to sell a specific good to the seller at a predetermined price for a specified period of time.[32]

In organized markets, option contracts are usually settled in cash; however, some are physically settled through the delivery of the underlying assets. [33]

The value of a call option increases as the asset price rises. However, if the price declines, the option's value remains at zero because the holder is not obligated to exercise it.[34] Hence, An option is exercised only if it is advantageous to the holder; otherwise, it expires worthless. Consequently, while the buyer's losses are limited to the premium, they may achieve unlimited gains, whereas the writer may experience unlimited losses.[35]

The financial state of an option is categorized into three conditions based on its potential payoff:

- **In-the-money (Positive Payoff):** This occurs when exercising the option results in a gain.

- **Out-of-the-money (Negative/Zero Payoff):** This occurs when exercising the option would result in a loss. In this case, the option expires worthless with a payoff of zero.

- **At-the-money (Zero Payoff):** A situation where the asset price equals the strike price, resulting in a payoff of exactly zero.[36]

Options provide an effective mechanism for risk management, allowing investors to protect their portfolios from market volatility. Assuming an investor holding 1000 shares at $28 each fears a price drop in the near term. To mitigate this risk, the investor purchases Put contracts with a strike price of $27.50.

If the underlying stock price drops below the predetermined strike price, the investor exercises the right to sell at that strike price, securing a guaranteed exit value and preventing catastrophic losses in exchange for a fixed cost (the premium).

On the other hand, if the stock price remains above the strike price, the options expire worthless. The investor retains the underlying shares and benefits from their price appreciation, with the total net profit reduced only by the cost of the premium paid at the outset.

From another perspective, options serve as instruments for speculation. This application allows investors to profit from the price movements. If a speculator anticipates a rising market, they can utilize Call options; conversely, if they expect a decline, they can capitalize on the trend through Put options. The primary advantage of this approach is the ability to leverage market volatility with a predefined and capped risk, as the potential loss is strictly limited to the initial premium paid for the contract.[37]

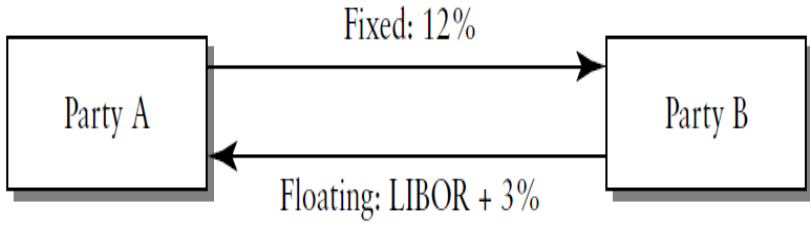
2.4 Swaps:

A swap is an agreement between two parties, to exchange sets of cash flows over a period in the future. Unlike standardized futures, swaps are privately negotiated instruments. They operate in an off-exchange, over-the-counter (OTC) environment.[38]

While forwards, futures, and swaps share a common functional purpose in risk management, swaps generally entail significantly lower credit risk than forwards. This is primarily due to the periodic settlement mechanism of swaps.[39]

To understand the mechanism of swaps, it is essential to note that this financial derivative exists in several forms, such as: interest rate swaps, currency swaps, equity swaps, commodity swaps, and credit swaps. However, the two most common types are interest rate swaps and currency swaps.[40]

Figure2: Interest Rate Swap



Source: Robert W. Kolb, James A. Overdahl , Financial Derivatives, John Wiley & Sons, Inc. 2003, p (170).

- **Interest Rate Swaps:** This mechanism allows institutions to transform a floating-rate loan into a fixed-rate loan or vice versa.[41]

In a plain vanilla interest rate swap, one counterparty has an initial position in a fixed-rate debt instrument, while the other has a floating rate obligation. In this initial position, the party with the floating-rate liability is exposed to changes in interest rates. By swapping, this counterparty mitigates risk associated with changing interest rates. For the party with a fixed-rate obligation, the interest rate swap increases the interest rate sensitivity.

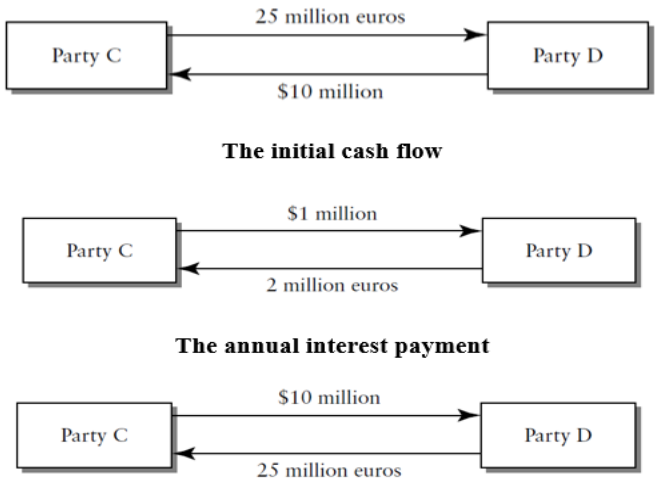
For instance, Party A agrees to pay a fixed rate of 12 % to Party B. In return, Party B agrees to pay a floating rate of LIBOR (London Interbank Offered Rate) + 3 % to Party A as shown in Figure2.[42]

In principle, this transaction serves the interests of both parties based on the concept of comparative advantage. The first party seeks absolute certainty regarding their financial obligations to ensure clear outcomes for budgetary planning. Conversely, the second party gives up this certainty and assumes risk in anticipation of a lower interest rate, accepting uncertainty in exchange for the potential reduction of their borrowing costs.

Therefore, an interest-rate swap contract consists of a contract to exchange, in one currency and during a specified period of time, cashflows related to interest payments or receipts on a notional amount of principal that is never exchanged.[43]

- **Foreign Currency Swaps:** These are instruments used to transform a loan in one currency into a loan in another currency.[44] For example, Party C may have euros and be anxious to swap those euros for U.S. dollars. Similarly, Party D may hold U.S. dollars and be willing to exchange those dollars for euros. With these needs, Parties C and D may be able to engage in a currency swap as illustrated in **Figure3**.[45]

Figure3: Foreign Currency Swap



Source: Robert W. Kolb, James A. Overdahl, Financial Derivatives, John Wiley & Sons, Inc. 2003 p (171,172).

Unlike interest rate swaps, Currency Swaps involve the actual exchange of principal amounts in different currencies. The primary objective is to obtain foreign currency liquidity that might otherwise be costly or difficult to access. Consequently, the intermediate stage represents the periodic interest payments, where each party services the debt in the currency they received, ensuring that both parties benefit from the liquidity provided by the other.

Ultimately, swaps represent a vital instrument in the derivatives market, offering effective hedging solutions against global market volatility by enabling institutions to manage their financial obligations precisely. Furthermore, swaps enhance liquidity and ensure the stability of cross-border cash flows.[46]

3.THE ISLAMIC FRAMEWORK FOR FINANCIAL DERIVATIVES:

Having explored the concept of financial derivatives, it is appropriate to examine the Islamic framework governing dealing with them, by identifying their ruling and proposing Shari'ah-compliant alternatives, with reference to the philosophy behind Islamic legislation regarding financial transactions related to derivatives.

3.1 The Islamic Framework for Forward Contracts:

The forward contract, as previously mentioned, is an agreement to buy or sell a commodity at a predetermined price at a future date. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has deemed that such contracts are impermissible because they either represent a Salam contract where the capital was not paid upfront, or they represent the sale of a commodity with a stipulated delay in both delivery and payment, neither of which is permissible.[47]

Analytically, transactions -according to Islamic law- are classified into four types based on the delivery of the countervalues. First: The immediate sale, where both price and commodity are exchanged on the spot, which is permissible. Second: The deferred payment sale, where the commodity is delivered while the payment is delayed; this is also permissible. Third: Salam sale, where the payment is advanced and the commodity is deferred, remaining permissible subject to specific conditions. Fourth: Deferring both

payment and delivery,[48] which is referred to as Bay' al-Kali' bi-al-Kali' which is prohibited in accordance with the narration of Ibn Umar who reported that "the Prophet (peace be upon him) forbade selling a debt to be paid at a future date for another".[49]

The latter form applies directly to forward contracts,[50] given that the agreement concluded between the parties constitutes a contract; for a contract is the conformity of offer (Ijab) and acceptance (Qabul) regarding a subject matter, and deferring the delivery of both countervalues is prohibited, as previously noted.

Regarding AAOIFI's position, while forward contracts bear a resemblance to Salam contract, the latter strictly mandates upfront payment of the price which is not a feature of forward contracts.

It appears that the closest characterization for forward contracts is a sale deferred to a future date (Al-Bay' al-Mudhaf ila al-Mustaqbal), meaning a sale where the offer and acceptance are linked to a future timeframe. This form is void according to the majority of scholars because a contract of sale does not admit suspension or future deferral.[51]

The prohibition of future-dated contracts reflects a fundamental principle in Islamic finance, which stats that contracts must transfer ownership immediately upon execution. Forward contracts, however, delay these effects until the settlement date, which directly conflicts with this Shari'ah principle.[52] Furthermore, forward contracts involve selling what one does not own, which is strictly prohibited.[53]

Innovating contracts to enhance hedging is legitimate, as both the buyer and the seller have the right to secure their interests and protect themselves against market volatility. However, since the core of forward contracts conflicts with Islamic transactional principles, it becomes necessary to seek alternatives that are both effective and Shari'ah-compliant. Among the proposed alternatives are:

- **Istisna'a**: A comparative analysis of forward contracts and permissible Islamic transactions reveals that Istisna'a serves as the most suitable alternative due to its structural similarity to forward contracts and the flexibility of its requirements,[54] since it remains valid even if the price payment is deferred.[55]

Although Istisna'a is limited to manufactured goods and cannot meet all market needs, it perfectly shows how Islamic finance can innovate within Shari'ah rules to match global markets.

- **Salam:** This contract involves immediate payment for deferred asset delivery. Like forward contracts, the asset is non-existent at inception, but its price, quantity, and specifications must be fixed.

In contrast to forward contracts, Salam strictly requires full capital payment at inception. Consequently, adhering to Salam regulations serves as a Shari'ah-compliant rectification to the forward contract mechanism.[56]

- **Wa'd bi al-Ba'i (Unilateral Promise to Sell):** A Wa'd involves a unilateral commitment to buy or sell at a future date, deemed permissible by the International Islamic Fiqh Academy if binding on one party only.[57]

Similar to forward contracts, the asset in this case is non-existent at inception, while its price, quantity, and specifications are fixed. Both parties secure price certainty, and both countervalues are deferred. notably, unlike Salam, the buyer is not obligated to pay at inception because a Wa'd is not a contract. Hence, obligations arise only upon execution at the specified date.

The fundamental distinction between forward contracts and Wa'd lies in their legal natures: a forward contract is a bilateral agreement with deferred execution, whereas a Wa'd is merely a promise that requires a subsequent, explicit contract to take effect.

From Shari'ah perspective, the distinction between forward contract and Wa'd is critical. While both achieve the same economic outcome, a forward contract automatically binds parties at maturity without a new agreement. Conversely, Wa'd is a one-sided promise to execute a future contract. Therefore, a forward contract can be Shari'ah-compliant by restructuring it as a Wa'd, requiring a completely new contract at maturity in line with the International Islamic Fiqh Academy resolutions.

3.2 The Islamic Framework for Futures Contracts:

As previously noted, futures contracts are standardized forward agreements regulated by an exchange clearinghouse, utilized for hedging or speculation. The International Islamic Fiqh Academy has ruled them impermissible, while AAOIFI standards further prohibit both their formation and trading.[58]

Futures contracts share the same reasons of prohibition as forward contracts, given that futures are essentially standardized forwards subject to daily settlement. Thus, they are prohibited due to the following infractions: the sale of a non-existent asset, deferring both payment and delivery, and postponing the contract execution to a future date.[59] In addition to these infractions, futures are structurally driven by speculation similar to gambling.[60]

Proposing Shari'ah-compliant alternatives to futures contracts requires breaking down the transaction and identify the participants' roles to determine the closest jurisprudential equivalents.

Structurally, opening a position constitutes a commitment to buy or sell at a future date. This commitment either persists until physical delivery, rendering it subject to the aforementioned rulings on forward contracts, or ends via closing the position at the investor's will. The latter is achieved by executing an offsetting contract, which cancels the initial obligation and settles the resulting profit or loss through the net differential between both commitments.

The First Case: Continuation Until Execution: This case shares the same prohibition's causes as forward contracts, compounded by the prohibition of daily settlement managed by the clearing house. Since futures are standardized contracts with daily price adjustments, they generate unearned profits or losses regardless of hedging or speculative intent. Such outcomes cannot stem from the contract itself, which only takes effect at maturity. Furthermore, daily settlement fundamentally involves prohibited uncertainty (gharar), as it relies on unpredictable price movements.

The Second Case: Closing the Position to Generate Profit or Mitigate Loss: This practice represents the vast majority of stock market transactions. However, it contradicts the Quranic guidance regarding the fulfillment of contracts, as well as Shari'ah philosophy regarding the binding nature of sales contracts(luzum). On this point, Al-Qarafi maintained that the inherent nature of a contract is to be binding, as its very institution is designed to fulfill its intended purpose.[61]

Seeking Shari'ah-compliant alternatives and financial innovations is religiously mandated, as the jurisprudential maxim stipulates that transactions are permissible by default, and Shari'ah's core objective is to preserve wealth and ensure its circulation among people. Therefore, exploring permissible contracts that closely mirror futures contracts becomes imperative. Accordingly, this study concludes that Ijarah Sukuk represent the most suitable alternative to futures.

This financial instrument is defined as equal-value investment certificates that represent undivided shares in the ownership of tangible assets or income-generating usufructs.[62] Ijarah Sukuk were chosen to replace futures contracts for several reasons, including:

- Ijarah Sukuk do not represent a debt liability,[63] thereby eliminating the prohibition' s causes surrounding debt-based transactions, such as deferring both payment and delivery, debt trading, or usury.

- Ijarah Sukuk were specifically chosen over other types based on the permissibility of trading them in the Secondary Market unlike Salam Sukuk, for instance.[64]

- Ijarah Sukuk can be freely traded in the secondary market to any buyer at a mutually agreed price, whether equal to, lower than, or higher than their face value.[65] Thus, secondary trading serves as a Shari'ah-compliant alternative to closing the position for hedging or speculation. Furthermore, the tradability of these Sukuk eliminates the previously mentioned causes of prohibition; since purchasing Sukuk constitutes an immediate executed sale whose underlying subject matter is not a non-existent commodity, but rather the Sukuk themselves.

- Ijarah Sukuk generate periodic profits for the holder, which effectively substitutes for the daily settlement profits managed by the clearinghouse.

- Ijarah Sukuk Align with the operational structure of futures regarding regulatory oversight, potential profit generation for all parties, and risk mitigation, as the International Islamic Fiqh Academy has permitted hedging against capital risks in Sukuk through cooperative insurance governed by Shari'ah rules.[66]

3.3 The Islamic Framework for Options:

Options grant the holder the right to buy or sell a commodity at a specified date. However, the International Islamic Fiqh Academy has ruled them prohibited because their subject matter is not considered wealth (Mal), as the underlying asset in these contracts is the mere right to buy or sell, rather than the commodity represented by the contract itself. That right cannot serve as the subject matter of a contract. Thus, trading options is inadmissible.[67]

In addition to the above, this transaction involves certain elements that necessitate prohibition, including selling what one does not possess, the virtual nature of most sales, gambling (Qimar), and the excessive risk (Gharar) since the real intent of the option holder remains completely uncertain, making it impossible to determine whether he will eventually execute the contract or not.[68]

It should be noted that options as traded in international exchanges differ entirely from the concept of (Bay‘ al-Khiyar) recognized in Islamic jurisprudence. In modern exchanges, an option is an independent contract distinct from the sale of the underlying commodity, where the option has its own value. Conversely, (Bay‘ al-Khiyar) in Islamic jurisprudence represents a right to cancel a sale for a specific reason; thus, it is a dependent right rather than a separate contract. Furthermore, this right is neither priced nor permissible to be sold.[69]

Moreover, despite the attempts of certain researchers to assimilate options to (Bay' al-'Arboun),[70] these transactions are different, since the payment made in (Bay' al-'Arboun) constitutes an advance toward the total price of the asset. whereas, the premium paid for options is a separate sum representing the cost of the option itself, whether or not the transaction is ultimately executed.[71]

Regarding Islamic alternatives to options, researchers are divided: some believe no exact substitutes exist,[72] while others propose alternatives such as:

- Concluding a contract with an earnest payment ('Arboun), so the buyer holds the right to cancel the contract within a set period, in which case the seller keeps the 'Arboun amount. However, this cancellation right cannot be traded.

- Including a condition known as (Al-Khiyar), giving one or both parties the right to revoke the agreement during a specific period, but this option is not eligible for trading.

- Issuing a binding promise to buy or sell assets, provided there is no counter-value (price/fee) charged for the promise itself. Likewise, this promise cannot be traded.[73]

These alternatives overcome the issue of selling what one does not own. They also achieve the primary purpose of options which is hedging. However, these suggestions are different from options which are typically traded independently of any underlying commodity.

To find closer alternatives, we must focus on the core characteristics of options: they are derived from underlying assets, are tradable, and are used for hedging or speculation. These features can be found in Islamic Sukuk, as they are tradable financial instruments backed by real transactions that generate profits for their holders. Furthermore, Sukuk provide holders with the right to exit their obligation by selling the sukuk, or to maintain it until the redemption date.

Therefore, Sukuk serve as a suitable alternative to options in this regard. To select the best types for this purpose, focus has been placed on agricultural transactions, namely sharecropping (Muzara'ah sukuk), irrigation (Musaqat sukuk), and agricultural (Mugharasah sukuk), where Sukuk holders own the land. This choice is based on specific reasons, which are outlined alongside their definitions as follows**:**

- **Sharecropping Certificates (Muzara'ah Sukuk):** Equal-value certificates issued to mobilize funds for financing a project based on a Muzara'ah contract, entitling holders to a share in the crop as agreed.

- **Irrigation Certificates (Musaqat Sukuk):** Equal-value certificates issued to employ funds for irrigating, spending on, and caring for fruit-bearing trees based on a Musaqat contract, entitling holders to a share in the crop.

- **Agricultural Certificates (Mugharasah Sukuk):** Equal-value certificates issued based on a Mugharasah contract to employ funds for planting trees and covering related expenses, entitling holders to a share in both the land and the plantation.[74]

- These sukuk finance productive transactions that support asset-backed economics and food security. Furthermore, using sukuk to acquire physical commodities provides an effective alternative to commodity option contracts.

- According to Shari'ah standards, Muzara'ah, Musaqat, and Mugharasah sukuk are tradable once subscription closes, and operations begin, provided the sukuk holders own the underlying land.[75]

- These financial instruments facilitate both profit generation and hedging; if crop prices rise, both the Sukuk holder and the farmer profit from the shared output. Conversely, if the prices fall, holders can hedge by selling their Sukuk to terminate their liability. Moreover, land ownership protects holders against price volatility and agricultural risks; because the sukuk's value is tied to the land itself not just the harvest.

- By utilizing this Shari'ah-compliant alternative, Sukuk trading serves as a substitute for call and put options due to the holder's freedom to trade.

3.4 The Islamic Framework for Swaps:

Swap contracts are over-the-counter (OTC) transactions representing an agreement between two parties to exchange financial flows at a future date. They are among the safest hedging tools and take many forms, the most famous of which are interest rate swaps and currency swaps.

- **Interest Rate Swaps:** Interest Rate Swaps involve exchanging variable interest rates for fixed ones to benefit both parties. One party seeks fixed rates for better budget planning despite potential losses, while the other accepts uncertainty hoping for lower Loan costs. This transaction is prohibited as it manages the outcomes of usurious transaction (Riba).

Adhering to Shari'ah rules and avoiding prohibited transactions, especially Riba, obviates the need for solutions to manage their negative financial impacts.

Furthermore, beyond the prohibition of Riba itself, interest rate swaps involve exchanging an uncertain amount for a fixed one, which is invalid according to the principles of Sarf (currency exchange)[76] that require strict equality, based on the Islamic legal maxim stating that: "Ignorance of equality is equivalent to the existence of inequality".[77] Consequently, exchanging a variable interest rate for a fixed one is prohibited, as it results in exchanging usurious money for its own kind with an excess.

In addition, this transaction involves gambling (Qimar), as it depends on the future direction of interest rates, whereby one party gains while the other loses, which is the very essence of gambling.[78]

- **Currency Swaps:** Currency swaps entail exchanging a loan in one currency for a loan in another, aiming to acquire a currency that is typically difficult to obtain. This transaction is impermissible,[79] as it constitutes a currency exchange contract (Sarf) in which the delivery of both counter-values is delayed, resulting in Riba al-Nasi'ah (interest due to delay) and the sale of debt for debt.[80]

In this regard, the International Islamic Fiqh Academy has ruled that hedging through mutual loans in two different currencies is impermissible, as it falls under the category of 'a loan conditional upon another loan,' which is Shari'ah-non-compliant.[81]

The fact that swap contracts are structurally based on usury (Riba) complicates the process of proposing a Shari'ah-compliant alternative, given that the transaction is fundamentally invalid at its core essence, rather than an external condition or circumstance associated with it. Therefore, any proposed alternative cannot be based on rectifying the existing contract, but rather on replacing it with a distinct, Shari'ah-compliant transaction that achieves the same desired economic outcomes as swaps.

By examining financial engineering products, Ijarah Sukuk emerge as a viable alternative to interest rate swaps. Under this mechanism, an institution issues Sukuk representing assets that generate variable returns, which are then offered to investors. Immediately upon the closing of the subscription, the institution receives a fixed amount of liquidity to utilize in its investments. In return, the Sukuk holders receive periodic returns. As a result, the institution transfers the variable returns of its assets to the Sukuk holders, who invest in them in pursuit of profits, subject to compliance with the Shari'ah rules of Ijarah Sukuk.

As for currency swaps, they can be rectified by adhering to the rules governing currency exchange (Sarf) and debt set-off (Muqassah) as recognized in Islamic jurisprudence, without the need to seek other alternatives.

4. CONCLUSION:

Based on the jurisprudential and financial analysis conducted in this study, the main findings and recommendations can be summarized as follows:

Conventional forward contracts are impermissible because they constitute the sale of a commodity with a stipulated delay in both delivery and payment, defer the sale to a future date, and involve selling what one does not own.

To achieve their economic objectives without these prohibitions, the study proposes replacing them by activating Istisna'a contract and the unilateral promise to sell.

Futures Contracts are prohibited for the same reasons as forwards, in addition to gambling.

Interest Rate Swaps are strictly forbidden because of usury and gambling.

The study proposes Ijarah Sukuk as the most suitable, asset-backed financial alternative to replace both futures contracts and interest rate swaps, allowing for efficient risk mitigation and liquidity management.

Conventional options contracts are prohibited due to gambling and excessive risk (Gharar).

As a compliant alternative, the study suggests introducing Agricultural Sukuk (Mugharasah, Musaqat, and Muzara'ah), provided that the Sukuk holders are considered as the legal owners of the underlying land.

Conventional currency swaps are impermissible as they result in Riba and the sale of debt for a debt, and structurally create a loan conditional upon another loan.

The study concludes that currency swaps do not require an external alternative; instead, they can be internally rectified by restructuring them to adhere strictly to the rules of currency exchange (Sarf) and debt set-off (Muqassah).

Considering the importance of financial derivatives as instruments for hedging and wealth creation, significant attention must be directed toward developing Islamic financial products that match the financial efficacy of these contracts while avoiding their associated Shari'ah prohibitions. Hence, the study recommends dedicating greater resources and initiatives to Islamic financial engineering to rectify existing financial derivatives and innovate competitive, alternative products.

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