Conventional derivatives products Vs Islamic derivatives products

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Introduction

Over the last thirty years, the globalization of the economy has led companies to become aware of financial risks. This has prompted the financial services industry to invent remarkable products to manage these risks. We then witnessed the growing development of derivatives on the financial markets not only in terms of volume but also in terms of types of contracts. Derivatives have also grown much faster than conventional financial transactions, which themselves were already outpacing growth in production or merchandise trade. But what is a derivative? It is actually a contract whose value is "derived" from the price of something else, usually "cash investments", such as stocks, bonds, money instruments, or commodities. Thus their recourse makes it possible to manage the risks of the products to which they are linked by anticipating the fluctuations on the markets. Overall, the size of the derivatives market is significant.

Under the broad perspective of Islamic Capital Markets, where derivative transactions fall into the Islamic financial instruments need to follow the axioms of Shariah and Islamic Law. From the viewpoint of contemporary scholars like Kahf, any Islamic financial instrument or transaction has to undergo strict screening and abide under the principles of (i) Consent, Aptitude, (ii) Balance, (iii) Moral commitment / Ethical Foundation, (iv) Shariah Permissibility and (v) Realism. Looking at the history of derivatives they were introduced for a noble purpose of managing risk and hedging open financial exposures of genuine needs. But the unfortunate part is that they have become the most famous, and the most used instrument for arbitrage and speculative activity.

Major categorisations of derivatives as to how they will be discussed in this project are forwards, futures, options, swap, urbun, salam, waad and istisnaa.

- So what is the difference between Islamic and conventional derivatives products?
- And on what this difference is based?
Derivatives are securities whose value is determined by an underlying asset on which it is based. Therefore the underlying asset determines the price and if the price of the asset changes, the derivative changes along with it. A few examples of derivatives are futures, forwards, options and swaps. The purpose of these securities is to give producers and manufacturers the possibility to hedge risks. By using derivatives both parties agree on a sale at a specified price at a later date. In each derivative certain aspects are documented such as the relation between the derivative, type of underlying asset and the market in which they are traded. It is essential to understand the strengths and weaknesses of each derivative to employ them to their fullest potential.

### Futures:
Futures are exchange organized contracts which determine the size, delivery time and price of a commodity. Futures can easily be traded because they are standardized by an exchange. Per commodity traded there are different aspects specified in a futures contract. First of all is the quality of a commodity. For a commodity to be traded on the exchange, it must meet the set requirements. Second is the size of a single contract. The size determines the units of a commodity that is traded per contract. Thirdly is the delivery date, which determines on which date or in which month the commodity must be delivered.

### Swaps:
A swap is a derivative in which two counterparties agree to exchange one stream of cash flows against another stream. Swaps can be used to hedge interest rate risks or to speculate on changes in the underlying prices. Since swaps are not used in equity markets in India, we would not go into further details of swaps. For example, when trading commodities the first party, an airline company relying of kerosene, agrees to pay a fixed price for a pre-determined quantity of this commodity. The other party, a bank, agrees to pay the sport price for the commodity. Hereby the airline company is insured of a price it will pay for its commodity. A rise in the price of the commodity is in this case paid by the bank. Should the price fall the difference will be paid to the bank.

### Forward Contracts:
A forward contract is an agreement to buy or sell an asset on a specified date for a specified price. The main features of this definition are

- There is an agreement
Agreement is to buy or sell the underlying asset

- The transaction takes place on a predetermined future date
- The price at which the transaction will take place is also predetermined

**Option Contracts:**
An option contract is a contract which gives one party the right to buy or sell the underlying asset on a future date at a pre-determined price. The other party has the obligation to sell/buy the underlying asset at this pre-determined price (called the strike price). The option which gives the right to buy is called the CALL option while the option which gives the right to sell is called the PUT option.
CHAPTER 2: "Islamic derivatives products"

➢ Arbun:

The arbun is a commission paid by a potential buyer to a potential seller for the purpose of having the right to acquire a property, paying its price of course, within a specified time interval in the arbun. In case of purchase, the buyer only pays the remaining amount of the arbun, since the latter is considered part of the price to be paid. Otherwise, that is to say if the potential buyer renounces to buy during the period of time reserved for him by the arbun, the seller has the right to keep the arbun. This financial instrument is reminiscent of the call option, known in conventional finance.

Unlike a conventional option, the arbun is not for sale or buy since this practice induces speculation (gharar), illegal in Islam.

➢ Waad:

Waad is a word in Arabic that means promise. This is a promise to sell or buy a property. This promise is declared unilaterally. The one who has promised must keep his commitments on the day of execution of the waad contract. In the same way, the one who is promised must be held to honor the waad by a penalizing clause. Finally, and if the promisor does not keep his promise contained in the waad contract, the court may force the execution of the contract or the compensation of the promised party. From this point of view, the waad contract, while valid and compatible with sharia law, does not offer incentives (whether legal or financial) for the promisor to conclude it.

➢ Salam:

Salam contract under the fiqh rules is a transaction between two parties for sale/purchase of an underlying asset at a predetermined future date but at a price determined and fully paid on the day the contract was signed. The seller in a contract at the initiation of the contract agrees to deliver the asset in the agreed quantity and quality to the buyer at the predetermined future date.

the salam contract is subject to several conditions, including the following:

1 Full payment by buyer at the time of effecting sale.

2 The underlying asset must be standardisable, easily quantifiable and of determinate quality.

3 Quantity, quality, maturity date and place of delivery must be clearly enumerated in the Salam agreement.
4 The underlying asset or commodity must be available and traded in the market throughout the period of contract

- **Istisna’**:

  Istisna’ means asking someone to construct, build or manufacture an asset. In Islamic finance, istisna’ is generally a long-term contract whereby a party undertakes to manufacture, build or construct assets, with an obligation from the manufacturer or producer to deliver them to the customer upon completion. In practice, the key advantage of an istisna’ contract is that it can provide flexibility to the customer, where payments can be made in installments linked to project completion, at delivery or after project completion. In contrast to istisna’, for salam contract the payment has to be made in full, in advance.
Chapter 3: "Difference Between Islamic and Conventional Derivatives Products"

- **Shariah permissibility**

  The Shariah permissibility refers to the standard that all financial instruments should pass to be considered halal, or be acceptable by the Muslim community as in accordance with the Islamic Law. According to Khan (1996), at a primary level, all financial instruments and transactions must be free at least the following five items: (a) riba (usury), (b) rishwah (corruption), (c) maysir (gambling), (d) gharar (unnecessary risk) and (e) jahl (ignorance).

- **Riba**

  Riba is literally defined as increment, an addition or augmentation. Islam, like all other monotheistic religions, prohibits riba (Kahf, 2006). The prohibition of riba in Islam is given in strong and clear-cut terms:

  And whatever ye lay out as Riba, so that it may increase in the property of (other) people, it shall not increase with Allah. (Quran 30:39).

- **Rishwah (corruption)**

  As evident by the very word, any kind of corruption in any contract or any Islamic financial instrument is not permitted. As earlier mentioned, the concept of ‘ethical investment’ and morality is one of the principles that the instrument needs to confirm with.

- **Maysir (gambling)**

  Maysir from a financial instrument viewpoint would be one where the outcome is purely dependent on chance alone, as defined in the modern day word ‘gambling’. Why Islam prohibits maysir is explained in the view of jurists, as the game of chance that does not give a reason for the transfer of wealth from one party to another. Also, an instrument dependent on a chance does not serve economic purpose and gives rise to speculation which is prohibited as it may exploit and harm a party.

- **Gharar (unnecessary risk)**

  Gharar is one of the most important causes of invalidity of any contract or financial instrument. According to Sarakhsi, ‘gharar takes place where the consequences (of a transaction) remain unknown’. From the viewpoint of Islamic financial instruments, it can be referred as that there is uncertainty from one or both parties about the underlying asset.
As mentioned earlier, it is unacceptable from a Shariah viewpoint that one party may gain advantage out of the ignorance of the other party. Both the counterparties should be well aware of what the instrument of financial transactions they are undertaking. With the element of ‘jahl’ it borders on exploitation which results in the very contract being void under majority of jurists’ viewpoints.

“Comparison between Islamic and conventional derivatives products”

Urbun:

<table>
<thead>
<tr>
<th>Mécanisme</th>
<th>Conventional équivalent</th>
</tr>
</thead>
<tbody>
<tr>
<td>_ The money is not as a premium rather it is earnest, it is a down payment on the price of contrat. _ The buyer pays the seller a deposit to have the right to conclude or cancel the sale. _ If the buyer continues with the contract within the stipulated time period, the earnest money becomes a part of the price negotiated already. _ In the case the buyer decides to cancel the transaction or decide not to go ahead with the sale, the earnest money is forfeited by the buyer. The deposit money can be kept by the seller.</td>
<td>_ Nature and the use of options are such that amounts to maysir(gambling). _ Options are used for excessive speculation. _ The premium paid is impermissible. _ The deposit money in Bay Al Arbun becomes a part of the price of the contract while in the case of a conventional call option, the down payment is the price of buying the right to that price.</td>
</tr>
</tbody>
</table>
Bai salam:

In reference to discussion regarding future and forward contracts in earlier sections, the current conventional future contracts are similar to the Salam contract in all the conditions except the full prepayment by the buyer. The Table addresses the five conditions for a valid salam contract as earlier mentioned in comparison to the conventional derivative.

<table>
<thead>
<tr>
<th>Condition</th>
<th>Conventional future contrat</th>
<th>Salam contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full prepayment</td>
<td>Contradicts</td>
<td>conforms</td>
</tr>
<tr>
<td>Standardisable asset</td>
<td>conforms</td>
<td>conforms</td>
</tr>
<tr>
<td>Confirmed quality and quantity</td>
<td>Conforms</td>
<td>conforms</td>
</tr>
<tr>
<td>Maturity date defined</td>
<td>Conforms</td>
<td>conforms</td>
</tr>
<tr>
<td>Asset must be available in market</td>
<td>Conforms</td>
<td>conforms</td>
</tr>
</tbody>
</table>

Istisnaa

<table>
<thead>
<tr>
<th>Mécanisme</th>
<th>Equivalent conventional</th>
</tr>
</thead>
<tbody>
<tr>
<td>_ the nature and quality of the item to be specified.</td>
<td>_ istisnaa is more in line with the conventional forward contract where the price is not paid in advance as well.</td>
</tr>
<tr>
<td>_ the manufacturer must make a commitment to produce the item as described.</td>
<td>_ As for the delivery of the property, it will be completed as the property is manufactured only when the two parties have agreed on the terms of the contract.</td>
</tr>
<tr>
<td>_ The item is deliverable upon completion by the manufacturer.</td>
<td>_ The cash payment can, in fact, be used to purchase the equipment needed to manufacture the property.</td>
</tr>
<tr>
<td>_ the contract is irrevocable after the commencement of manufacture except where delivered goods do not meet the contracted terms.</td>
<td></td>
</tr>
<tr>
<td>_ Payment can be made in one lump sum or in installments, and at any time up to or after the time of delivery.</td>
<td></td>
</tr>
<tr>
<td>_ the manufacturer is responsible for the sourcing of inputs to the production process.</td>
<td></td>
</tr>
<tr>
<td>_ in istisnaa not a condition to advance the payment.</td>
<td></td>
</tr>
</tbody>
</table>
### Waad

<table>
<thead>
<tr>
<th>mechanism</th>
<th>Conventional equivalent</th>
</tr>
</thead>
<tbody>
<tr>
<td>two parties performing two unilateral promises on the same subject.</td>
<td>among the principales of shariah, it is not permissible to link two financial transactions.</td>
</tr>
<tr>
<td>the waad contrat although valid and compatible with the sharia, does not offer incentives for the promisor and to conclude it.</td>
<td>indeed, in a swap contract, there are two linked operations that take place.</td>
</tr>
<tr>
<td>in this form, it is rare to see waad contracts concluded in the world of islamic finance</td>
<td>Cash sale of the national currency.</td>
</tr>
</tbody>
</table>
Conclusion

The fact is that these instruments (futurs; swaps; options..) are illicit in Islam, and therefore not usable by some companies that want to respect Islamic sharia, has the effect of negatively affecting the competitiveness of Islamic companies. Indeed, these derivatives are intended to protect the company against different risks: currency risk, risk of failure to deliver goods, etc. Hence, these instruments are extremely important to protect the company against these risks and allows it to focus on its core business instead of focusing its efforts on risk management through daily monitoring of different courses: that of commodities or foreign currencies.

Aware of the negative repercussions that may result from the non-use of these financial techniques, the Muslim religion has allowed certain techniques: bai-al-salam, Istisna, Arbun And waad.
Bibliography


