Revisiting of an Islamic Options Permissibility from Shariah Perspectives

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Abstract: The popularity of derivative instruments especially in managing uncertainty (risk) had become popular after several financial crises that occurred since the Great Economic Depression. There are various tools have been developed in managing risk such as the Options, Forwards, Futures and Swaps. In addition, these kinds of tools are commonly used by institutional and individual investors. Given this popularity, conventional risk management strategies is completely against from Islamic risk management as Islamic financial market are keep on growing drastically at Cumulative Average Growth Rate (CAGR) of 15% on yearly basis (Mckinsey, 2005). This is clearly shows that, Islamic finance development are in line with conventional financial development. Therefore, there is need to maintain consistency in product structures offered by these two financial markets. The complexity is mainly contributed by the structures and the design of the products especially on Islamic derivatives tools. Therefore, to get a significant picture of the Islamic risk management tools, this paper will only examines the contemporary derivative instruments namely; Option and the Islamic viewpoints of this instrument. As we know, Islamic finance is governed by Shariah principle and guidelines which prohibit Riba, Gharar, and Masir etc. Therefore, this paper attempts to explore the validity of options from Islamic and Shariah perspectives by reviewing Islamic scholar’s opinions on an options market.

Keywords: Options, Islamic Finance, Conventional Finance, Risk Management.

Introduction

As we know that when the businesses become increasingly complex, it is becoming more difficult for CEO’s and director to know what problems might lie in wait. Broadly speaking in finance, there are different types of risks involved (Bacha O. I., 2010), namely; (i) Price risk, fluctuation in assets price due to the market instability, (ii) Inflation risk, deterioration of purchasing power due to the inflationary pressure, (iii) Interest rate risk whereby value for assets are greatly affected by changes in nominal interest rate, (iv) political risk such as imposition of exchange rate control, imposition of unfavourable tax or ownership requirement etc and (v) Liquidity risk whereby it is arises from thin or illiquid trading. Given all these risk, the concept of risk management becomes popular among investors and businessman whereby it involves the management of unpredictable events that have adverse consequences for a firm.

In finance, risk is defined as uncertainties associated with returns from an investment which subsequently can cause volatility (standard deviation) in returns from an investment. Therefore, it is necessary to practice a good risk management where risk and return is at optimum level or to be simple, minimizing risk and maximize return. A good risk-management refers to the techniques of reducing the risks faced in an investment or business. There are three
common broad steps in a good risk management, namely, (i) identifying the source and type of risk, (ii) measuring the extent of the risk and (iii) determining the valid response (it can be on Balance Sheet or Off Balance Sheet) techniques.

The tools we used in risk management is knows as derivative instrument or financial engineering. A derivative instrument is one whose value depends on the value of an underlying security, commodity or index. It derives its value from the value of the underlying commodity. It means that the price of the derivative and the price of the underlying commodity will be closely related. Common forms of derivatives would be Forwards, Futures, Options, and Swaps or exotics derivatives such as Swaptions, Long Term Equity Anticipation Security (LEAPs) and collateralized mortgage obligation (CMO). By using derivatives instrument, firm and investors believe that it enable to avoid unnecessary risks. However, the conventional derivatives tools are very complex in general and very risky contracts having the current market value of trillions of dollars around the world. As reported in one of the articles in the Economists magazine mentioned that there are about $128 trillion of over the counter derivatives were outstanding in June 2002. Today, as world becoming increasingly brittle as more and more derivative and hedging instrument emerge. This has left Islamic institutions with far fewer hedging instrument than their conventional peers. Islamic financial industry has been performing well compared to their counterparts as all their assets are backed by real asset or tangible asset. However, the common problem that always associated with Islamic financial industry would be risk factors.

Innovative Islamic financial product being developed as this industry expands rapidly. However, there are some products are almost similar as conventional counterparts but it is adapted tom meet Muslim needs and demands. One of financial product that mostly debateable in Islamic finance would be “Option” and it is still in the process adapt it in the Islamic financial institution.

Conventionally speaking, option is defined as short – term claims on the underlying stock, are created by investors and sold to other investors. According to (Jordan & Dolvin, 2012), option is created when someone writes (sells) it. Option can be created and destroyed; therefore, there is no predefined number of puts and calls. Options can be divided into two categories, namely (i) call option where it defined as option to buy a specified number of shares of stock at a stated price given specified time period and (ii) put option is known as option to sell a specified of shares of stock at a stated amount of price and specified time period. However, the acceptance of option from Islamic perspectives become one of the most debateable issues in Islamic finance nowadays. In line with this, the current study attempts to explore the puzzle of option issues in regards with Islamic principles and Shariah point of views by reviewing the scholar opinions on options.

As reported by (Mckinsey, 2005), Islamic financial institutions on investment emerged as a response to rising investor demand in the Middle East in the 1970s and is now making notable inroads into the Islamic community all through worldwide at an estimated cumulative average growth rate (CAGR) of 15% . The market growth has been primarily investor-driven. On the whole, a huge collection of financial institutions are managing the estimated US$250 billion to $300 billion of Islamic funds nowadays. However, as the market industry grow greater day by day, at the same time, risk associated to these investments expand relatively.

Literature Review

Islamic Finance and Shariah Prohibitions

As mentioned by (Aggarwal and Yousef, 2000), Islamic finance is getting popular among private and public stakeholders. This industry shows a rapid growth in term of size where the assets are increased tremendously and hold in excess of $100 billion by participating in more than 60 over countries worldwide. According to the (Zaher and Hassan, 2001), in coming ten
years’ time, this institution is subjected to growth around 40 to 50 percent in term of saving. The financial products offered by Islamic financial institution are in line with Islamic teachings (the Shariah) which are governed by two primary sources—the Muslim Holy Book (the Qur’an) and the Sunnah of Prophet Muhammad (pbuh). According to the Shariah law, taking or giving interest are prohibited and it is the most important feature of Islamic banking. Therefore, most of the financing sources are developed based on profit sharing and fee-based financing which compliance with shariah laws. This mode of financing have applied in retail, private and commercial banking for debt and capital market, insurance, asset management, structured and project financing, derivatives, etc. Therefore, in a nutshell, all Islamic financial instruments in general must meet a number of criteria in order to be considered halal (acceptable). Even though Islamic finance industry is an important part of the global financial fabric, it is also not that immune from many obstacles faced by the global financial industry.

Any businesses would anticipate going for capital protection to make sure stable profit realization is attainable. Derivatives (forward contract, futures contract, options contract, swaps contract) are the tools used not to eliminate totally risk incurred in any commerce transaction, but at least these tools helps to minimize the occurrence of losses to face by an institution. Principles of capital protection, risk management and risk hedging acceptable to general principles of Islamic law.

Figure 1: Shariah Prohibitions

- **Riba**: Prohibit taking or giving interest rate
- **Masir**: Involved in gambling or speculative type of business and transaction
- **Gharar**: Uncertainty about the term of contract or the subject matter
- **Undesirable**: type of business which dealing with alcohol, gambling etc.

From figure 1, in order to develop financial products, it must fulfill the above-mentioned Islamic principles and shariah compliant. (Bacha O. I., 2010)

a) Riba can be in different forms and is prohibited in all its forms. For example, Riba can also occur when one gets a positive return without taking any risk.

b) As for gharar, there appears to be no consensus on what gharar means. It has been taken to mean, unnecessary risk, deception or intentionally induced uncertainty.

c) Masyir from a financial instrument viewpoint would be one where the outcome is purely dependent on chance alone – as in speculation.

d) In the context of financial transactions, involved in the business that is alcoholic based company, gambling etc.
Analysis of Islamic Options

In line with the growth and product innovation in Islamic finance industry, fundamental hedging and risk management tools are in need to develop within the Shariah parameter in order to maintain not only Shariah compliance credibility, but as well as to enlarge trade between banks, intermediaries and corporate institutions. It is important that counterparties to have such access to the products in order for Islamic finance industry to continue its growth and increased level of financial intermediation to occur as an effort to deepen the Islamic finance market.

Risk and return are two common measurements for business entity. The higher the risk, the more return are suspected to decrease in value. Risk management is a crucial strategies needed for every business organizations. Risk controlling product allow market participant to engage in micro level to avoid undesirable risks. These products make it possible to transfer the risk to other participants who like to bear them (Obaidullah M., 2002). Among the risk management techniques well-known are hedging practices which acknowledge as the derivatives tools. Derivatives participants like individuals and companies employ themselves to transfer for a price any undesired risk to other parties who possess risk that offset or who want to assume that risk (Chance, 2004). All traded options come into two types which are call option and put option. Arab writers used different term for options, the most commonly is known as Amaliyat Al Shartiyyah Al Ajilah (deferred conditional transactions).

We present two examples, to show how Islamic option functions in hedging price fluctuation based on conventional counterpart. One for call option and another one for put option for Islamic options.

Example 1: Hedging using Call option

Mr. Ali bought a March Call Option on Coke at a strike price of $40.00 Mr. Ali paid a premium of $1.60 on the option. The market price for Coke is $41.15. Assuming Mr. Ali just hold the Call option till expiry (end of March). The market price of Coke ended at $39.25 on the expiry date. Since the strike price is $40.00, then the call option will be worthless. Now, let assume the price of Coke went up to $41.00. Mr. Ali could bought the Coke shares at $40.00 (strike price) and “gain” $1.00 on this purchase. However, Mr. Ali paid $1.60 for the call option, so he net lost is $0.60. But this is still better than losing $1.60 by not exercising the call option. If the price of Coke appreciates, the value of the Call option will appreciate accordingly. Mr. Ali could sell the Call option in the secondary market and gain on the difference. For example, if the price of Coke has gone up to $45 and the Call option price gone to $5.30, Mr. Ali can sell the Call option at $5 and make a profit of $3.70. By buying the Call option of Coke at $1.60, Mr. Ali was able to limit his lost to the maximum of $1.60. However, the gain that Mr. Ali could enjoy in the event that the market price of Coke raise is unlimited.

Example 2: Hedging using Put option

A writer (seller of option is called writer: Assume, Mr. Osman) sells a March Coke Put option at an exercise price of $45. At the time, market price of Coke was $41.15 and the premium of the put option was $3.70. Let say, the market price of Coke drop to $35.00. The Put option owner (buyer, assume Mr. Salman), who did not own the share of Coke, previously, could instruct his broker to buy Coke share from the market at $35. At the same time, Mr. Salman can exercise the Put option and sell the share at $45. Here, Mr. Salman will make $10 from this exercise. Since he paid $3.70 for the Put option, he still has a net gain of $6.30. If the share price of Coke increases to more than $45, then Mr. Salman could just let the Put option expired and lost the entire premium that he paid for the put option ($3.70).
However, the question arises in practicing this risk management tools from an Islamic perspectives. Researchers have studied the custom of financial moral conduct which is applicable to financial market from the view of Holy Quran and Sunnah. (Obaidullah M., 2002) define the norms of Islamic financial ethics into few measures;

a) Freedom of Contract – this mean that buyer and seller shall have the freedom to enter the transaction without any enforcement from any party. If any coercion involve in this issue, the contract will become invalid.

b) Freedom from Al Riba – all form of contract must not enclose with any element of Riba. This indicates that there is no reward for time preference and under condition of zero risk (Al Suwailem, 2006). Issues on Riba definition and implications are highlighted in voluminous literatures which clearly explain its irrationality of application.

c) Freedom from Al Gharar (Excessive Uncertainty) – all form of contract shall be free from excessive uncertainties which are not permissible by Islamic scholars which conditions and situation are highlighted to not promoting the value of justice (Adl) among partakers. To lessen the usage of al-gharar in Islamic option trading, (Elahi & Aziz, 2011) suggest to apply the al-ikhtiyar concept. This are said to benefit the Islamic option trading which consequently may reduce the conflict between parties as al-ikhtiyar minimize incorrect decisions among them (Obaidullah M., 1998).

d) Freedom from Al Qimar (gambling) and Al Maysir (Unearned Income) – contracts having the element of gambling are strictly prohibited. An uninformed speculation in its worst form is also akin to gambling. Furthermore, a contract that involves game of chance or unearned income is not permissible in the eyes of Al-Quran and Al-Hadith.

e) Freedom from Price Control and Manipulation – Islam promotes the value of justice in commencing any deals. Freedom of interference even from regulators in the price formation process shall take place in order to reach ethical business conduct. The price should be purely determined by market forces (demand and supply). Any manipulation with the intention of influencing price through the creation of artificial demand/supply is seen to be immoral.

f) Entitle to transact at Fair Price – if there is any difference between business deal price and fair price based on expert valuation, it is defined as gubn, which are considered to be unethical.

g) Entitle to Equal, Adequate and Accurate Information – Islamic ethics requires that all relevant information shall be disclosed for both partakers in business dealing. Release of inaccurate information is forbidden. The party having information disadvantage may call to annul the contract at the time of entering into contract. Islamic scholars urge that the contract should also be free from any mispresentation to be considered Islamic. Islamic ethics require that all information relevant to expected cash flows and assets valuation should be equally accessible to all market investors.

h) Freedom from Darar (Detriment) – this refer to third party being adversely affected due to contract among two parties. Any contract enacted should not impair to third party interest.

i) Maslahah Mursalah (Unrestricted Public Interest) – this mean consideration which secures a benefit or prevents harm, in a mean time, harmonious with the objective of Shariah (Maqasid Shariah). These objectives are to protect five essential values, that is; religion, life, intellect, lineage and property.

Given that all listed norms of Islamic financial principles above, Hanbali school provide that the option is invalid in exchange of Ribawi good (gold, silver, barley, dates, salt, wheat) in advance purchase (Salam) and wherever the intent is to profit on a loan. Rather, Arbun/ down
Arbun contract works when buyer concludes a purchase and make an advance of some sum ($X) less the purchase price ($P), stipulate that if he decide to take the good, he will pay the price minus the advance ($P - $X), but if he decide not to take the good, then the seller keeps the advance paid earlier by the buyer.

Diagram below depicted from (Elahi & Aziz, 2011) which indicate how Islamic option is divided in it categories of rights which may influence to the validity of a contract in the eye of Shariah. It can be divided into several which are: Khiyar Al-Shart (Option as a Condition), Khiyar Al-Ayb (Option from Defect), Khiyar Al-Tayeen (Option of Determination or Choice), Khiyar Al-Ruyat (Option of Inspection), Khiyar-Al-Majlis (Option of Meeting/Acceptance), Khiyar Al- Ghabn (Option of Deception), Khiyar Al-Taakhir (Option of Delay), Khiyar Kashf Al-Hal (Option of Status), Khiyar Al-Naqd (Option of Payment), Khiyar Al-Qabul (Option of Accept) and Khiyar Al-Taghhrir (Option of Fraud).

**Figure 2: Structure of Al-Khiyarat (Islamic Option)**

One of the main challenges in al-khiyarat is on the issue of time, time of delivery matter and conditions of contract. On the issue of timing for instance, the trading may be cancelled during the khiyar al shart or khiyar al-takhir. Taking consider on the condition of contract, if any of the condition is not comply, it may constitute to impermissibility of the contract.

In order to have clear view on option applicability from Islamic perspective, this paper will categories altogether comprehensive view among Islamic scholar’s argument against and argument for acceptance:
Arguments against the acceptability of option contract

a) Islamic option contract are mainly executed on the principle of Arbun contract. According to (Vogel & Hayes, 1998), most scholars declare Arbun contract as void agreement on the ground that this was forbad by Prophet in hadith. Further, it is said that Arbun makes a gift conditional on a sale, therefore offend principle against combining cost-free contract with difficult ones. It also adds to standard sale contracts more than one additional term (shart), which a hadith forbids. It is also argued to be part of gambling. In addition, the buyers need not to fix a time frame for the option, thus result the contract to be fatally indefinite. OIC Academy has endorsed Arbun contract if only the time limit is specified.

b) Overall, derivatives are mainly defined as zero sum game whereby if one counter party makes losses, the other counter party market gain/surplus (Greenspan A., 1999). Here, it clearly understandable that contract with same effect to gambling is strictly prohibited in the eyes of Shariah.

c) (Zaher & Hassan, 2001) in their comparative literature survey of Islamic finance and banking argued that derivatives securities trade (option and futures); the option contract implies that option buyers will exercise the contract only when it is beneficial to them, while being a potential loss for the seller. Hence, when buyer imposes a loss to the seller may make such contract as null in Islamic point of view.

d) Muhammad Taqi Usmani treat option contract as unconcluded contract as unfunded or partially funded trading do not imply legal ownership and possession of the reference asset, which would guarantee the delivery of the contractual asset with full certainty in future agreed date (Usmani, 1999).

Arguments valid the acceptability of option contract

a) (Smolarski, Schapek, & Tahir, 2006) argument emphasis on unnecessary risks (gharar) consumption, the anticipate lack of a physical asset in an options agreement, and tendency to manipulate the ignorant. They argue due to these issue, options may be permitted under Shariah teaching for hedging purposes as long as the economic underlying activities are themselves permissible (halal) from Islamic point of view.

b) Shannat al Jundi, Yusuf Sulayman, and Ali Abd al-Qadir are all whom affirm the validity of options trading and concur that the option buyer pays for a right or a benefit and the seller who grants sales options is entitled to be paid for it. These are also the authors who have carefully transcribe the regulated procedures of trading options which virtually eliminate uncertainty in the transaction which eventually eradicate dispute arising between the parties.

c) (Kamali, 1997) wrote in his research of Istishtan that Khiyar al-shart (option contract) is basically disagreeable to the principle norm of contract as Khiyar al-shart enables the contracting parties to delay that moment and suspend the legal concerns of contract by means of demand to a later date. In general, contracts grow into binding as it is authentically concluded. But since khiyar al-shart has been clearly validated in the hadith, on grounds of equity and fairness - which is to provide one or both of the contracting parties with an opportunity to decide whether or not to ratify the contract. It is then said that the Sunnah validated option contract with respect to istishtan.

d) Analysing on fundamental option contract, for example time to maturity, premiums, and delivery mechanism shows that essentially there is no sense of frightful in granting an option, exercising it over certain time or imposing a fee for it. Likewise, option trading, in the same way as different mixtures of trade is allowable (mubah) and thus it is basically the basic freedom that the Quran has acknowledged (Kamali,
1995 cited in (Bacha O. I., 1999)). A fundamental freedom here does not imply that we are allowed to lead any trades. Nonetheless, one who manages the trade must be concerned with particular requirement that are expressed in the Quran, such as, one cannot apply trick, cannot manipulate, cannot speculate, and etc. (Raysuni, 1993).

e) (Vogel & Hayes, 1998) study claim that only the Hanbali school of thought uphold Arbun contract (options sales contract). They cite a story from the time of Caliph Umar, in which an official purchased a house for a prison, giving an advance to hold the house pending Caliph Umar approval. Another hadith recount that famous judges approval of an individual’s reserving a lease on a caravan and promising to pay penalty if he fails to take it.

f) Few scholars allow option contracts operation and view it as helpful (manfaa) within the context of wealth (maal). Hence the option contract is permitted as it offers the buyer a benefit. However, it is not agreeable since the one who attain the benefit is only the purchaser. Concern is not given to the seller which gets very minute advantage. This shows that the buyer is perceived to be more significant than the seller. Trading of warrant is permitted by Malaysian SEC since it possess the character of an asset which fulfills the concepts of haqq mali and haqq tawalluq which is transferable based on the majority of fiqahas views. Thus, this right can be classified as an asset and it can be traded (Obaidullah M., 2002).

g) After critically review the accepted contract and the scholars’ debate, (Jobst & Solé, 2012) found that their research on operative principle of Islamic derivatives offers an obvious perspective on a principle-based permissibility of derivatives under Islamic law.

Conclusion

From analyzing the opinion of scholars above, it shows that Islamic options contract is still debatable on its permissibility from Shariah perspective. However, considering all the facts and respect to the opinion of scholars, this paper found that permissibility on Islamic options shall be granted if this instrument fulfilled the features of mal (property) according to Islamic jurisprudence as outlined in the haq maliy and haq tamalluk principles. Haq may be traded if it complies with Islamic principles and conditions of buying and selling. An options is a right to trade, not an obligation, thus to make sure this is permissible, it should possess three significant features which are; underlying assets, exercise price and exercise period. Underlying assets is a must for any contract to take place by giving the right, not the obligation to buy/sell at agreed price on a certain date or future date. The time period shall be fixed in order to eliminate confusion within the exercise price. The validity of exercise options shall also be constraint in time which will later than it has no value. Having this instrument will further assist on the development of Islamic finance to step up further as better option than the conventional banking system which are known of its defaults.

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1 Ibn Qudama, 4:289; Muhyi al-Din al-Nawawi (d.676), Kitab al-Majmu’ (Jedd: Maktabat al Irshad, 1992) 9:408

2 Bukhari 2:124
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