

PERMISSIBILITY OF CERTAIN FINANCIAL CONTRACTS

Q: 3- I have attempted to give examples of some financial contracts which can be used for various purposes - for risk reduction or hedging and speculation involving options, futures, and swaps; and direct and indirect investment in equity. Kindly let me know to what extent these are permissible under Islam.

FUTURES CONTRACTS ON STOCK EXCHANGE

Q:4- 1. An example of a future contract in shares:

i) Two individuals, A and B enter into a contract on 1st January 1996 under which A would sell a share of company X at a price of \$100 to B after an expiry of six months. B has an obligation to purchase at this price irrespective of the market price on 31st June 1996.

ii) If the object of transaction is any commodity or gold, or silver, or currency and not share as in the above three cases, in what way the validity or otherwise of the contract is affected?

Please note that the non-transferability of rights and obligations severely limits the possibility of speculation on Futures Exchanges. A commonly held belief is that future contracts are prohibited when they are used for speculation. Does this imply that futures contracts are permissible when these are used for hedging?

A leading Islamic Bank's Annual Report shows that the bank entered into futures transaction for hedging its foreign currency risk. One view is that such hedging may be justified in view of extreme volatility in currency markets. (In my correspondence with a top executive of the said bank, I was given the reference of a book, Islamic Law and Finance by Chibli Mallat, I still do not have access to this book).

2. An example of an option contract in shares:

i) Two individuals, A and B enter into a contract on 1st January 1996 under which A grants a right to B without any obligation on B's part. B under the contract, gets a right to purchase a share of Company X from A any time on or before 30th June 1996 at a price of \$ 100 (irrespective of the market price on the day of purchase). B, however, does not have any obligation to purchase.

A accepts a consideration of \$5 from B for granting him his right without obligations. This is called a call option in shares.

ii) A and B enter into a contract on 1st January 1996 under which A grants a right to B without any obligation on B's part. B, under the contract, gets a right to sell a share of Company X to A

at any time on or before 30th June 1996 at a price of \$100 (irrespective of the market price on the day of purchase). B, however, does not have any obligation to sell.

A accepts a consideration of \$5 from B for granting him this right without obligations. This is called a put option in shares.

iii) A and B enter into a contract on 1st January 1996 by which A sells 100 shares of Company X at a price of \$100 per share. The transaction is settled with exchange of cash for the shares. A also grants a right to B under which B can sell back the shares to A on the expiry of six months, that is, 30th June 1996 at a price of \$ 120 per share. This right however, is cancelled if the price of the share increases beyond \$ 120 and remains at that level for 21 consecutive days before 30th June 1996.

Unlike the previous two instances of transactions in pure options, the above is a case of option as an additional feature of an equity sale and purchase.

iv) If the object of transaction is any commodity or gold, or silver, or currency and not share as in the above three cases, in what way the validity or otherwise of the contract is affected?

3. An example of an Islamic swap used by some Islamic banks:

Two banks enter into an agreement to exchange deposits for a period of six months in different currencies on 1st January 1995 at the prevailing exchange rate. Bank A exchanges Rupees 30 million with Bank B for US Dollars one million, and the Rupee-Dollar exchange rate prevailing on the date is 30:1. During these six months, each bank utilizes the deposits it received at its own risk. At the end of six months, Bank A pays back one million dollars to Bank B and receives Rupees 30 million from it irrespective of the Rupee-Dollar exchange rate prevailing on June 30, 1995, for example, the Rupee-dollar exchange rate might have become 35::1 or 25: 1 on June 30, 1995. Is this contract Islamically permissible?

4. Examples of direct and indirect investment in equity:

i) Company A raises funds by selling shares and interest-bearing bonds and invests all funds in predominantly halaal and profitable activities. Is it permissible to purchase shares of Company A for an individual?

ii) Company B raises all its funds by selling shares and invests all its funds in shares of Company A above and similar companies. Is it permissible for an individual to purchase shares of Company B ?

iii) Company X sells financial securities on which it promises dividends at a rate of 10 per cent on its total sales during the year. Is it permissible to purchase these securities where dividends are paid as a predetermined proportion of sales revenue and not profits?

Answers are as follows:

1. i) This is an example of a futures transaction. The futures transactions as in vogue in the stock and commodities markets today are not permissible for two reasons: firstly, it is a well recognized principle of Shariah that sale or purchase cannot be effected for a future date. Therefore, all forward and futures transactions are invalid in Shari'ah. 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 Shari'ah.

More detailed discussion on the Shariah aspect of futures transactions may be found in my Arabic book; 'Discussions of Contemporary Juristic Issues' under the heading "Futures Contracts in Commodities".

ii) As futures transactions are not permissible, no rights or obligations can emanate therefrom. Therefore, the question of transferring these rights and obligations does not arise.

iii) Futures transactions, as explained earlier, 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.

2. i, ii, iv, & v.) According to the principles of Shariah, an option is a promise to sell or to purchase a thing at a specific price within a specified period. Such a promise in itself is permissible and is morally binding on the promisor. However, this promise cannot be the subject matter of a sale or purchase. Therefore, the promisor cannot charge the promisee a fee for making such a promise.

Since the prevalent options transactions in the options market are based on charging fees on these promises, they are not valid according to Shari'ah. This ruling applies to all kinds of options, no matter whether they are call options or put options. Similarly, it makes no difference if the subject matter of the option sale is a commodity, gold or silver, or a currency; and as the contract is invalid ab-initio, the same cannot be transferred.

iii) This contract has two aspects; Firstly, if the option of selling back the shares to A has been made a precondition of the original sale transaction, the whole transaction will be invalid because, according to Shariah, a sale transaction cannot accept such a condition. Secondly, if the option is an independent promise without being a precondition for the original sale, no fee can be charged for such a promise as mentioned earlier. Although a complimentary promise of this kind is permissible in Shariah, it can not serve the purpose of the option market.

3. It is one of the principles of Shariah that two financial transactions cannot be tied up together in the sense that entering into one transaction is made precondition to entering into the second. Keeping this principle in view, the swap transaction referred to in the question is not permissible because the deposit of one million dollars has been made a precondition for accepting the

deposit of 30 million rupees, since both the parties will use the deposits for their own benefit, they are termed in Shari'ah as loans (Qarz) and not as trust (Wadee'ah). Therefore, advancing one loan has been made a precondition for receiving another, which means that two financial transactions are tied up together.

This is my initial opinion about this transaction. However, it needs further study and research.

4. i) If Company A raises funds by issuing shares and interest bearing bonds and invests all funds in predominantly Halaal and profitable activities, the permissibility of purchasing shares of such a company depends on four conditions:

- a. All the business activities of the company should be Halaal.
- b. The shares of such a company have to be purchased after it has acquired tangible assets like machinery, buildings, raw materials or stock in trade.
- c. If it becomes evident from the income statements of the company that a part of its income consists of interest given by the bank on its deposits, that proportion of the dividend must be given in charity.

For example, if the total profit of the company is \$100 and 5% of it has accrued through interest received on bank deposits, then 5% of the dividend must be given in charity.

- d. The shareholder should express his disagreement over depositing surplus funds in an interest bearing account and raising funds through interest bearing loans. A preferable method would be to object against??? such interest bearing transactions in the annual general meeting of the company.

If the four conditions are strictly fulfilled, it is hoped that purchasing shares of such a company will be permissible in Shariah.

A possible objection which may be raised against this ruling would be that because the company had raised a considerable amount of its funds by issuing interest bearing bonds, a substantial part of its funds is impure according to Shariah; therefore, it should not be permissible to participate in such a business. This objection may be refuted on the ground that although taking an interest bearing loan is strictly prohibited in Shariah, yet the effect of this prohibition is that the persons responsible for taking such loans will be committing a sin. However, the amounts so borrowed are treated by the Shariah as their own. Although they will be liable to punishment in the Hereafter, the money borrowed comes into their ownership and anything purchased by that money will not be treated in Shariah as Haraam.

Therefore, if the capital raised by the company consists of some amounts borrowed on interest,

it will not render the whole capital impure.

ii) If the four conditions mentioned above are fulfilled it will also be permissible to purchase the shares of Company B which has invested all its funds in the shares of Company A.

iii) It is necessary for the permissibility of Musharakah that the profits of the joint venture are distributed among the partners on an agreed proportion of the actual profit and not in proportion to the sale revenue. Therefore, it is not permissible to purchase the securities issued by Company X.

Contemporary fatawaa