

# Financial options in Islamic contracts Potential tools for risk management

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**Abstract.** The paper attempts to undertake an Islamic assessment of financial contracting in the global currency markets. Some basic currency-related contracts in mainstream finance, such as, spot transactions, options, forwards, futures, swaps are examined in the light of Islamic norms of financial ethics, such as, freedom from riba, gharar, jahl, qimar and maisir

The study also highlights the views of Islamic scholars on various conventional as well as Shariah-based contractual mechanisms. In cases where there is some degree of divergence of views, the study examines the nature and source of disagreement as also the implications and economic significance of the arguments. In view of the overwhelming importance of currency risk management in volatile markets, the study undertakes an assessment of the various financial contracts as risk management tools

Islamisation of currency markets poses a great challenge to Islamic scholars and thinkers even today. The elimination of riba, gharar, qimar and maisir are among the major goals of the process of Islamisation of financial markets. While significant success has been achieved in engineering an alternative Islamic model in specific segments of the financial markets, such as banking and the insurance sector, the same has not been the case with currency markets. A majority of Islamic scholars have held a view, that only spot transactions in currencies, both domestic and foreign, are permissible

This view, specifically in relation to exchange of foreign currencies, has been labelled as unduly restrictive and somewhat impractical by policy makers and regulators in most Islamic economies. Further, with divergent views (i.e. other Islamic scholars, the issue is perhaps largely unresolved

The outcome has been that the currency markets all over the globe have continued with "un-Islamic" transactions with all the undesirable consequences that follow. Ironically, the Islamic world has realised the urgency of implementing the Islamic and ethical alternative after incurring a heavy cost, as some of the fastest growing Islamic economies in South East Asia have been engulfed in an unprecedented

financial crisis, primarily because of riba-based and maisir-driven contracting .that were permitted in these markets

The purpose of this paper is to identify the Islamic system for currency exchange. Since the financial system essentially implies the system of financial contracting, the paper focuses on the Islami city of alternative contractual mechanisms in the currency markets in the light of Islamic norms of ethics, such as, prohibition of riba, gharar and maisir. The paper seeks to present a comprehensive analysis of various arguments in support of and against the permissibility of some basic contracts involving currencies. Section 2 discusses some basic forms of contracting from the Islamic legal literature that may have relevance for currency .markets

These are also compared and contrasted with currency-related contracts found in conventional markets, such as, spot contracts, forwards, futures, options, and swaps. We also undertake a survey of past studies that have examined the Islamicity of these conventional contracts. In section 3 we explicitly deal with the issue of prohibition of riba from a fiqhi point of view and examine the various contracts from the standpoint of riba prohibition. The central theme of section 4 .is the issue of gharar and maisir

We examine the various forms of contracting in the light of the Islamic requirement to avoid excessive gharar and minimise the possibility of speculative gains or maisir. In section 5 we examine the issue of risk management in volatile currency markets which is often used as an argument for tolerating speculative abuse of various conventional mechanisms called currency options, futures, .forwards and swaps

We also highlight some Islamic alternatives for risk management. Section 6 attempts to evaluate the contractual mechanisms from another fiqhi perspective, the issue of swapping one debt for another or bai al kali hi al kali . Section 7 undertakes a holistic view of all the Shariah related issues as also their economic .significance and provides a summary of major conclusions

**FORMS OF CONTRACTING:** The Islamic law of contracts explicitly deals with exchange of currencies. There is a general consensus among Islamic jurists on the view that currencies of different countries can be exchanged on a spot basis at a .rate different from unit

There also seems to be a general agreement among a majority of scholars on the view that currency exchange on a forward basis is not permissible, that is, when the rights and obligations of both parties relate to a future date. However, there is considerable disagreement among jurists when the rights of either one of the

parties, which is same as obligation of the counterparty, is deferred to a future .date

To elaborate, let us consider the example of two individuals A and B who belong to two different countries, India and US respectively. A intends to sell Indian rupees and buy US dollars. The converse is true for B. the rupee-dollar exchange rate agreed upon is 1:20 and the transaction involves buying and selling of \$50. The first situation is that A makes a spot payment of Rs 1000 to B and accepts payment of \$50 from B. The transaction is settled on a spot basis from both ends. Such transactions are valid and Islamically permissible. There are no two .opinions about the same

It may be noted here that the real life spot markets for currencies often provide for actual delivery within 48 hours or two banking business days due to practical reasons (for example, time differences among various global markets). Some authors, such as M. Akram Khan (1988) have argued that the above practice of .allowing a two day lag cannot be accepted in the Islamic framework

Others consider this position to be too rigid and find this practice to be Islamically acceptable on the ground that the so-called time lag involved in the spot transaction is not a time lag between the delivery of one currency compared to the delivery of the other, but rather is a lag between the deals date and the execution date. Further, even if there is a time lag, the same does not affect the .price or the exchange rate between the two currencies involved

The second possibility is that the transaction is partly settled from one end only. For example, A makes a payment of Rs 1000 now to B in lieu of a promise by B to pay \$50 to him after six months. Alternatively, A accepts \$50 now from B and .promises to pay Rs 1000 to him after six months

There are diametrically opposite views on the permissibility of such contracts. The Fiqh Academies across the globe have been deliberating on the permissibility of such contracts. Among the scholars who argue in favour of permissibility of such contracts, the views of Justice Muhammed Taqi Usmani have received wide .attention

On the other hand, scholars, such as, Dr M. Nejatullah Siddiqi have sought to justify the more commonly held view that only spot settlement is permissible in case of currency exchange on the ground that if settlement from one end is allowed to be deferred to a future date, this would become a source of earning riba. Such contracts are however, not very common in the conventional financial .markets

The third scenario is that settlement of the transaction from both ends is deferred to a future date, say after six months from now. This implies that both A and B would make and accept payment of Rs 1000 or \$50, at the case may be, after six months. Such contracts are known as currency forwards and futures in mainstream finance. The predominant view is that such contracts are not Islamically permissible. The Islamic Fiqh Academy, Jeddah in its seventh session clearly ruled out the permissibility of such contracts

According to Justice Taqi Usmani, "it is a well recognised principle of the Shariah that sale and purchase cannot be effected for a future date. Therefore, all forward and future transactions are invalid in Shariah. Secondly, because in most of the futures transactions, delivery of the commodities or their possession is not intended. In most cases, the transactions end up with the settlement of difference of prices only, which is not allowed in the Shariah

As futures are not permissible, no rights and obligations can emanate therefrom. (Further), futures are totally impermissible regardless of their subject matter. Similarly, it makes no difference whether these contracts are entered into for the purpose of speculation or for the purpose of hedging." Other contemporary scholars, such as, Subhi Mahmassani (1983), M Akram Khan (1988), M Fahim Khan (1995) and Kamali (1996) have also examined the Islamicity of forwards and futures and have found these contracts to be forbidden, the notable exception being Kamali (1996). M Mahmassani notes, "contracts concerning future things (al ashya al mustaqbalah) are basically invalid, for such things are non-existent at the time of contract- except for the fact that the majority of the jurists have exceptionally permitted certain contracts such as salam (forward sale) and istisna (contract of manufacture)." M Akram Khan prefers to make a clear distinction between forwards and futures as the latter have a "strong element of speculation

While condemning the latter, Khan observes that the former are not legally enforceable. The two parties may "agree" or "promise" to transact an exchange business at a future date and that such an agreement is "morally" enforceable. Mohammed Fahim Khan finds currency forwards and futures to be totally forbidden and prefers to examine only the case of commodity-related contracts for possible modification and making them acceptable in the Islamic framework. As he states, "the present concept and practice of foreign currency futures involves interest as well as violates the Islamic principle of delivery with respect to exchange of currencies hand to hand." Kamali however does not find anything objectionable about futures in general, "futures trading falls under the basic "(principle of permissibility (ibahah

However, even Kamali's affirmative opinion pertains to futures in general without specifying the underlying asset. Kamali also explicitly recognises the need to view currency related contracts differently from other commodities. While asserting that possession (qabd) is not an essential requirement of sale and therefore futures may not be deemed prohibited on this ground, he also states that "only in case of sale of currency for currency (sarf) is qabd elevated to a prerequisite of a valid contract

Yet another form of contracting which has been described as an Islamic swap may be as follows. A makes a payment of Rs 1000 to and receives US \$50 from B today at the given rate 1:20. Both A and B use and invest the money so received at their own risk. At the end of a stipulated time period, say six months, the transaction is reversed

A repays US \$50 to and receives Rs 1000 from B. This form of contracting can also be viewed as an exchange of or swapping of interest-free loans between A and B. This is in contrast to conventional swaps which are generally interest-based and involve swapping of principal (often notional) and interest payments. Conventional swaps clearly have no place in the Islamic system. As discussed and demonstrated later in section 5, Islamic swaps may help both A and B in various ways, such as, enabling them to manage their currency risk. There are again divergent views on the permissibility of such contracting

The other common form of currency-related contracting in mainstream finance relates to purchase and sale of currency options. Scholars who consider that currency exchange must be settled on a spot basis rule out the possibility of any option for either or both parties. The currency option if considered as a promise, is not binding as the two parties cannot agree in advance to the rate to be applied for currency exchange in future according to the traditional Islamic law. Justice Taqi Usmani rules out the acceptability of conventional options which are promises traded as independent contracts for a fee. As he asserts, "such a promise in itself is permissible and is normally binding on the promisor

However, this promise cannot be a subject matter of sale or purchase. Therefore, the promisor cannot charge the promisee a fee for making such a promise. It makes no difference if the subject matter of the option sale is a commodity, gold, silver or a currency the contract is invalid ab-initio." The Islamic Fiqh Academy has also resolved that all forms of conventional options traded as independent contracts themselves are not permissible. These views however, do not rule out the possibility of a sale contract with a stipulated option for either party or both in the khiyar in shart (option as condition) framework of the Islamic law of

contracting. Whether the possibility also exists with respect to currency exchange .deserves further investigation

**THE ISSUE OF RIBA PROHIBITION:** The need to eliminate riba in all forms of exchange contracts is of utmost importance. This is emphasised by the Quranic verse: "But Allah has permitted sale and forbidden usury" (2:275). The original Quranic prohibition of usury or nba relates to loan contracts or riba al-jahiliyyah which surfaces when the lender asks the borrower on the maturity date if the latter would settle the debt or extend the same. Increase is accompanied by charging .interest on the amount initially borrowed

Apart from this pre--Islamic form, riba may exist in a loan contract, if it provides any advantage to the lender. Thus, provision for any excess in the amount to be repaid by the borrower over what was borrowed in the contract is a source of .usury or riba

The definition of riba was later extended to the exchange of currencies and several denominated articles, primarily based on several hadiths. One hadith that is widely quoted by scholars because of its concise form is: the Holy Prophet (peace be upon him) said, "Exchange gold for gold, silver for silver, wheat for wheat, barley for barley, date for date, salt for salt, measure for measure and - hand-to-hand; and when the articles of exchange are different, exchange as it suits you, but hand-to-hand." The prohibition W~S further extended by fiqh scholars to .exchange of commodities other than the six mentioned in the hadith

Riba in any exchange or sale contract is defined by fiqh scholars as "an unlawful gain derived from the quantitative inequality of the counter values in any transaction purporting to effect the exchange of two or more species (anwa), which belong to the same genus (jins) and are governed by the same efficient cause (illah)." Riba is generally classified into riba al-fad! (excess) and riba al-nasia (deferment) which denote an unlawful advantage by way of excess or deferment respectively. Prohibition of the for :~ier is achieved by a stipulation that the rate of exchange between the objects is unity and no gain is permissible to either party. The latter kind of riba is prohibited by disallowing deferred .settlement and ensuring that the transaction is settled on the spot by both parties

The prohibition of riba in the exchange of currencies belonging to different countries requires a process of analogy (qiyas). And in any such exercise involving analogy (qiyas), efficient cause (illah) plays an extremely important role. It is a common efficient cause (illah), which connects the object of the analogy with its subject, in the exercise of analogical reasoning. The appropriate efficient cause (illah) in case of exchange contracts has been variously defined by



the major schools of Fiqh. This difference is reflected in the analogous reasoning for paper currencies belonging to different countries

A question of considerable significance in the process of analogous reasoning relates to the comparison between paper currencies with gold and silver. In the early days of Islam, gold and silver performed all the functions of money (thaman). Currencies were made of gold and silver with a known intrinsic value (quantum of gold or silver contained in them). Such currencies are described as thaman haqiqi, or naqdain in fiqh literature. These were universally acceptable as principal means of exchange, accounting for a large chunk of transactions. Many other commodities such as various inferior metals also served as means of exchange, but with limited acceptability. These are described as fals in fiqh literature.

These are also known as thaman istilahi because of the fact that their acceptability stems not from their intrinsic worth, but due to the status accorded by the society during a particular period of time. The above two forms of currencies have been treated very differently by early Islamic jurists - from the standpoint of permissibility of contracts involving them. The issue that needs to be resolved is whether the present age paper currencies fall under the former category or the latter. One view is that these should be treated at par with thaman haqiqi or gold and silver, since these serve as the principal means of exchange and unit of account like the latter.

Hence, by analogous reasoning, all the Shariah-related norms and injunctions applicable to thaman haqiqi should also be applicable to paper currency. Exchange of thaman haqiqi is known as bai-sarf, and hence, the transactions in paper currencies should be governed by the Shariah rule relevant for bai-sarf. The contrary view asserts that paper currencies should be treated in a manner similar to fals or thaman istilahi because of the fact that their face value is different from their intrinsic worth. Their acceptability stems from their legal status within the domestic country or global economic importance (as in case of US dollars, for instance).

**ANALOGICAL REASONING (QIYAS) FOR RIBA PROHIBITION:** The prohibition of riba according to the above quoted hadith applies to the two precious metals (gold and silver) and four other commodities (wheat, barley, dates and salt). It also applies, by analogy (qiyas), to all species which are governed by the same efficient cause (illah) or which belong to any one of the genera of the six objects cited in the tradition.

However, there is no general agreement among the various schools of Fiqh and even scholars belonging to the same school, on the definition and identification of efficient cause (illah) of riba. For the Hanafis, efficient cause (illah) of nba has two dimensions: the exchanged articles belong to the same genus (jins); these .(possess weight (wazan) or measurability (kailiyya

If in a given exchange, both the elements of efficient cause (illah) are present, that is, the exchanged countervalues belong to the same genus (jins) and are all weighable or all measurable, then no gain is permissible (the exchange rate must be equal to unity) and the exchange must be on a spot basis. In case of gold and silver, the two elements of efficient cause (illah) are: unity of genus (jins) and .weighability

Thus, when gold is exchanged for gold, or silver is exchanged for silver, only spot transactions without any gain are permissible. It is also possible that in a given exchange, one of the two elements of efficient cause (illah) is present and the other is absent. For example, if the exchanged articles are all weighable on measurable but belong to different genus (jins) or, if the exchanged articles belong to same genus (jins) but neither is weighable nor measurable, then exchange with gain (at a rate different from unity) is permissible, but the exchange must be on a spot basis. Thus, when gold is exchanged for silver, the .rate can be different from unity but no deferred settlement is permissible

Further, the possibility of stipulating options in the contract for either or both parties is also not lawful. It is stated in al-Hidaya that such stipulations are preventive of mutual seisin (or settlement), which is an indispensable condition. If none of the two elements of efficient cause (illah) of riba are present in a given exchange, then none of the injunctions for riba prohibition apply. Exchange can .take place with or without gain and both on a spot or deferred basis

Considering the case of exchange involving paper currencies belonging to different countries, riba prohibition would require a search for efficient cause (illah). Currencies belonging to different countries are clearly distinct entities; these are legal tender within specific geographical boundaries with different intrinsic worth or purchasing power. Hence, a large majority of scholars perhaps rightly assert that there is no unity of genus (jins). Additionally, these are neither weighable nor measurable. This leads to a direct conclusion that none of the two .elements of efficient cause (illah) of riba exist in such exchange

Hence, the exchange can take place free from any injunction regarding the rate of exchange and the manner of settlement. The logic underlying this position is not difficult to comprehend. The intrinsic worth of paper currencies belonging to



different countries differ as these have different purchasing power. Additionally, the intrinsic value or worth of paper currencies cannot be identified or assessed unlike gold and silver which can be weighed. Hence, neither the presence of *riba al-fadl* (by excess), nor *riba al-nasia* (by deferment) can be established

The Shafi'i school of *fiqh* considers the efficient cause (*illah*) in case of gold and silver to be their property of being currency (*thamaniyya*) or the medium of exchange, unit of account and store of value. However, the efficient cause (*illah*) of being currency (*thamaniyya*) is specific to gold and silver, and cannot be generalised. That is, any other object, if used as a medium of exchange, cannot be included in their category. Hence, according to this version, the Shariah injunctions for *riba* prohibition are not applicable to paper currencies

The Maliki view also considers the efficient cause (*illah*) in case of gold and silver to be their property of being currency (*thamaniyya*) or the medium of exchange, unit of account and store of value. However, according to this view, even if paper or leather is made the medium of exchange and is given the status of currency, then all the rules pertaining to *naqdain*, or gold and silver apply to them

Thus, according to this view, exchange involving currencies of different countries at a rate different from unity is permissible, but must be settled on a spot basis. As far as Hanbali view is concerned, different versions attributed to Ahmad Ibn Hanbal have been recorded as documented in *al-Mughni* by Ibn Qudama. The first version is similar to the Hanafi version while the second version is close to the Shafi'i and Maliki version

**COMPARISON BETWEEN CURRENCY EXCHANGE AND BAI-SARF:** *Bai-sarf* is defined in *fiqh* literature as an exchange involving *thaman haqiqi*, defined as gold and silver, which served as the principal medium of exchange for almost all major transactions

Proponents of the view that any exchange of currencies of different countries is same as *bai-sarf* argue that in the present age paper currencies have effectively and completely replaced gold and silver as the medium of exchange. Hence, by analogy, exchange involving such currencies should be governed by the same Shariah rules and injunctions as *bai-sarf*. It is also argued that if deferred settlement by either parties to the contract is permitted, this would open the possibilities of *riba-al nasia*

Opponents of categorisation of currency exchange with *hai-sarf* however point out that the exchange of all forms of currency (*thaman*) cannot be termed as *bai-sarf*. According to this view *bai-sarf* implies exchange of currencies made of gold and silver (*thaman haqiqi* or *naqdain*) alone and not of money pronounced as such

by the state authorities (thaman istilahi). The present age currencies are examples of the latter kind. These scholars find support in those writings which assert that if the commodities of exchange are not gold or silver, (even if one of these is gold or silver) then, the exchange cannot be termed as bai-sarf. Nor would the stipulations regarding bai-sarf be applicable to such exchanges

According to Irnam Sarakhsi, "when an individual purchases fals or coins made out of inferior metals, such as, copper (thaman istilahi) for dirhams (thaman haqiqi) and makes a spot payment of the latter, but the seller does not have fals at that moment, then such exchange is permissible. . . .taking possession of commodities exchanged by both parties is not a precondition" (while in case of bai-sari it is.) A number of similar references exist which indicate that jurists do not classify an exchange of fals (thaman istilahi) for another fals (thaman istilahi) or for gold or silver (thaman haqiqi), as bai-sarf

Hence, the exchanges of currencies of two different countries which can only qualify as thaman istilahi can not be categorised as bai-sarf. Nor can the constraint regarding spot settlement be imposed on such transactions. It should be noted here that the definition of bai-sarf is provided in fiqh literature and there is no mention of the same in the holy traditions. The traditions mention about nba, and the sale and purchase of gold and silver (naqdain) which may be a major source of nba, is described as bai-sarf by the Islamic jurists. It should also be noted that in fiqh literature, bai-sarf implies exchange of gold or silver only; whether these are currently being used as medium of exchange or not

Exchange involving dinars and gold ornaments, both qualify as bai-sarf. Various jurists have sought to clarify this point and have defined sarf as that exchange in which both the commodities exchanged are in the nature of thaman, not necessarily thaman themselves. Hence, even when one of the commodities is processed gold (say, ornaments), such exchange is called bai-sarf

Proponents of the view that currency exchange should be treated in a manner similar to bai-sarf also derive support from writings of eminent Islamic jurists. According to Imam Ibn Taimiya "anything that performs the functions of medium of exchange, unit of account, and store of value is called thaman, (not necessarily limited to gold and silver). As far as the views of Imam Sarakhsi regarding exchange involving fals is concerned, according to them, some additional points need to be taken note of. In the early days of Islam, dinars and dirhams made of gold and- silver were mostly used as medium of exchange in all major transactions. Only the minor ones were settled with fals

In other words, fals did not possess the characteristics of money or thamaniyya in full and was hardly used as store of value or unit of account and was more in the nature of commodity. Hence there was no restriction on purchase of the same for gold and silver on a deferred basis. The present day currencies have all the features of thaman and are meant to be thaman only. The exchange involving currencies of different countries is same as bai-sarf with difference of jins and .hence, deferred settlement would lead to riba al-nasia

Dr Mohammed Ncjatullah Siddiqi illustrates this possibility with an example. He writes "In a given moment in time when the market rate of exchange between dollar and rupee is 1:20, if an individual purchases \$50 at the rate of 1:22 (settlement of his obligation in rupees deferred to a future date), then it is highly probable that he is in fact, borrowing Rs 1000 now in lieu of a promise to repay Rs 1100 on a specified later date. (Since, he can obtain Rs 1000 now, exchanging the \$50 purchased on credit at spot rate) "Thus, sari can be converted into interest-".based borrowing and lending

DEFINING THAMANIYYA: It appears from the above synthesis of ۳,۳ alternative views that the key issue seems to be a correct definition of thamaniyya. For instance, a fundamental question that leads to divergent positions on permissibility relates to whether thamaniyya is specific to gold and silver, or can be associated with anything that performs the functions of money. We raise some issues below, which may be taken into account in any exercise in reconsideration .of alternative positions

It should be appreciated that thamaniyya may not be absolute and may vary in degrees. It is true that paper currencies have completely replaced gold and silver as medium of exchange, unit of account and store of value. In this sense, paper currencies can be said to possess thamaniyya. However, this is true for domestic currencies only and may not be true for foreign currencies. In other words, Indian rupees possess thamaniyya within the geographical boundaries of India only, and .do not have any acceptability in US

THESE CANNOT BE SAID TO POSSESS THAMANIYYA IN US UNLESS A US CITIZEN CAN USE: Indian rupees as a medium of exchange, or unit of account, or store of value. In most cases such a possibility is remote. This possibility is also a function of the exchange rate mechanism in place, such as, convertibility of Indian rupees into US dollars, and whether a fixed or floating exchange rate system is in place. For example, assuming free convertibility of Indian rupees into US dollars and vice versa, and a fixed exchange rate system in which the rupee-dollar exchange rate is not expected to increase or decrease in .the foreseeable future, thamaniyya of rupee in US is considerably improved

The example cited by Dr Nejatullah Siddiqi also appears quite robust under the circumstances. Permission to exchange rupees for dollars on a deferred basis (from one end, of course) at a rate different from the spot rate (official rate which is likely to remain fixed till the date of settlement) would be a clear case of .interest-based borrowing and lending

However, if the assumption of' fixed exchange rate is relaxed and the present system of fluctuating and volatile exchange rates is assumed to be the case, then it can be shown that the case of riba al-nasia breaks down. We rewrite his example: "In a given' moment in time when the market rate of exchange between dollar and rupee is 1:20, if an individual purchases \$50 at the rate of~1:22 (settlement of his obligation in rupees deferred to a future date), then it is highly probable that he is, in fact, borrowing Rs 1000 now in lieu of a promise to repay Rs 1100 on a specified later date. (Since, he can obtain Rs 1000 now, exchanging the \$50 purchased on credit at spot rate)". This would be so, only if the currency risk is non-existent (exchange rate remains at 1:20), or is borne by the seller of .(dollars (buyer repays in rupees and not in dollars

If the former is true, then the seller of the dollars (lender) receives a predetermined return of ten percent when he converts Rs 1100 received on the maturity date into \$55 (at an exchange rate of 1:20). However, if the latter is true, then the return to the seller (or the lender) is not predetermined. It need not even be positive. For example, if the rupee-dollar exchange rate increases to 1:25, then the seller of dollar would receive only \$44 (Rs 1100 converted into dollars) for .his investment of \$50