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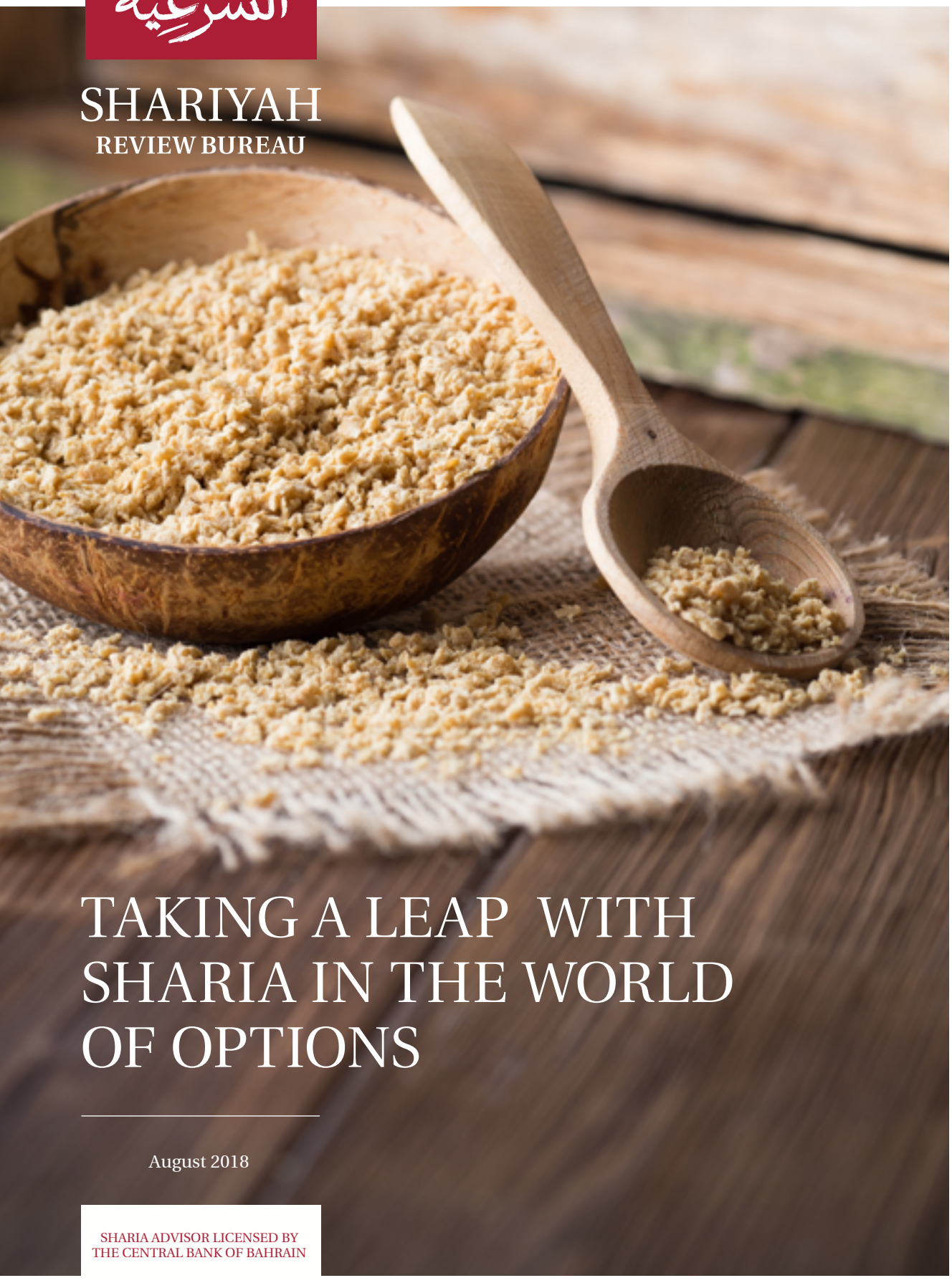

# TAKING A LEAP WITH SHARIA IN THE WORLD OF OPTIONS

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## Introduction

The conventional markets are known for their range of different financial instruments incorporating plain vanilla assets to exotic assets.
From among these financial instruments, derivatives have become very common. The main types of derivatives are forwards, futures, options and swaps.
This paper will be focussing on the option contract. Initially, derivatives will be analysed. Thereafter, the option contract will be presented in detail. This will be followed by a Shariah review of options, with Shariah compliant alternatives being recommended in the conclusion.

# DERIVATIVES

A derivative product is a financial product that derives its value from another underlying financial product. For example, an option to buy a share is a financial product which derives its value from that underlying share. Similarly, an interest rate swap derives its value from the value of the cash flows on the underlying loan. Hence the term "derivative"[1].

Financial derivatives enable parties to trade specific financial risks - such as interest rate risk, currency, equity, commodity price risk, and credit risk, etc – to other entities willing to take or manage these risks typically without having to trade in these primary assets. The risk embodied in a derivatives contract can be traded either by trading the contract itself, such as with options, or by creating a new contract which embodies risk characteristics that match, in a countervailing manner, those of the existing contract owned[2].

The goal of all derivative products is to obtain funding at a preferential rate or to take speculative advantage of a movement in a financial market for the investor.

Therefore, there are two fundamental reasons why derivatives are used:

- Earning income
- Managing risk

1 Hufson, A. (n.d), 'Dealing with Derivatives' Available online: http://www.alastairhudson.com/financelaw/derivativeslawcourse.pdf

2 IMF (1998), Financial Derivatives, Eleventh Meeting of the IMF Committee on Balance of Payment Statistics, Washington D.C., Available from: https://www.imf.org/external/bopage/pdf/98-1-20.pdf

To achieve these core goals there are four basic forms of activity:

1.Speculation
2. Hedging
3. Asset liability management
4. Arbitrage

**1. Speculation**

A derivative product may enable an investor to mimic the result of trading on an underlying financial market by entering into an off-market transaction with a financial institution. Therefore, a company can obtain the effect of speculating on the FTSE-100 without actually having to buy shares in companies in the FTSE-100.

**2. Hedging**

Derivative products can also be used as a risk management tool against market movements or rate changes. Purchase of a derivative product will enable the buyer to control its exposure to standard financial operations as disparate as its ordinary borrowing or its exposure to other investments.

**3. Asset Liability Management**

The growth in mixed portfolio funds has benefited from the capacity of derivatives to construct mixed hedging and speculative strategies. Where an institution seeks to deal with its portfolio of liabilities, their size and exposure to market movements can be managed by the use of derivative instruments. Where a portfolio is weighted to heavily towards an exposure to sterling, derivatives can change that exposure to another currency entirely.

**4. Arbitrage**

The use of derivative products makes it possible for market users to take advantage of mismatches in prices or market conditions by speculating on the underlying financial products without the need to undergo the formalities of conventional market trading. An American option to trade on a market, enables the investor to take advantage of price differentials which occur during the life of the option.
Derivatives markets in themselves contain the possibility to generate arbitrage opportunities and can be used as part of an arbitrage strategy as a result.

**5. Other possible uses**

Derivatives can also be used for objectives which are not specifically geared to speculative profit or hedging. There are often regulatory or capital adequacy goals in investing in a particular type of derivative instrument rather than owning market instruments or obligations. Similarly, there are often accounting advantages in holding derivative instruments rather than ordinary financial instruments. Under most accounting codes, interest rate swaps or currency swaps options are not required to be disclosed separately on a company's balance sheet, whereas an underlying loan would have to be disclosed.

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

# SHARIAH ANALYSIS OF DERIVATIVES

One academic has succinctly summarised the dilemma of using derivatives in Islamic finance: Options and futures contracts cannot be traded under Shariah, as they are too remote from the underlying assets, which is *Gharar* (contractual uncertainty) in essence[3].

Under Shariah law, the main grounds upon which contemporary Islamic scholars base their objections to financial derivatives may be summarised as follows[4]:

1. In futures transactions, because neither counter-value, i.e., money or goods, is present at the time of contract, the sale is not genuine but merely an exchange of promises. A sale is only valid under Shariah law as long as only the price or delivery, but not both, is postponed.

2. For a sale to be valid, ownership of the item sold must exchange hands. Therefore, a seller who does not own the item cannot transfer ownership. The rationale behind 'taking possession' is to prevent *Gharar*.

3. Futures and option trading that involve speculation verge on *Maysir, Qimar* (gambling) and *Gharar*.

4. Option trading is merely the right to buy or sell, for which charging fees is impermissible.

5. Futures trading, where both counter-values are deferred, is the illegal exchange of one debt for another, i.e., *bay' al-kali bil kali* (a sale of two deferred counter-exchanges).

3 Wilson, R. (2007). Global Islamic capital markets. Islamic Finance News.

4 Kunhibava, S. (2010), Derivatives in Islamic Finance, Research paper 7, ISRA

# WHAT IS AN OPTION?

An option is a contract between two parties giving the taker (buyer) the right, but not the obligation, to buy or sell a security at a predetermined price on or before a predetermined date. To acquire this right the taker pays a premium to the writer (seller) of the contract[5].

The options contract is a derivative. Derivative as explained before, is a security, whose value is derived from the price of another security (this is the asset that you choose to buy or sell when you own the option). This means if another security's price moves by some amount, the price of the option also moves and there is a specific (and often complicated) relationship between the two. The other (underlying) security can be a stock, a currency, a rate, a commodity, and many other things. If the underlying asset wouldn't exist, the derivative security would have no value only by itself, as there would be no sense in owning it[6].

5 ASX (2015), Understanding Options Trading, ASX Australian Share Market, Available from: https://www.asx.com.au/documents/resources/

6 Macroption, What is an Option?, Available from: http://www.macroption.com

# THE DIFFERENT TYPES OF OPTIONS

The two basic types of options are 'call' and 'put' options.

## Call options

Call options give the taker a right, but not the obligation, to buy underlying shares at a predetermined price, on or before a predetermined date.

**Call option example**

Santos Limited (STO) shares have a last sale price of $8.00. An available 3 month option would be an STO 3 month $8.00 call. A taker of this contract has the right, but not the obligation, to buy 100 STO shares for $8.00 per share at any time until the expiry. For this right, the taker pays a premium (or purchase price) to the writer of the option. In order to take up this right to buy the STO shares at the specified price, the taker must exercise the option on or before expiry. On the other hand, the writer of this call option is obliged to deliver 100 STO shares at $8.00 per share if the taker exercises the option. For accepting this obligation the writer receives and keeps the option premium whether the option is exercised or not.

## Put options

Put options give the taker the right but not the obligation to sell the underlying shares at a predetermined price on or before a predetermined date. The taker of a put is only required to deliver the underlying shares if they exercise the option.

**Put option example**

An available option would be an STO 3 month $8.00 put. This gives the taker the right, but not the obligation, to sell 100 STO shares for $8.00 per share at any time until expiry. For this right, the taker pays a premium (or purchase price) to the writer of the put option. In order to take up this right to sell the STO shares at a specified price the taker must exercise the option on or before expiry. The writer of the put option is obliged to buy the STO shares for $8.00 per share if the option is exercised. As with call options, the writer of a put option receives and keeps the option premium whether the option is exercised or not. If the call or put option is exercised, the shares are traded at the specified price. This price is called the exercise or strike price. The last date when an option can be exercised is called expiry day.

In addition to buying an option, an investor may also sell a call or put option the investor had not previously purchased, which is often called writing an option. Thus, the two basic option positions can be expanded into four option positions.

# THE PARTIES TO AN OPTION'S CONTRACT

An option's contract involves the following parties:

## 1.The Option Taker

An option taker is an investor or trader anticipating a significant move in a particular share price. Taking an option offers the opportunity to earn a leveraged profit with a known and limited risk. Taking a call option gives you the right to buy the shares covered by the option at the exercise price at any time until expiry. In general, call option premiums rise as the underlying share price rises. For this reason, the taker of a call option expects the underlying share price will rise.

Taking a put option gives you the right, but not the obligation, to sell the underlying shares. Put option premiums usually rise as the underlying share price falls. For this reason, the taker of a put option expects the underlying share price to fall.

In taking this right to buy or sell shares, the taker pays the premium. This premium represents the maximum possible loss on the option for the taker.

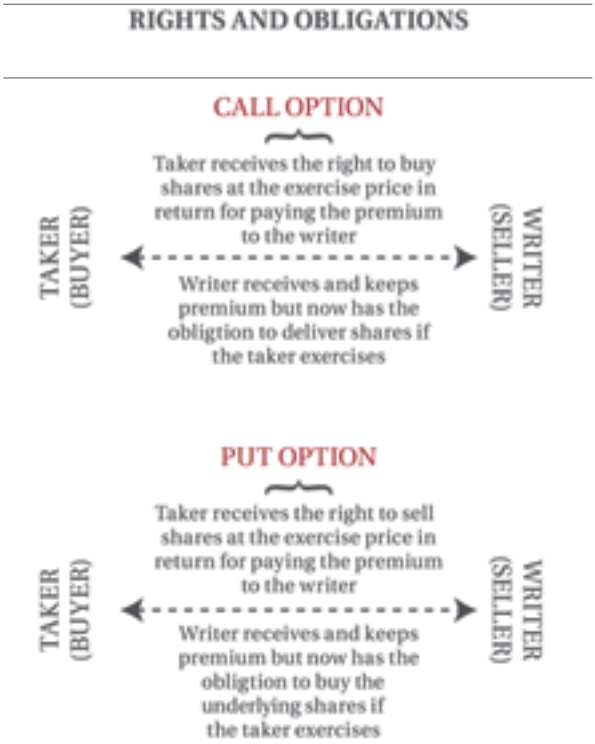
It is important to remember that it is not necessary for the taker of a put option to own the underlying shares at the time of taking the put. Certainly, if the taker chooses to exercise the put option they will be required to deliver the underlying shares, at the exercise price, to a randomly selected writer of put options in that series.

If the taker chooses to close out the option, a loss will be incurred if the premium that the investor receives on closing out is lower than the premium paid by the investor for the original taken contract. A profit will occur if the reverse is true. Every time the option is exercised, the premium paid for the option will be lost.

## 2.The Option Writer

Option writers earn premium for selling options. Both put and call option writers are generally looking for prices to remain steady.

The decision to exercise the option rests entirely with the option taker. An option writer may be exercised at any time prior to its expiry date when trading in an American style option. However, this is most likely to occur when the option is in-the-money and close to expiry, or when the underlying share is about to pay a dividend. Call option takers may exercise their right to receive the dividend.



# REASONS FOR OPTION TRADING[7]

Following are the key reasons for trading in options:

**Risk Management**
Put options, when taken, allow you to hedge against a possible fall in the value of shares you hold.

**Time to decide**
By taking a call option, the purchase price for the shares is locked in. This gives the call option holder until the expiry day to decide whether or not to exercise the option and buy the shares. Likewise, the taker of a put option has time to decide whether or not to sell the shares.

**Speculation**
The ease of trading in and out of an option position makes it possible to trade options with no intention of ever exercising them. If you expect the market to rise, you may decide to buy call options. If you expect a fall, you may decide to buy put options. Either way you can sell the option prior to expiry date so as to take a profit or limit a loss.

**Leverage**
Leverage provides the potential to make a higher return from a smaller initial outlay than investing directly. However, leverage usually involves more risks than a direct investment in the underlying shares. Trading in options can allow you to benefit from a change in the price of the share without having to pay the full price of the share.

**Diversification**
Options can allow you to build a diversified portfolio with a lower initial outlay than purchasing shares directly.

**Income generation**
You can earn extra income over and above dividends by writing call options against your shares, including shares bought using a margin lending facility. By writing an option you receive the option premium up front. While you get to keep the option premium, there is a possibility that the contractual position may could be exercised against as a result compelling you to deliver shares at the exercise price.

7 ASX (2015), Understanding Options Trading, ASX Austrailian Share Market, Available from: https://www.asx.com.au/documents/resources/pdf

# OPTION COMPONENTS

A standard options contract is composed of the following key components:

**1. Underlying securities**

Option is a derivative security, a contract giving owner (buyer) of the option the right (but not the obligation) to buy or sell a defined quantity of a defined asset. This asset is called underlying asset or underlying security or just underlying. The best-known underlying are single stocks (shares in companies traded in the stock market). There are also options on various indices like the S&P500. Options on futures, bonds, interest rates, currencies, ETFs, and many other kinds of assets or economic variables exist too[8].

**2. Expiry day**

Options have limited life. Every option has a defined expiration date that is also fixed during its whole life and nothing can change or move it. If an option is not exercised before or on its expiration date, it becomes worthless (it expires) after that date.

**3. Exercise/strike prices**

Strike price is the price for which the option's owner can buy or sell the underlying security, if he decides to exercise the option.
An option's strike price is fixed and does not change during the life of the option. For one underlying and one type of option (calls or puts) there are usually at least several different strike prices available. For example, for a stock which currently trades at 57 you can trade call options with strike prices of 50, 55, 60, 65 etc. and put options with strikes of 50, 55, 60, 65 etc. But of course, every single option always has only one strike price defined and once you own it you can't change its strike – it's fixed.
Remember that an option's strike price is different than its market price. Option's market price is the price for which you trade the option itself and it changes during the life of the option, as supply and demand in the options market change.

**4. Option premium**

The premium is the price of the option which is arrived at by the negotiation between the taker and the writer of the option.

**8** Macroption, 5 Basic Characteristics of Every Option, Available from: http://www.macroption.com/option-5-basic-characteristics/#expiration

# OPINIONS OF SHARIAH SCHOLARS ON OPTIONS

Our understanding is that options are prohibited for two principle reasons:
Contractual uncertainty (*Gharar*) and an invalid subject matter (*mabi'*) of sale.

The exercising of the option is unknown and uncertain. This ambiguity in the subject matter makes it *Gharar*. It is a right which enforces another contract, however, the enforcing is uncertain and suspended on an uncertain event. Hence, it is different to other rights, this right is a right with *Gharar*.

*Gharar* literally means: danger or exposure to destruction, risk, hazard, deception, delusiveness, peril, hazard, fallaciousness, undisclosed, and uncertainty. In financial application, *Gharar* means deceptive uncertainty indicating the practice of deception or fraud through the use of extreme contractual uncertainty. In Fiqh, *Gharar* means doing something blindly without sufficient knowledge, or taking the plunge in an act which carries the risk of not knowing exactly what will happen, or to enter the arena of risk without thinking of consequences, or something whose consequences are hidden, uncertainty or ignorance over the object of sale. According to Imam ibn Taymiyyah, *Gharar* occurs when someone does not know what is stored for him at the end of the trading activities which is similar to *Qimar* (gambling). The prohibited form of *Gharar* is known as *Gharar Fahish* (gross uncertainty). Minor uncertainty is acceptable as it is immaterial, insignificant and negligible. The difference between the two is that the former is more likely to lead to dispute. Minor uncertainty is very unlikely to lead to dispute, and therefore, it is overlooked and permissible.

*Gharar* may arise in the form of uncertainty in the contract and anything that is related to the contract, such as uncertainty in the value of the subject matter, uncertainty in the time of payment on deferred sale, in the quality and quantity of the subject matter, existence, ownership, deliverability, availability or nature of the object of the contract[9]. The prophetic narrations clearly prohibit *Gharar* in transactions. Abu Hurairah (May Allah be pleased with him) narrated: "*The Messenger of Allah (salallahu alayhi wasallam) prohibited sales of 'whatever a pebble thrown by the seller hits,' and sales in which there is Gharar.*" [Sahih Muslim]

Another reason for prohibition of options is non-compliance of its subject matter with Shariah. Options are essentially a choice which you are purchasing. This 'ability to choose' is the subject matter. There are two choices a person buys: transact or not to transact. Let alone the existence of *Gharar* in the subject matter, the subject matter is not even valid in Islamic law. A choice is not something for which consideration can be given. Selling 'choices to transact' is invalid as a choice does not conform to Mal (property), Manfa'ah (usufruct) nor a valid Haqq (right) in Shariah. In an option contract, one is trading this choice, which is a contract, to hedge against the risk. The choice incorporates risk. When the underlying asset is in one's favour, the option contract is exercised. When the underlying asset exposes one to loss, the option contract is not exercised. Thus, the contract is being traded to hedge against the risk exposure in the underlying asset.

In an option contract, the right to buy (or sell) an underlying asset at a predetermined strike price requires payment of a fee. According to Mufti Muhammad Taqi Uthmani, an option is a 'promise' which in itself is permissible and "normally binding on the promisor". However, the fact that an option transaction requires payment of a fee on the promise invalidates this type of derivative under Shariah[10]. He opines that this ruling applies to all types of options, whether they be calls or puts, because options are rights, not physical assets, and therefore cannot be bought or sold. The 'right to buy' is a commitment, pledge and promise to transact. Let alone being lawful commodities, promises are not even assets.

**9** Mihajat (2016), Contemporary Practice of Riba, Gharar and Maysir in Islamic Finance in International Journal of Islamic Management and Business 2 (2), IIUM Institute of Islamic Banking and Finance, Available from: http://www.crimbbd.org/wp-content/uploads/2015/01/pdf

**10** Uthmani, M.T. (2014), Fiqh al-Buyu, Karachi: Maktaba Ma'arif al-Qur'an

Promises are merely an expression of imposing a task on one's personal liability. Mufti Taqi Uthmani further states that a premium is paid without any transfer of property, benefits or rights. Hence, when there is no counter-exchange being transferred, a premium is unwarranted. As a consequence, the premiums paid for options fall under *Rishwa* (bribe) and are prohibited. *Rishwa* refers to taking consideration for something which does not warrant a premium or consideration[11].

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

> "Option contracts as currently applied in the world 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.[12] "

The OIC Islamic Fiqh Academy's decision was confirmed by the European Council for Fatwa and Research.

Dr Mohammed Obaidullah asserts that in options the buyer and seller have diametrically opposite expectations. Depending on the actual outcome, one of them will win at the expense of the other. The gains are therefore in the nature of *Maysir*, and *Maysir* cannot occur without the existence of *Gharar*, being a subset of that larger category. Dr Obaidullah explains that speculating on where random fluctuations will move the price of an underlying asset or commodity in the future infers that the parties' gains and losses also will be random, demonstrating that dealing in option contracts is nothing more than a game of chance. Gains are therefore in the nature of *Maysir*, while the possibility of suffering default after incurring massive losses indicates *Gharar*. Dr Obaidullah concludes his discussion on options by stating that "options as an independent contract may not be a suitable form of hedging or managing risk, these can be used for speculating on price movements and generate unearned income, which violates Islamic norms of financial ethics"[13].

Shaykh Yusuf DeLorenzo holds a similar opinion, stating that options and futures, are part of zero-sum markets where gains result from corresponding losses. He opines that this sort of economic activity is clearly forbidden under Shariah law. He adds that, while proponents of futures and option markets may argue that such activities function to stabilise prices and regulate risk, as far as the Shariah is concerned such markets produce nothing of value. He concludes that "options and futures amount to bets on the

11 Uthmani, M.T. (2014), Fiqh al-Buyu, Karachi: Maktaba Ma'arif al-Qur'an

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

13 Iqbal et al. (2012), Application of Options in Islamic Finance, ISRA

direction the market is moving in. Obviously, the ethics of this market are unacceptable".
Options being derivatives, are zero-sum games and a form of gambling. Dr Sami Al-Suwailem explains that, in a zero-sum game, one party gains at another's expense, i.e., it is a "transfer of wealth for no counter-value"; this he opines is "condemned in the Qur'ān". He explains that the direct conflict of interest inherent in a zero-sum game may create hatred between the two parties, which is one reason the Qur'ān prohibits gambling (*Maysir*): "Satan only wants to plant enmity and hatred among you through wine and gambling" (Q6:91). Al-Suwailem argues that the use of derivatives is a clear example of a zero-sum game, obliging an exchange of underlying assets for money, or certain amounts of money, at a future date. In the latter type of contract, the price difference between the time of contract to expiration date is debited from one party and credited to another; this is why they are called contracts for differences. Al-Suwailem suggests that, to achieve a desirable transfer of risk, Islamic finance must utilize structures that allow for mutual gain, in other words, non-zero-sum games. "Such games, while implying the possibility of zero-sum outcome, permit a positive-sum outcome, and thus provide room for mutual benefits."

## The Shariah rulings on options

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI, 2008) in Standard 20, Sale of Commodities in Organised Markets has declared the impermissibility of options. The standard describes options and states:

5/2/1 A contract by means of which a right is bestowed -but not an obligation- for the purchase or sale of an identified item (like shares, commodities, currencies, indexes or debts) at a determined price and for a determined period. There is no obligation in this contract except on the person selling this right.

5/2/2 Options indicated above are not permitted neither with respect to their formation nor trading.

# ALTERNATIVES TO OPTIONS

In respect to the alternatives for options, the AAOIFI Standards state:

**5/2/3 Shariah substitutes for options**

5/2/3/1 The conclusion of a contract pertaining to ascertained assets is permitted according to the Shariah, along with the payment of part of the price as *'Arbun* (Earnest Money) with the stipulation that the buyer has the right to revoke the contract within a specified period in lieu of the entitlement of the seller to the amount of earnest money in case the buyer exercises his right of revocation. It is not permitted to trade the right established with respect to the earnest money.

5/2/3/2 The conclusion of a contract for commodities in themselves along with the stipulation of an option for establishing the right of revocation for one of the parties, or for both, during a known period. This option is not eligible for trading.

5/2/3/3 The issuance of a binding promise by the owner of assets to sell them, or a binding promise by one desiring to buy them, without specifying a counter-value for the promise. This promise is not eligible for trading.

*Arbun*, *Khiyar*, *Hamish Jiddiyyah* all give the holder a choice, however, they cannot be traded like options. If the objective is to give the holder a choice to complete a transaction or trade, these can be used. However, if the objective is to trade risk, such concepts in Islamic finance cannot be used to replicate options.

Options are different to rights (*Huquq*) recognised in Shariah; *Huquq* generally confer the power to benefit from an asset/service, whilst options necessitate the other party to transact once exercised. Options enforce the other party to contract. Options are connected to underlying contracts and securities, and thus, derivatives. The option is the 'right to contract' which is being traded and this contract to contract is not considered Shariah compliant.

It is incorrect to analogise options with Shar'ia options such as the option of condition (Khiyar al-shart), option of defect (*Khiyar al-ayb*), option of inspection (*Khiyar al-ru'yah*). These are not detached from the contract; rather, they are embedded in the contract and are exercised for the same contract. In fact, they are regarded as terms of the contract[14]. On the other hand, options are independent and are exercised to initiate another contract. They are not terms of a contract.

Options are different to *Arbun* (earnest money) too. *Arbun* is paid by the buyer to the seller at the time of contract on the basis that the buyer has the option to revoke the contract during an agreed period of time. If he confirms the contract, the earnest money is credited towards the price. If he does not confirm the contract or fails to pay the remaining price during the stipulated time, the seller is entitled to forfeit *Arbun* (Earnest Money)[15]. Thus, *Arbun*, as mentioned in the Hanbali Fiqh, is part of a contract and not an independent payment to exercise another contract. Furthermore, in *Arbun*, the partial payment made is considered as earnest money; as such, if the buyer does not revoke the contract and continues, the earnest money would form part of the purchase price. However, if the contract is revoked within the specified time, the partial payment will be forfeited to the seller. Thus, the partial payment is not a fee or premium, as in an option contract, but more of a deposit.

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**14** Al-Laknawi, Umdat al-Ri'ayah, Beirut: Dar al-Kutub

**15** AAOIFI (2017), Shariah Standard No. 53: Arboun (earnest money, Bahrain: AAOIFI

The tradability of a 'right to buy' in a secondary market is non-compliant with Shariah principles. However, if the incentive element of an option is considered, an alternative Shariah compliant incentive can be offered as a substitute to an option. A unilateral *Wa'd* (promise/undertaking) agreement can be structured to offer incentive features of an option. The seller of the option can instead make an undertaking to transact equity with the buyer for a limited time at a pre-determined price or market rate. This is supported by the AAOIFI standard No. 49 which states:
*"It is permissible for a party to promise to enter into a commutative contract in the future."*

The legal nature of such a promise is described in the standard in the following words:

"It is permissible to promise to perform an action or a financial transaction and it is then a religious obligation to fulfil it, meaning that breaking a promise without an excuse is a sin. However, a promise is not legally binding except when there is a real need for it to be enforced, such as when the promisor causes the promisee to incur a liability as a result of the promise. For example, if a person instructs a merchant to purchase a specific item and then resolutely promises the merchant that he will buy this item from him. If the merchant purchases the item solely in reliance on the promise, the promisor is legally bound to purchase the item from him, failing which the promisor is required to indemnify the promisee (merchant/seller) for any actual loss suffered such that if the merchant is unable to sell the item for a price that covers the cost of the item, the promisor is required to make up the difference between the cost of the item and the price obtained by the merchant for it. Actual loss does not include opportunity cost."

In reference to exercising the promise, the standard states:

> "When a promise is made to enter into a contract in the future, such contract is not effected automatically. The contract must be entered into at the relevant time by the exchange of offer and acceptance. Where the promise is legally binding, if the offer is made by the promisee, the promisor is bound religiously and legally to accept it. And if the offer is made by the promisor, the promisee has the option |to accept or reject it."

However, unlike options, such a *Wa'd* cannot be traded as the trading of a *Wa'd* is not Shariah compliant.

Some Shariah scholars and Islamic banks have adopted *Wa'd* structures with fees. However, there is some debate among Shariah scholars on the acceptability of these structures. *Wa'd* has been used to create option structures engineered for risk management in currency exchange, although this is not universal, i.e., not all banks use these structures. The banks that do use these structures do so upon the approval of their Shariah Supervisory Boards. One structure has been developed using *Wa'd*. A fee is paid, one through the mechanism of a commodity Murabahah and the other with direct payment of fees[16].

**16** Iqbal et al. (2012), Application of Options in Islamic Finance, ISRA

The FX *Wa'd* is a structure very similar to the conventional option. It uses a *Wa'd* that is binding on one party. On the start date of the transaction, the bank will undertake to the investor to exchange Currency 1 against Currency 2 at a pre-agreed rate on a future date. On the same date, the bank will execute a commodity Murabahah whereby payment is paid on the spot; thus in reality, the bank receives a fee from the investor for its undertaking. On the future date, the investor might ask the bank to fulfil its promise or might release the bank from its undertaking. On the maturity date, if the investor wants to execute the *Wa'd*, the bank and the investor will exchange the currencies. The fee will be the banks to keep whether or not the investor exercises the promise or not.

A similar mechanism is used in Sukuk. An option like mechanism is used usually to redeem the principal to investors at maturity or in the event of default. The options are typically in the form of purchase or sale undertakings to buy/sell the underlying assets using the concept of *Wa'd*. For example, in an Ijarah Sukuk, the issuer will sell the underlying assets to the SPV (special purpose vehicle) and subsequently lease them back. At maturity, in order to pay back the principal to the investors, the issuer will give a purchase undertaking to buy the assets at the principal value. Usually, the SPV will also give a sale undertaking to ensure that the issuer gets back the assets at maturity. The use of options in Sukuk does not usually involve any separate fees for giving the undertakings. Note that some Sukuk are callable, but even in such structures the option premium is not separately paid; rather, it is usually embedded in the Sukuk price[17].

**17** Iqbal et al. (2012), Application of Options in Islamic Finance, ISRA

## Conclusion

This research has attempted to present an overview of options and how it operates in the conventional markets as well as a Shariah analysis. Options are derivatives used for multiple reasons, primarily hedging and speculation for income. Majority of the contemporary scholars are of the view that conventional options are not Shariah compliant. The arguments and reasoning of most scholars revolve around the presence of Gharar (contractual uncertainty), the element of *Maysir* (gambling) and the option itself not being a valid tradeable item in Islamic law. It is essentially the trading of risk itself. If it is the element of choice in a contract, there are Shariah compliant alternatives which give the traders a choice such as *Arbun*, Khiyar and *Hamish Jiddiyyah*. However, all such alternatives cannot be traded on a secondary market. A minority opine on the use of payments for the *Wa'd*, however, that is against the majority understanding including the AAOIFI Shariah standards. Thus, to develop an identical Shariah compliant product to options is very difficult due to the nature of options. Further research is required to develop products which are truly Shariah compliant and acceptable for risk management in Islamic finance.

# 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 Sharia Scholars from 19 countries. And we're not done yet: our Sharia Advisory and Sharia Audit services will continue to improve—serving local and international businesses to help them maintain and manage Shari'a compliance.

We've been preparing our clients for a new world in which Sharia Advisory rapidly becomes the currency of choice. From faster Certification programs, to direct Sharia 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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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.