Conventional derivatives products Vs Islamic derivatives products

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  - Chapter 1: conventional derivatives products.
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Introduction
Chapter 1: "Conventional derivatives products"

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.

**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.

**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.
**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 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.
**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.
The buyer only pays the remaining amount of the arbun.
The arbun is considered part of the price to be paid.

**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.
The one who is promised must be held to honor the waad by a penalizing clause.
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.

Istisnaa:

Istisna’ means asking someone to construct, build or manufacture an asset. In Islamic finance, istisna' is generally a long-term contract where by 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.
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. The prohibition of riba in Islam is given in strong and clear-cut terms:

\[
\text{وَمَا آتَيْتُمْ مِنْ رِبًا لِيَرْبُوَ فِي أَمْوَالِ النَّاسِ فَلََ يَرْبُو عِنْدَ اللَّهِ}
\]

- **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.
**Jahl (ignorance)**

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.</td>
<td>_ Nature and the use of options are such that amounts to maysir(gambling).</td>
</tr>
<tr>
<td>_ The buyer pays the seller a deposit to have the right to conclude or cancel the sale.</td>
<td>_ Options are used for excessive speculation.</td>
</tr>
<tr>
<td>_ If the buyer continues with the contract within the stipulated time period, the earnest money becomes a part of the price negotiated already.</td>
<td>_ The premium paid is impermissible.</td>
</tr>
<tr>
<td>_ 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>_ The deposit money in Bay Al Ar bun 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 contract</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></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 manufacturer is responsible for the sourcing of inputs to the production process.</td>
<td>_ The cash payment can, in fact, be used to purchase the equipment needed to manufacture the property.</td>
</tr>
<tr>
<td>_ in istisnaa not a condition to advance the payment.</td>
<td></td>
</tr>
</tbody>
</table>
Waad:

<table>
<thead>
<tr>
<th>Mechanisme</th>
<th>Conventional equivalent</th>
</tr>
</thead>
<tbody>
<tr>
<td>_ two parties performing two unilateral promises on the same subject.</td>
<td>_ among the principals of sharia, 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. Cash sale of the national currency.</td>
</tr>
<tr>
<td>_ in this form, it is rare to see waad contracts concluded in the world of Islamic finance.</td>
<td></td>
</tr>
</tbody>
</table>
Conclusion