

The Current Position of Islamic Law on Options Contracts in the Financial

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Abstract

This study is an overview of options contracts and the Islamic law view on them based on its current application in the financial markets. Methodology that has been used in this study is descriptive methodology, where secondary data have been collected from books, published journals, and the resolutions of the international Islamic academies, where they were reviewed and discussed in order to clarify the criticisms of Islamic law and Muslim scholarly consensus toward options contracts in light of its present application in the financial markets versus who supports the use of options within a certain range. The study concluded that the current options include forbidden elements such as Gharar (ambiguity), Riba usury and Gambling. However, these contracts can be developed under certain conditions and used in the field of hedging.

Keywords: Options, Islamic options, Arabun, Khiyar al-shart.

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1. INTRODUCTION

This study is an overview of options contracts and Islamic law view on them based on its current application in the financial markets. The study consists of five broad sections: section 2 an overview of option contracts; section 3 Arguments rejecting options; Section 4 Arguments accepting options; section 5 conclusions.

2. Overview of Options Contracts

Option contract is defined as contract that gives the right, but not the obligation, to buy or sell underlying assets such as equity, interest rate, commodities and currencies, at a specific price called strike price during specified period in exchange for this right the buyer pays to seller a cost known as premium (option price). Options contracts include two parties; the first is the 'buyer' who has a long position and the 'seller' who has a short position, he issues option in exchange for a premium. With options, you can either be a buyer or seller

There are many advantages of using options contracts one of the best advantages is the possibility to make huge earnings out of doing so without necessarily having to have big sums of money as well as provide an opportunity, to make proportionately more returns from the same capital investment. The second important advantage of trading option is hedging feature, by purchasing options traders and investors can hedge themselves from risk. Option contracts are a vital tool can be used to hedge against losses in underlying assets whether prices decreased or rose.

3. Arguments rejecting options

OIC Fiqh Academy ^[1] stated that the current options are new types of transaction which do not come under any of the Shari'ah nominate contracts. So, it is confirmed that these

contracts are illegal in the perspective of Shari'ah.

3.1. Options contract and Gharar (Ambiguity)

If you look to current application of the options contracts many of options are used to sell asset or item is not owned by the seller or even not exist at the time of contracting. Underlying asset of option contract does not exist in the seller ownership or in his possession. ^[2] Considered the current derivatives contracts forbidden because they include selling from the item prior possession. ^[1] Selling what you don't have is invalid for the lack of ownership. Asserted when both seller and buyer in options, agree to defer the price payment and the delivery of item to future this type of contract consider gharar contract. ^[1,3] The sale of pure right is not accepted in Islamic law. Highlighted the prohibition of options contract, because it's just a selling of right, where the sale of such right is a form of bay' al-ma'adum (selling non extant) and thus it is unsound for a contract. ^[4] This is because the options contract is only right, and right in Islam cannot be traded unless it is linked with haqqmali (property or usufruct). Imam Shafei defined mali as anything sold that has value. Consequently, the current application of option sale does not include haqqmali (property) or usufruct (benefit) or services, and it is only right to buy or sell underlying asset, and the underlying asset mentioned in the option contract is only a symbol to make profit. So, this is another form of forbidden ambiguity.

3.2. Options Contracts and Riba (Usury)

Options contract is trading independently from underlying asset. ^[4] Dawabah ^[5] also confirmed that the options differ from the arabun (down payment), where

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the price of arabun is advance payment of underlying asset price, while the price of options is a price of right or adherence. Although there is a derivation and a relationship between the price of underlying asset and option, where the change in option price is depends on the change in the price of underlying assets. But giving option contract a separate financial value or price in the financial markets to be bought and sold separately exactly like underlying assets or like other financial securities is not permitted from the Islamic law perspective. Revocation of right in options contract is a form of usury, where the option seller receives option price from the buyer of option without anything to offset the price paid (option premium) and this contradict with the Islamic contract. Where the promisor does not have right to charge promised price (option premium) for making such promise.

Options contracts that are conducted on the prohibited underlying assets are absolutely prohibited options, such as interest rate options.^[1] Furthermore, currency options are not allowed, since currencies must be traded on spot hand to hand otherwise delaying the exchange like what's going on option currency is considered a type of prohibited riba al-nasiah. Option on interest bearing products, bond option, options on conventional banks stocks, there is no doubt that it is forbidden because of the sanctity of the of underlying asset.

3.3. Options and Maysir (Gambling)

Option contract includes prohibited maysir, actually from options most current application of financial derivatives are used for speculation and gambling, where there is no real intention to buy or exchange underlying assets and there is no physical delivery. This is because options traders not only can buy one option contract, but they can also combine more than one option as straddle, strangle or enter option on options contract and other types and strategies which are considered as instruments and methods to enable them to speculate on the price fluctuations of underlying asset in the financial market, in order to make abnormal profit. This can inversely affect the Islamic markets and economy of Islamic countries when it misused on prime commodities such as food and oil. The ultimate goal from that is just paying and receiving the price differences between sellers and buyers. This is considered gambling and it is therefore impermissible. Stated that options contracts are corrupt contracts because it contradicts with the purpose of permissibility of Islamic options (khiyar al-shart), where al-khiyar in Shari'ah is gharar in the contract, but it became acceptable due to the need of it, rather than to achieve capital gains by exploiting the price fluctuations in the markets. Option maturity is associated with price, so it becomes corrupt contracts where the corrupt condition is often associated with an increase of the price. There is a positive relationship between the option price and the maturity period in the current application of options, where the increase in maturity causes increase in price, and this would not be permissible. OIC Fiqh Academy^[1] has concluded that the current options contracts in financial market do not come under any one of the Shari'ah nominate contracts and thus it is illegal, because the subject matter is not haqq mali and; therefore, it is not permissible for trading.

4. Arguments for accepting options

Many specialists assured that main purpose of options is for hedging, where the use of such contracts at the current

evaluation in Islamic finance industry, should be taken into account. The Gharar issues in options contracts namely the sale of what you don't have some Muslim scholars, argued that the hadith of "sell not what you don't have," applies only to a specific asset, not for fully described goods. Ibn Taymiah (1398H) stated that the hadith related to sale of what is not present and what the seller cannot deliver. Obaidullah^[6] assured that the causality of forbidden sell not what you don't have is incapability to deliver the underlying assets on the maturity day. While these financial options operations are carried out under the supervision of the financial market, which guarantees delivery on the day of maturity.

On other hand with regard to usury and gambling issues in options, International Association of Islamic Banks^[7] decided the option price that is paid from buyer to the seller in option contracts in exchange seller gives the buyer the right to implement or revoke the contract is accepted. Options contract is similar to Islamic arabun contract and; therefore, the premium is acceptable.^[8] The Shari'ah Advisory Council of Malaysia's Securities Council has accepted the tradability of options contract based on the principle of any form of manfa'ah can be interpreted as a property (mal), which in turn can be subjected to sale.^[9] Muslim scholars viewed usufruct (manfa'ah) as properties; it has a value and could be measured by money. Thus, they see using the option right as benefit in permitting the option buyer to buy and sell in order to manage or protect their assets from potential risks in the financial market. by charging the option price, the seller is simply receiving compensation for granting a right to the buyer. Muslim researchers see options contract similar to khiyar al-shart, which is approved by Maliki and Shafei scholar.^[10] They see there is a possibility to develop options contracts according to the Islamic law requirements and use them as hedging tools in commodities markets such as commodities options.

4. Conclusion

The study concluded options considers a vital risk protection instrument offer hedge against risk and loss whether prices drooped or rose. Nevertheless, Islamic Fiqh Academies see the current application of option contract in the financial markets is a form of forbidden contracts includes many prohibited elements such as gharar (ambiguity), riba (usury) and gambling, and therefore it cannot be used as a hedging instrument or even take benefit of its advantages. However, some Muslim researchers see the possibility of using option contracts in the event that some adjustments and conditions are applied on option contracts that guarantee there are no prohibited elements such as usury and gharar, and ensure there are no deviate from the main goal which is the hedging feature in the Islamic financial markets, the starting development can be start through commodities options. Finally, this study recommends more research in Islamic law and hedging science to develop shariah compliant options contracts such as Arabun and khiyar al-shart without falling into forbidden elements.

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