دار المراجعة الشرعية

SHARIYAH
REVIEW BUREAU

RETAIL FOREX TRADING: VIEWS FROM THE FRONT LINES OF ISLAMIC FINANCE

August 2018

SHARIAH ADVISOR LICENSED BY
THE CENTRAL BANK OF BAHRAIN

Introduction

Foreign exchange trading has been one of the fastest-growing activities among private investors in the past 15 years. According to research by Citi in 2014, 4 million people are now trading currencies online, and retail traders account for around 20 per cent of the average daily turnover of the global spot forex market[1]. An estimated $5.3tn changes hands every day in the foreign exchange markets. On a daily basis, the financial institutions of the City of London make speculative currency trades worth nearly as much as the entire nation's GDP for a whole year. According to the Global Policy Forum, in 2011 only 0.6% of foreign exchange could be traced to genuine international trade in goods and services. Of the rest, a minimum of 80% was directly attributable to exchange rate speculation[2]. However, three quarters of people who trade with online currency firms lose money[3]. With such easy access to the financial markets and minimal margin requirements, it is becoming common for Muslims to consider Forex trading as an investment. Thus, this paper considers the Shariah compliance of trading in retail forex by individual Muslim investors. To appreciate the discussion on currency trading, the paper initially discusses the concept of money in Islamic economics before discussing the juristic interpretations related to fiat currencies. Thereafter, the different methods and products to trade Forex are investigated and an opinion from a Shariah perspective is offered for each type of trade.

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1 Financial Times (2015), Q&A: Retail Forex trading, Available from: www.ft.com/content/d3d46f6e

2 Andreou, A. (2013), The rise of money trading has made our economy all mud and no brick in The Guardian, Available from: www.theguardian.com/content

3 Business Insider, Some Stunning Facts About Online Currency Trading, Available from: https://www.businessinsider.com/online-currency-trading-facts-2011-4?IR=Tcommentisfree/2013/nov/20/money-trading-economy-foreign-exchange-markets-economy

MONEY IN ISLAMIC ECONOMICS

Money is an integral subject in finance and it is the lubricant of an economic system. From the Islamic point of view, money should be observed as a medium of exchange and a standard of measurement (of economic value). Imam Ibn Taymiyyah (d. 728 H) states that the physical body of money is never the objective of acquiring money, rather, it is the counter-exchange which is the objective and benefit of money[4]. Money is neither a productive good nor a consumption good. Therefore, if money needs to be exchanged with money, the Islamic injunction on trading *Ribawi* (usurious) material is applied. Such a transaction must take place with the condition that it is on spot basis and for an equal amount if the currencies are homogeneous.

If profit making is the motive of an exchange, money needs to be integrated into capital by legal combination (and assume the risk which is associated with the project/property), or be interchanged to a commodity/asset (to assume the intrinsic utility transformation function or by exchanging a different currency in a Shariah compliant manner[5]. Thus, although money plays the role of a medium of exchange and a standard of measurement, profit by exchange is permitted as long as it is in accordance with the Shariah principles as the AAOIFI Sharia Standard No.1 states:

> “It is permissible to trade in currencies, provided that it is done in compliance with Shariah rules and precepts[6].”

4 Ibn Taymiyyah, Majmu’ al-Fatawa, Majma’ al-Malik Fahd)

5 Omar, M. (2011), The Islamic View on Money Its Implications for Financial Instruments, Available from: https://ifikr.isra.my/library/viewer2/338

6 AAOIFI (2016), Shariah Standards, Bahrain: AAOIFI

OPINIONS OF FIAT CURRENCIES ACCORDING TO CONTEMPORARY ISLAMIC FINANCE

Before discussing Forex, it is pertinent to understand the different views held by Muslim economists and jurists regarding fiat currencies and paper money. The concept of money has evolved rapidly in the last 100 years; items of intrinsic value, commodity-backed papers, fiat currencies, credit and digital currencies have all been exchanged as money.

According to some jurists, fiat currency is regarded as a replacement for gold and silver. Thereby, a fiat currency itself attracts the characteristics of the respective precious metal. The currency of any given country is seen as if it were the gold it once was based on. As a result, the laws of trading gold and silver apply to fiat currencies in an identical manner.

Another opinion argues that fiat currencies hold the same legal position as *Fulus* (copper money) in classical legal thought. Historically, *Fals* (single unit of copper money) used to be a locally restricted currency for small transactions. This view is supported by the fact that fiat currencies share a feature of *Fulus* in that they are not weighed nor measured in volume but counted. Gold and silver are weighed. Like copper money, fiat currencies are a standard for prices. Furthermore, its value changes like that of copper coins did. This is due to the fact that the face value of fiat currencies exceeds the intrinsic value.

A third opinion suggests that fiat currencies are an independent type of money. They can be seen as one *thaman* among many. In this conception, different currencies as well as gold, silver, and *Fulus* are regarded as different types of money[7].

7 Siegfried, N. (2001), Concepts of Paper Money in Islamic Legal Thought,

CONSEQUENCES OF DIFFERENT INTERPRETATIONS

There are two mainstream opinions among Shariah scholars regarding the legal laws of exchanging fiat currencies.

The AAOIFI considers fiat currencies to be a new breed of currencies which are in the same category as gold and silver. Fiat money is deemed to be *Thaman Haqiqi* (real money) and as a result, shares the same rulings as commodity money such as gold and silver. This is because free-floating fiat currencies have replaced gold and silver as a medium of exchange and are considered to be money today. As a result, the rulings of *Sarf* (money exchange) applies to fiat money also.

Another opinion argues that despite fiat currencies being a new breed of currencies, they are not in the ruling of gold and silver, instead, they share similar properties to *Fulus* (copper coins). As a result, they are not natural forms of money like gold and silver, rather, they are based on custom and can be activated/deactivated as currency based on practice. Based on this, not all the rulings of *Sarf* apply to fiat currency exchange.

This group of scholars restrict the rulings of *Sarf* to gold and silver exchange. In respect to fiat currencies, the rulings of trading *Fulus* and *Riba* apply in certain scenarios. This opinion is predominantly held by Hanafi scholars in the Indian subcontinent and Southern Africa. Mufti Muhammad Taqi Uthmani (may Allah preserve him) is considered to be among the pioneers of this analysis[8].

[8] Uthmani, M.T. (2012), Fiqh al-Buyu, Maktabah Maariful Quran: Karachi

CURRENCY TRADING LAWS IN THE AAOIFI STANDARDS

It is permissible to trade in currencies, provided that it is done in compliance with the following Shari'a rules and precepts.

- Both parties must take possession of the counter values before dispersing, such possession being either actual or constructive.
- The counter values of the same currency must be of equal amount, even if one of them is in paper money and the other is in coin of the same country, like a note of one pound for a coin of one pound.
- The contract shall not contain any conditional option or deferment clause regarding the delivery of one or both counter values.

CURRENCY TRADING LAWS ACCORDING TO OPINION 2:

It is permissible to trade in currencies, provided that it is done in compliance with the following Shari'a rules and precepts.

- One party must take possession in the trading session, being either actual or constructive.
- The counter values of the same currency must be of equal amount, even if one of them is in paper money and the other is in coin of the same country, like a note of one pound for a coin of one pound.

Based on the Hanafi school, the '*illa* (legal causative factor) of *Riba* are homogeneity of the counter-values and both counter-values being weighable or measureable[9].

These two '*illa* do not apply when exchanging different fiat currencies. Each country's currency is regarded as a separate genus. Neither are fiat currencies weighable or measureable, instead, they are countable. However, possession by one party is required for *Ta'yin* (specifying a counter-exchange in a contract) according to the Hanafi jurists, as a legal principle states that money is not specified by specification prior to possession and receipt; money is only specified by *Qabd* (possession).

9 The amount of the counter-values must be in excess of half Sa' for the 'illa of Riba to apply. The Hanafi jurists argue that anything under half Sa' is not subject to Riba. This is based on the fact that the lowest measurement in Shariah is half Sa'. Anything below half Sa' does not fall under any valid measurement in Shariah to have a legal consequence.

What is Forex?

Forex is the shortening of foreign exchange, sometimes referred to as FX or currency trading. Forex trading is the simultaneous buying of one currency and selling another. Currencies are traded through a broker or dealer and are traded in pairs[10]. The forex market is the place where such currency trading occurs and is the largest, most liquid market in the world with an average daily trading amount of more than $5 trillion.

What forex means for the global economy is huge. There is a need to trade currencies around the world to conduct foreign trade and business, which is why the market is so large. The market also provides many opportunities for investors to profit from the changing values of currencies, but one must understand what is forex before you can do so.

The forex market is where businesses, governments, banks and traders come to buy, sell and speculate on currencies. It is open for 24 hours a day, 5 days a week as it has trading centres in different time zones across Sydney, Tokyo, Hong Kong, Singapore, Frankfurt, Zurich, London and New York.

With no central marketplace, forex trading is conducted electronically over the counter. This means the market is active at all hours, resulting in price fluctuations and many opportunities to make gains from currencies rising or falling in value throughout the day. A broker is required to begin trading on the markets[11].

The foreign exchange (FX) market is one of the largest financial markets in the world. Transactions in FX are performed to fulfil a number of functions including as a means of payment in the real economy for goods or services, hedging foreign currency risk for financial assets or commercial contracts, investments or speculation in foreign currency. A variety of financial instruments are used to perform FX transactions such as swaps, options, forwards and spots[12].

10 Babypips, Buying and Selling Currency Pairs, Available from: www.babypips.com/learn/forex

11 Sharp Trader, What is Forex, Available from: www.sharptrader.com/new-to-trading/

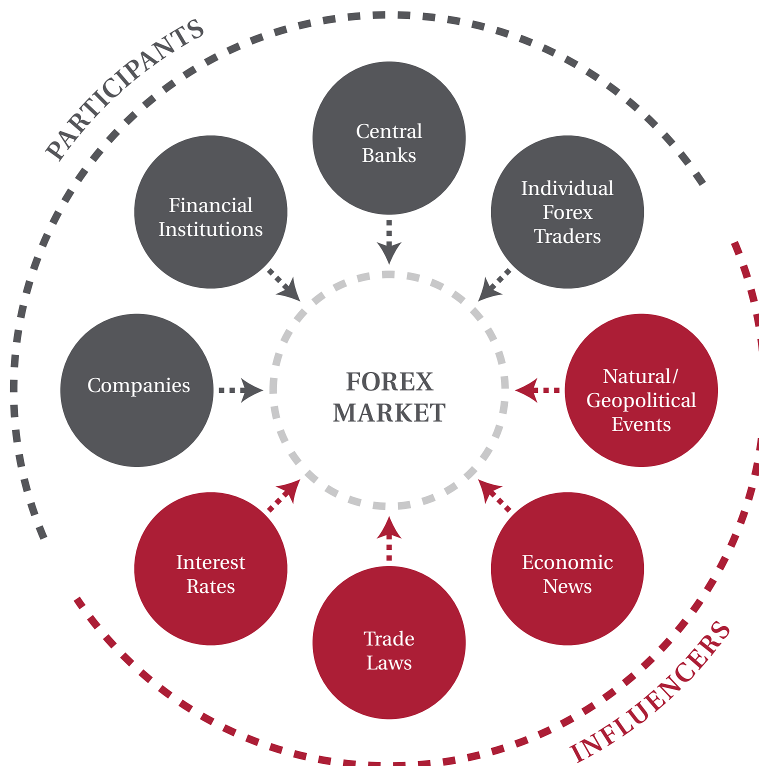
12 Norton Rose Fullbright (2014), Things you should know – Regulation in the FX Markets, Available from: www.nortonrosefulbright.com/knowledge

History of Forex

Foreign exchange dates back to ancient times, when traders first began exchanging coins from different countries. However, the foreign exchange itself is the newest of the financial markets. In the last hundred years, the foreign exchange has undergone some dramatic transformations. The Bretton Woods Agreement, set up in 1944, remained intact until the early 1970s. Trading volume increased rapidly over time, especially after exchange rates were allowed to float freely in 1971.

In 1971, the Bretton Woods Agreement was first tested because of uncontrollable currency rate fluctuations, by 1973 the gold standard was abandoned by president Richard Nixon, currencies where finally allowed to float freely. Thereafter, the foreign exchange market quickly established itself as the financial market. Before the year 1998, the foreign exchange market was only available to larger entities to trade currencies for commercial and investment purposes through banks. Now online currency trading platforms and the internet allow smaller financial institutions and retail investors access a similar level of liquidity as the major foreign exchange banks, by offering a gateway to the primary (Interbank) market[13].

Forex Market: Participants and Influencers



13 Gaucan, V. (n.d.), Introduction to The Foreign Exchange Market, Journal of Knowledge Management, Economics and Information Technology, Available from: www.scientificpapers.org/wp-content/files

DIFFERENT WAYS TO TRADE FOREX

There are multiple ways to trade Forex. In this section, we analyse each method of trading Forex and consider the Shariah rulings relating to it.

1. Contract for Differences (CFD)

This method is predominantly offered by brokers for individual investors in the retail market for speculation. No real currency is bought or sold in the retail market. The retail FX market is purely a speculative market. No physical exchange of currencies ever takes place. All trades exist simply as computer entries and are netted out depending on market price. For dollar-denominated accounts, all profits or losses are calculated in dollars and recorded as such on the trader's account[14]

What are CFDs?

This is a very common method of speculating on the Forex market. Many Forex brokers offer CFDs. A CFD is an agreement between you and your broker. When the contract is closed the broker promises to pay a certain amount for every pip the bought currency has moved in your favour, if it moved against your position, it's you who pays the broker. The term comes from the fact that upon closing the position you take the difference between the closing price and the opening price and that money is transferred/deducted to/from your account. It is important to note that at no point you physically or virtually possess the bought currency, nor must you deliver the sold currency[15].

A CFD replicates the movements of an asset like futures or shares. Thus, for instance if it is based on the EURUSD, then the spot EURUSD is the underlying of that specific CFD. Thus, when you are trading with a provider on a Forex CFD, you will not be buying the actual currency instead you will be trading on the provider's prices. Your CFD provider acts as the counter-party and sole market maker in all your trades, so in absence of in-house hedging mechanisms you can end in a situation where when you win, the provider will lose, whilst when the provider wins, you will lose. CFD providers are sometimes criticised for setting arbitrary spreads or suspending trading in crucial moments. Perhaps more significantly is that forex based CFDs will be based on the cash market but it will be more trusted if the provider tells you that they use
CME's currency futures or Tier 1 Banks' prices and liquidity for hedging[16].

Shariah Ruling

CFD Forex trading is not Shariah compliant due to the following reasons:

a. Contractual uncertainty and (Gharar)
b. Invalid commodity in Shariah
c. Gambling (Qimar)

Gharar is involved because the end result and outcome of the transaction is unknown. One can lose or make a gain in this transaction.

The transaction does not involve any valid Shariah compliant commodity. One is taking a position on the movement of a currency pair. In reality, this is a *Qimar* (gambling) transaction as one is staking his wealth against his broker. The one who speculated correctly makes a profit at the expense of the other.

14 Investopedia, Top 6 Questions about Currency Trading, Available from: www.investopedia.com/articles/

15 Stack Exchange, Difference between spot forex and CFD, Available from: www.money.stackexchange.com/questions/45576/

16 CFD, Forex CFDs versus Forex Spot Trading, Availale form: www.contracts-for-difference.com/Forex

2. FX Futures

This method is offered by brokers for individual investors in the retail market for speculation. Futures contracts are also traded among other FX market participants.

Currency futures, also called forex futures or foreign exchange futures, are exchange-traded futures contracts to buy or sell a specified amount of a particular currency at a set price and date in the future. A currency futures contract is a contract to buy or sell currency at a specific price on a future date. This contract is used to hedge against foreign exchange risk by fixing the price at which a currency can be obtained. A futures contract is traded on an exchange, so it has a standard amount, expiry date, and settlement rules. An initial deposit into a margin account is required to initiate a futures contract. The contract is then repriced (marked to market) each day, and if cumulative losses drain the margin account, a company is required to add more funds to the margin account. If the company does not respond to a margin call, the exchange closes out the contract[17]. The futures market is very similar to the forward market, except that all futures contracts are legally binding and contain a specific termination date, at which point the currency must be exchanged.

Shariah ruling on Futures

In a futures transaction, the counter-value is not present at the time of contract, it is a mere exchange of promises. Futures trading, where both counter-values are deferred, are held as exchange of one debt for another, i.e., *bay' al-kali bil kali* (a sale of two deferred counter-exchanges). The deferral of both counter-currencies results in a deferred transaction.

According to AAOIFI standards, such a contract is not valid as it fails to fulfil the primary condition of dual possession of counter currencies. A future Forex is also non-Shariah compliant according to the scholars who argue one sided possession is sufficient, as there is no possession by any party.

17 Accounting Tools (2017), Currency Futures, Available from: www.accountingtools.com/articles/

3. Forex Spread betting

This method is predominantly offered by brokers for individual investors in the retail market for speculation.

The term spread betting is used because there is an additional spread around the market price (they make their money on the spread, hence the word) and the reason it is called a bet is because if that term is used it means you are exempt from all capital gains taxes[18].

Spread betting is a derivative product. With a spread bet you don't actually own the asset (such as a commodity, currency or share) that you're speculating on. Instead, you trade on margin. This means you get the same level of exposure you would if you bought the underlying asset outright, but for a smaller initial outlay. It also means that you can bet on the price falling or rising. You buy (go long) when you think the price will rise, or sell (go short) if you think it will fall. You complete the transaction - closing your position - by effectively placing the opposite bet[19].

When you spread bet, you take a position based on whether you expect the price of an instrument to rise or fall in value. You will make a profit or loss based on whether or not the market moves in your chosen direction. With spread betting, you don't buy or sell the underlying asset (for example a physical share or commodity). Instead, you place a bet based on whether you expect the price of a product to go up or down in value. If you expect the value of a share or commodity to rise, you would open a long position (buy). Conversely, if you expect the share or commodity to fall in value, you would take a short position (sell)[20].

Key differences between CFDs and spread betting[21]

- **UK Capital Gains Tax**
  Currently in the UK, any profits made from spread betting are free from UK Capital Gains Tax. This benefit is not applicable to profits made from CFD trading

- **Commission**
  CFD equity trades are the only positions you are charged a commission for on each trade you place – other CFD trades do not carry a commission charge. Spread betting positions on any instrument do not incur a commission charge, but you pay a slightly wider spread

- **Trade Sizes**
  Trade sizes differ across spread bets and CFDs. Spread bets are traded in pounds per point. With CFDs you trade a number of CFDs. For example, a £1 spread bet is the equivalent of 100 shares in a CFD equity trade.

Shariah ruling on spread betting

Similar to CFDs, spread betting is essentially a gambling transaction (*Qimar*) and is non-Shariah compliant. One opens a position and takes a view on the movement of the currency pair. The key difference between this and share trading is that in shares, one actually purchases the shareholding. The price paid is converted into shareholding for which one bears the risk. In a spread bet, the amount paid is for merely opening a position. The amount is not converted into ownership of any shariah compliant commodity. Therefore, it is purely the staking of wealth for speculative purposes.

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18 Financial Spread Betting Guide, Why is it called Spread betting? Available from: www.financial-spread-betting.com/Bid-offer

19 SpreadCo, What is Spread betting?, Available from: www.spreadco.com/spread-betting/spread

20 CMC Markets, What is Spread Betting?, Available from: www.cmcmarkets.com/en-gb/learn-spread

21 CityIndex, Spread betting vs CFD Trading, Available from: www.cityindex.co.uk/spread-betting/

4. FX Options

This method is predominantly offered by brokers for individual investors in the retail market for speculation.

A currency option is a type of foreign exchange derivative contract that confers to its holder the right, but not the obligation, to engage in a forex transaction. In general, buying such an option will allow a trader or hedger to elect to purchase one currency against another in a specified amount by or on a specified date for an up-front cost. This right is granted by the option's seller in exchange for an up-front cost known as the option's premium[22].

There are two types of options available to retail forex traders for currency option trading: put/call options and STOP options. The call option gives the buyer the right to purchase a currency pair at a given exchange rate at some time in the future. The put option gives the buyer the right to sell a currency pair at a given exchange rate at some time in the future. Both the put and call options are a right to buy or sell, and not an obligation. If the current exchange rate puts the options out of the money, then the options will expire worthless.

Shariah ruling on FX Options

Options is prohibited because it is a form of uncertain transaction (*bay' al-Gharar*). The option is *Gharar*. The exercising of the option is unknown and uncertain. The uncertainty in the subject matter makes it *Gharar*. It is a right which enforces another contract, however, the enforcement (of that right) is uncertain and suspended on an uncertain event. Hence, it is different to other rights because this right is a right with immense uncertainty (*Gharar*).

Another reason for the prohibition of options is the non-compliance of the subject matter of sale with Shariah. An option represents the power, the right to choose. When you own an option, you can choose whether to buy an asset or not, or (with different type of options) whether to sell an asset or not. When you own an option, you have the right to buy or sell, but not the obligation. You only do what is favourable for you at that moment. Options are essentially a choice which you are purchasing. The 'ability to choose' is the subject matter.

In respect to options, the OIC Islamic Fiqh Academy states that:

"Option contracts as currently applied in the world of financial markets are a new type of contracts which do not come under any one of the Shariah nominated contracts. Since the object of the contract is neither a sum of money nor a utility or a financial right which may be waived, then the contract is not permissible in Shariah.[24]"

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in Standard 20, Sale of Commodities in Organised Markets has also declared the impermissibility of options trading.

22 ForexTraders, Currency options Explained, Available from: www.forextraders.com/forex-education/

24 OIC Islamic Fiqh Academy, "Resolution and Recommendations of the Council of the Islamic Fiqh Academy 1985-2000", 2000,

5. Spot Forex – two types with physical FX and speculation

After reviewing several documents and discussing with a number of brokers and traders, we understand that spot forex can be traded in the following ways:

1. Speculative spot FX
2. Physical FX

1. Speculative Spot FX

This is a non-deliverable trading agreement where delivery of the currencies never takes place. A spot forex is an agreement to exchange a set amount of one currency for another at a predetermined exchange rate in two business days (T+2). In speculative trading nobody actually wants to do the currency exchange, so at the end of each day, to avoid the exchange they offset their open position, and then re-open it to start the new trading day. There is no "liquidating" of positions because there is nothing to actually liquidate.

When you do a trade it's "as if" you are borrowing the short currency at its overnight rate, exchanging it for the long one, and depositing that at its overnight rate. So if you go long USD/JPY it's as if you are borrowing yen at the JPY overnight lending rate, converting them to dollars, then depositing the dollars at the USD overnight deposit rate. The carry is the difference between what you pay on the loan and what you receive on the deposit. When you close out your trade you reverse the process. Some brokers handle carry separately, while some incorporate it into the position rollover. (Note the "as if", that in reality the transactions doesn't actually take place)

Now, if you're wondering why you see the carry on the T to T+1 rollover if the exchange doesn't take place until T+2, it's because your P&L is credited immediately for the overnight carry you will pay/receive going from T+2 to T+3. That's also why you don't see carry on the day you close a position[25].
Hypothetical mechanics of a speculative spot forex:

a) Buy order (going long)

When purchasing USD/JPY, it is as if one borrows JPY and lends USD[26]. The transaction goes through the following hypothetical phases:

1. One borrows JPY from an interbank,
2. JPY is sold in lieu of USD
3. USD is lent to an interbank.
4. Interest payment is received[27]

b) Sell order (shorting)

When shorting USD/JPY, it is as if borrowing USD to buy JPY. When the trade is closed, JPY is sold and the borrowed USD is paid back with interest.

1 One borrows USD from an interbank
2. JPY is bought with USD
3. JPY is lent to an interbank.
4. Interest payment is received
5. JPY sold for USD
6. Interest paid for borrowed currency
7. Difference in opening and closing position settled

25 The Essentials of Trading, Forex Rollover and Carry Explained, Available from: www.theessentialsoftrading.com/Blog/2010/03/31/

26 Stack Exchange, Available from: www.money.stackexchange.com/questions/

Stack Exchange, How does purchasing your own country's currency work? Available from: www.money.stackexchange.com/questions/23602

27 Forex Trading Charts, Interest and Carry Trade in Forex, Available from: www.forex.tradingcharts.com/learn_forex/7

The dollars in the account never moves; it's just the collateral. Likewise, none of the above really happens, it is all just digital entries without any transfer of value, without any lending or borrowing. The trader merely gets exposure to the market with the position he has opened.

Many brokers offer "spot forex" as an alternative product purely to diversify their products in the market, however, the underlying mechanics and processes are very similar to CFDs and spread betting. In such a spot forex, one is merely opening a position and speculating on the price movements of the currency pair, without purchasing any currency.

CFD and this type of forex trades are generally executed in the same manner in an OTC market under a decentralized exchange. Both types of trading don't involve the physical transfer of the assets, as profit or loss are calculated based on the opening and closing prices. Because of these similarities, several brokers actually offer platforms that cater to both CFD and spot forex trading[28].

The primary similarity between CFD trading and forex trading is that neither entitles the trader to actual ownership of the underlying asset. When one buys EURAUD, for instance, one is not actually purchasing euros and selling Australian dollars; rather the trader is simply speculating on the exchange rate. Likewise, when a trader purchases a CFD contract on the FTSE 100, the trader is not actually owning the stocks in the FTSE index, but rather is speculating on its underlying price. In many ways, forex is simply another kind of CFD[29].

Interest is received/paid on the bought/borrowed currencies if held overnight[30]. In margin trading, there is no physical delivery, so all open positions must be closed daily at end-of-day and re-opened on the following trading day. This pushes out the settlement by one more trading day.
This strategy is called rollover. Rollover is agreed through a swap contract which comes at a cost or gain for traders. To keep the position open overnight, a swap transaction is required involving the currency pair[31].

Overnight positions represent all forms of open-long and short positions that a forex trader possesses. The next trading day, the trader's account either pays out or earns interest on each position depending on the two currencies' underlying interest rates, which is called rollover. For example, a trader has bought Canadian dollars and is selling U.S. dollars. If the Canadian interest rate is at 3.00% and the U.S. interest rate is at 2.50%, the trader will then receive a payment that equals 0.50% into his account[32].

Shariah ruling

Speculative and retail spot forex does not include any purchase or sale of real currency. Just like CFDs and spread betting, retail spot FX is essentially a gambling transaction (*Qimar*) and is non-Shariah compliant. One opens a position and takes a view on the movement of the currency pair. The amount is not converted into ownership of any shariah compliant commodity or currency. Therefore, it is purely the staking of wealth for speculative purposes.

This is coupled with uncertainty (*Gharar*) as the outcome of this transaction is totally unknown and suspended on chance. Furthermore, one's margin account receives interest payments for holding overnight positions. This income is impure and non-Shariah compliant.

28 Forex Ninja (2014), CFD Trading vs Spot Forex Trading, Available from: www.babypips.com/news/forex

29 ThinkMarkets, CFD vs Forex, Available from: www.thinkmarkets.com/uk/learn-to-trade/

30 www.money.stackexchange.com/questions/45576/

31 CFD, Forex CFDs versus Forex Spot Trading, Available form: www.contracts-for-difference.com/Forex

32 Investopedia, Overnight positions, Available from: www.investopedia.com/ask/answers

Physical FX

This is also referred to as deliverable FX as there is physical/digital delivery of the currencies. This is a basic foreign exchange contract, a binding agreement between parties to sell one currency and buy another in a specified amount, at a specified rate, for immediate delivery (within 2 days). Traditionally settled Spot (T+2) can be flexible within that time frame and can also be settled for same or next day value, providing the relevant payment cut off times are met[33].

Some firms and brokers offer physical FX trading services and liquidity to institutions and corporations in order to assist in managing risk as well as offering currency conversion for large amounts. Such firms manage their client's foreign exchange requirements, day to day currency purchases and liquidity requirements, to longer term hedging and portfolio management.

For example, if a person wants to purchase USD with GBP, the client opens an account with the broker with the required funds at the disposal of the broker. The broker searches for the most favourable GBP/USD rate. A payment instruction is agreed to by the client. Upon finding a favourable rate, the trade is executed. The broker debits the client's GBP account and transfers the funds to the counter-party. The trade is electronically recorded. The counter-party transfers the counter-currency either immediately on the closing of the transaction, or on the same day. At times, the transfer is made the next working day. Upon transfer, the broker credits clients account with the foreign currency[34].

33 Clear Treasury, FX Spot & Forward Contracts, Available from: www.cleartreasury.co.uk/foreign-exchange/

34 HC FX, Deliverable Foreign Exchange, see: www.hamiltoncourtfx.com/deliverable
Suden Financial, Deliverable FX, see: www.sucdenfinancial.com/en/markets/

Shariah Ruling

In such an exchange, the firm offering exchange services is a broker (*simsar*). Any commission taken by the firm is permissible if it is a known percentage or a fixed fee[35].

In respect to possession of currencies, physical FX satisfies the criteria set by those who consider fiat currencies similar to Fulus. The broker debits the client's account and transfers the amount to the counter-party. The counter-party receives the funds in real time into their account. The buy currency is settled and delivered at times immediately, or at times the very same day (even if this amount is not credited in the account of client but the broker has taken possession of currency on behalf of his client, it will be acceptable). This is deemed constructive possession as per the AAOIFI Standard No.1. which states:

"Constructive possession of an asset is deemed to have taken place by the seller enabling the other party to take its delivery and dispose of it, even if there is no physical taking of possession. Among other forms of constructive possession that are approved by both Shari'ah and business customary practices are the following:

a) To credit a sum of money to the account of the customer in the following situations:

1. When the Institution deposits to the credit of a customer's account a sum of money directly or through a bank transfer.

2. When the customer enters into a spot contract of currency exchange between himself and the Institution, in the case of the purchase of a currency against another currency already deposited in the account of the customer.

3. When the Institution debits – by the order of the customer– a sum of money to the latter's account and credits it to another account in a different currency, either in the same Institution or another Institution, for the benefit of the customer or any other payee. In following such a procedure, the Institution shall adhere to the principles of Islamic law regarding currency exchange."

Similarly, according to the AAOIFI standards, such a FX transaction seems acceptable as there is concession for a delay in making the transfer. The standard states:
"A delay in making the transfer is allowed to the Institution, consistent with the practice whereby

a payee may obtain actual receipt according to prevailing business practices in currency markets. However, the payee is not entitled to dispose of the currency during the transfer period, unless and until the effect of the bank transfer has taken effect so that the payee is able to make an actual delivery of the currency to a third party."

The delay in transfer is based on genuine reasons. The reason given for the exchange of the currency being made in two business days (T+2) is because of the significant difference in the law, regulatory requirements, technologies and settlement practices in the countries where the currencies originate. Unlike cash, which involves physical currency promptly changing hands, FX spot involves interbank settlement in two different banking systems. One system may be fast, the other slow; one reliable, the other less so. The two systems may operate in different time zones with limited overlap in the operating hours between them. These practical differences amount to obstacles to a pair of currencies arriving at the same time despite the fact that the market is built with electronic fund transfer and up-to-date information technology. It is also said that the major payment systems used in the inter-bank do not operate according to a daily timetable that permits simultaneous or near simultaneous settlement of the currencies. Many of these payment systems are designed so that final settlement of each day's payments takes place at a single point in time; namely, at the end of the system's operating day, rather than numerous times in a day[36].

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35 Ibn Abidin, Hashiyah ibn Abidin,

36 ISRA, Possession of Currency Prior to Sale, Research Paper

OTHER ELEMENTS OF FOREX TRADING

1. Leverage

Leverage is a financial tool that allows an individual to increase their market exposure to a point that exceeds their actual investment. Leverage is a by-product of margin and allows an individual to control larger trade sizes. Traders will use this tool as a way to magnify their returns. For example, a trader goes long 10,000 units of the USD/JPY, with $1,000 dollars of equity in their account. The USD/JPY trade is equivalent to controlling $10,000. Because the trade is 10 times larger than the equity in the trader's account, the account is said to be leveraged 10 times or 10:1.

In leverage, actual currency is not being lent to the trader; it is just an opportunity and chance to gain a higher volume of return on a trade. As a result of leverage, the broker gives you greater volume of win/loss and increases exposure to risk. The more money that is put at risk (as margin), the greater the return or loss. Therefore, leverage is just a gambling tool to increase potential return on capital and volume of gain, but equally, volume of loss too.

2. Margin

Margin is the amount required to hold the trade open. When you open a forex account, the broker will request that you deposit a small sum, known as margin, as insurance against the losses that your account may suffer. With this small sum, you're able to control a much larger amount, enabling greater gains, but also greater losses than you would be able to achieve with your deposit[37]. There are different terms related with margin as follows:

- **Margin required:** It is the amount of money that is held by the broker when you place a trade. It varies per currency pair per broker.
- **Account margin:** This is the total amount of money you have in your account to trade with.
- **Used margin:** This is the amount of money that is tied up in open positions. It is the combination of all the open trades that you have.
- **Usable margin:** This is the remaining amount of money you have available outside of your open trades.
- **Margin call:** This happens when your margin falls below the margin you have available. At this time, the broker will close all open trades at the current price the market is at, winning and losing trades.
- **Margin Level:** Is the Equity divided by used margin, it's used by traders within their trading accounts to leverage more of their investment[38].

A margin call occurs when there are not enough funds in your trading account to open trades. This is also when your floating losses are greater than the minimum margin required.

From a Shariah perspective, the margin funds is considered as the bet one places to take a view on the market and to open a position. Therefore, it is impermissible and non-Shariah compliant.

37 Forex Fraud, What are Forex pips, lots, margins and leverage

38 Markettraders, Guide to Margin, Available from: www.markettraders.com/blog/importance

3. Rollover

Rollover is the process of extending the settlement date of an open position (i.e. date by which an executed trade must be settled).
The forex market allows two business days for settling all spot trades[39] .

FX spot positions are typically for value T+2. This means that they usually settle two business days from the day of execution, if traded before 17:00 EST (New York time), which is the standard close of a Forex trading day. Since, there is no physical settlement of currency, so positions are 'rolled over' to a new value date on a tom/next basis daily and are subject to a swap charge or credit until closed out.

All open FX positions held overnight are subject to a debit or credit interest rate revaluation to reflect the position being rolled over to a new Value Date. The operation known as the Tom/Next Rollover is applied to spot positions held. The 'rollover' is made up of two components, namely the tom/next swap points and financing of unrealised profits or losses. The accumulated combined rollover credit or debit is added/deducted from the previous opening price of the position[40].

Interest is received/paid interest on the bought/ borrowed currencies if held overnight[41].
In margin trading, there is no physical delivery, so all open positions must be closed daily at end-of-day and re-opened on the following trading day. This pushes out the settlement by one more trading day.

This strategy is called rollover. Rollover is agreed on through a swap contract which comes at a cost or gain for traders. To keep the position open overnight, a swap transaction is required involving the currency pair[42].

From a Shariah perspective, paying a fee for rollover is an invalid service fee. One is paying to continue their gamble and bet. It is a payment for leaving one's betting position open to the next day. Any fee/interest received is also non-compliant as it is in lieu of a non-compliant contract.

39 XM, Overnight Positions, Available from: https://www.xm.co.uk/overnight-positions

40 Saxo Bank, What are Forex Rollovers?, Available from: www.help.saxobank.com/customer/en/

41 www.money.stackexchange.com/questions/45576/

42 CFD, Forex CFDs versus Forex Spot Trading, Available form: www.contracts-for-difference.com/Forex

RESOLUTION OF MALAYSIAN ISLAMIC RELIGIOUS COUNCIL'S FATWA COMMITTEE

The Muzakarah of the 98th Malaysian Islamic Religious Council's Fatwa Committee on the 13th to 15th February 2012 discussed the Foreign Exchange Traders by Individual Spot Forex Through Electronic Platform. The Muzakarah made the following decisions:

After listening to the briefing and clarification of experts from the International Shariah Research Academy in Islamic Finance (ISRA) and reviewing the evidence, arguments and views put forward, Muzakarah stressed that individual forex trading through individual spot forex electronic platforms involve *ribawi* items and from a fiqh point, it is subject to *Bay al-Sarf* law which is to be followed by the general terms of sale and the special requirements of *Bay al-Sarf*. In addition to fulfilling these conditions, *Muzakarah* also asserted that foreign exchange trading (forex) operations should be free from any element of usury, *al-Salaf wa al-Bay'* elements (debts provided under a sale and purchase transaction), gambling element, excessive *Gharar* and tyrannical or exploitation elements.

Based on the detailed studies that have been done, Muzakarah found that individual forex trades through an electronic platform contained elements such as *Riba* through the imposition of rollover interest, purchase terms of debt through leverage, unclear *Qabd* (possession) during exchange transactions and speculation that involves gambling.

In this regard, the Muzakarah agreed to decide that the individual spot forex transaction by the individual platform forex via the current electronic platform is illegal because it contravenes Islamic law. Accordingly, Muslims are prohibited from engaging in such currency trading.

Muzakarah also stressed that this decision was not applicable to foreign exchange transactions through counters in licensed money changers and foreign exchange transactions operated by financial institutions licensed under the laws of Malaysia[43].

43 I-FIKR, Foreign Exchange Trading Law, Available from: https://ifikr.isra.my/fatwa/final_level2/SC0110/4100

Conclusion

This paper reviewed a number of issues to do with retail FX and fiat currencies. There are two mainstream views among the scholars regarding the nature of fiat currencies. One group of scholars treat fiat currencies with the same principles as gold and silver, making the laws of *Sarf* (currency exchange) applicable. The other group of scholars consider fiat currencies an alternative to *Fulus* (copper coins), therefore, not applying the laws of *Sarf*. Nevertheless, conventional forex trading is purely speculative and fails to fulfil the Shariah principles of currency trading. Actual currencies are never exchanged, and delivery is never the objective of retail FX. Forex is traded in a number of ways such as CFDs, spread-betting, futures, options and spot trading. In all of these derivatives, there are a number of non-compliant elements such as *Qimar* (gambling), *Gharar* (major uncertainty) as well as non-compliant commodities. Treating money as a commodity is also against the principles of Islamic economics. An investor or trader who wants to invest in currencies must do so in compliance with Shariah. The Shariah stipulates that both parties must take possession of the counter-values before dispersing. Likewise, the counter-values of the same currencies must be of equal amount whilst different currencies can be traded at different rates as long as the contract does not contain any conditional option or deferment clause.

ABOUT SRB

Since our humble beginnings more than 13 years ago we've grown to include more than 100 companies across a host of industries, thousands of transactional programs, multi-disciplinary teams and a combined scholarly workforce of 35 Shariah Scholars from 19 countries. And we're not done yet: our Shariah Advisory and Shariah Audit services will continue to improve—serving local and international businesses to help them maintain and manage Shariah compliance.

We've been preparing our clients for a new world in which Shariah Advisory rapidly becomes the currency of choice. From faster Certification programs, to direct Shariah Supervisory access, and perhaps most critically, navigating through the economic structures of clients offerings within a matter of days. We've have been working hard to help clients like you capitalize on opportunities in global Islamic financial markets.

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The future of Shariah Advisory and Audit is exciting and we are very lucky to be a part of this business!

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Disclaimer

This is a preliminary Shariah research and is by no means a definitive conclusion or fatwa on the aforementioned subject. This paper was written to develop knowledge and research on this complex subject from a Shariah perspective. We hope that this paper will prompt and engage global Islamic finance bodies, Shariah scholars and Muslim economists to analyse, comment and build upon the arguments expressed.

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