

## CHAPTER FOUR

### THE FORWARD MARKET FOR CURRENCIES

#### *Basic Rules of Currency Exchange and Paper Money*

Before starting our discussion on the legality of forward currency markets in Islamic law, it is necessary to establish the legal status of modern currencies in Islamic law. Do they invoke the rules of gold and silver as the medium of exchange and source of value or they are like *fulūs* (cheap metal or copper money) known to early Muslim jurists or something totally different? The issue has been discussed in several forums such as that of the Islamic Fiqh Academy based in Makkah, the Board of Great Scholars in Saudi Arabia, and the Islamic *Fiqh* Academy based in Jeddah.<sup>1</sup> Each institution has passed a resolution on the subject. However, one of these resolutions may be enough to clarify the issue since there is a great similarity between these different resolutions. The major points of the resolution adopted by the Islamic *Fiqh* Academy based in Makkah were as follows:

1. Considering that gold and silver were the principle medium of exchange, and the *'illah* of *ribā* in these two metals was *mutlaq al-thamaniyyah* (the broader characteristic of being money) or money and the medium of exchange, then according to the most authoritative opinion of Muslim jurists, this *'illah* is not restricted to these two metals, although they represented the principle source. On the other hand, considering that paper money has become *thaman* and replaced gold and silver in their use today, it is through these currencies that the value of things is measured after the disappearance of the gold and silver standards. Moreover, people rely on and keep paper money as a store of value. Debt is settled by these currencies, despite the fact that their values are not intrinsic but based on their acceptance as medium of exchange; by this characteristic they become a *thaman*. Considering the fact that the *'illah* in gold and silver is the

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<sup>1</sup> See Majma' al-Fiqh al-Islāmī, *Majallat Majma' al-Fiqh al-Islāmī*, no. 3, vol. 3, p. 165. Resolution no. 21 (9/3).

*thamaniyyah*, which is also present in paper currency, the Academy decided that paper money is an independent kind of medium of exchange. It has the rules of gold and silver concerning *zakah*, *ribā al-faḍl* (riba related to trade and *ribā al-nasīʾah* (related to loan) as it is in gold and silver by way of analogy based on *thamaniyyah*. Thus, paper money will follow all rules related to gold and silver regarding *sharīʿah* obligations.

2. Paper money is considered an independent kind of currency as is the case with gold and silver. These different currencies should be considered as different types of currencies according to the country of issuance. In other words, the Saudi currency is a kind (*jins*) and the American currency is another kind (*jins*) and so on. Therefore,
  - *Ribā*, whether *faḍl* or *nasīʾah*, applies to these currencies as it does to gold and silver. Consequently, it is illegal to buy and sell these currencies in exchange for one another or for gold and silver on a deferred basis without taking possession at the time of the contract.
  - It is illegal to exchange the different tenders of any of these currencies with each other whether in a spot market or on a deferred basis. For instance, it is illegal to sell ten Saudi riyal for eleven on the spot or on a deferred basis.
  - It is legal to exchange these currencies if the transaction is conducted on the spot. For instance, it is legal to exchange two Lebanese lira with two Saudi riyal or more or less or an American dollar with three Saudi riyal or more or less if it is hand to hand. Also, it is legal to exchange three Saudi paper riyal with three Saudi silver riyal or more or less, if it is on the spot, because they are not from the same kind (*jins*).
3. *Zakah* the amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy) on paper money is obligatory if its value reaches the amount prescribed by the *sharīʿah* for silver and gold. But it should be based on any cheaper price of the two metals. If there are some commodities for trade, besides gold or silver, it should also be added as subject of *zakat*.
4. It is legal to use paper money as a price for *salam* and capital for partnership.<sup>2</sup>

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<sup>2</sup> See *Qarārāt Majlis al-Majmaʿ al-Fiqhī al-Islāmī*, Makkah 8 to 16, Rabi al-Ākhir, 1402, Fifth Session, pp. 96–97.

Thus, the spot currency exchange is unanimously agreed upon among Muslim jurists as a legal one. The majority of contemporary Muslim jurists, on the other hand, consider the forward exchange as illegal. This is also the position of the major Islamic institutions interested in Islamic commercial law. However, some scholars have argued for its legality by drawing an analogy with *fulūs* or by considering the concept of *ṣarf* (currency exchange) as just limited to gold and silver. This last opinion seems to be based on shaky grounds, given the fact that the difference between *fulūs* and paper money is obvious.

Nevertheless, Muslim investors may sometimes be in need of such transactions to manage risk associated with currency fluctuations. Is it possible to modify the existing forward currency market and bring it in line with *sharīʿah* principles? If this is not possible, what is the alternative?

It is indispensable for business managers today to know how the foreign exchange markets work and the ways in which currency risk can be reduced. Changes in the relative value of various currencies can disrupt the planning of firms engaged in the export or import business. Of course, the problem of fluctuating currency values is not so serious if the payment for goods, services, or securities is made promptly. Spot market prices of foreign currencies normally change very little from day to day. However, if payment is to be made weeks or months in the future, there is considerable uncertainty as to what the spot rate will be for any given currency on any given date. When substantial sums of money are involved, the rational investor or commercial trader tries to guarantee the future price at which currency can be purchased. This is the function of the forward exchange market that reduces the risk associated with the future purchase and delivery of foreign currency by agreeing upon a price in advance.<sup>3</sup>

A forward exchange rate contract is a contract to buy and sell a specified amount of different currencies for physical delivery of either side at some future date, calculated by reference to a contractually agreed strike price.<sup>4</sup> It is a tool that is used not only by borrowers, but also by traders who typically deal with foreign currency when importing or exporting their products. However, Muslim jurists are almost

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<sup>3</sup> Peter S. Rose, *Money and Capital Market—The Financial System in the Economy*, Business Publications, 1986, pp. 790–791.

<sup>4</sup> John Prebber (ed.), *Dimensions in Banking and Foreign Exchange Law*, Wellington, Butterworths, 1992, p. 222.

unanimous in agreeing that it is illegal to exchange currency if it does not involve immediate receipt or taking of possession, as we have mentioned before. Thus, al-Subkī said: “All scholars from whom we have learned are unanimous that any mutual exchange without immediate reciprocal taking of possession is void.” Ibn al-Munzir reported the *ijmāʿ* about it.<sup>5</sup>

Moreover, similar provisions have been adopted by the Egyptian and Sudanese Islamic banks.<sup>6</sup> In addition, a general stand about such transactions was taken in the second conference of Islamic banks held in Kuwait. It was clearly stated that “It is illegal to exchange gold, silver or currencies unless it is on the spot. Therefore, any exchange on future basis will be a kind of *ribā*.”<sup>7</sup> Furthermore, the Islamic *fiqh* Academy held a similar position, in its resolution no. 64/1/7 concerning Stock Markets adopted in its seventh session held in Jeddah.

The Accounting and Auditing Organization of Islamic Financial Institutions’s standard no. 1 on Trading in currencies is very explicit:

It is prohibited to enter into forward currency contracts. This rule applies whether such contracts are effected through the exchange of deferred transfers of debt or through the execution of a deferred contract in which the concurrent possession of both of the countervalues by both parties does not take place.<sup>8</sup>

It is also prohibited to deal in the forward currency market even if the purpose is hedging to avoid a loss of profit on a particular transaction effected in a currency whose value is expected to decline.

This prohibitive stand on the illegality of the forward contract in currency exchange is also maintained in the case of deferring one of the countervalues while the second is presented at the spot as in the case of *salam* in commodities. Several *aḥādīth* are explicit on the issue, such as “Exchange of gold for gold, silver for silver, wheat for wheat, oats for oats, dates for dates and salt with salt must be on the spot and in equal quantities, but if the two kinds [of commodities] differ, exchange them as you like, but the exchange must be completed on the

<sup>5</sup> Ibn al-Munzir, *al-Ijmāʿ*, p. 97.

<sup>6</sup> Sudin Haron and Bala Shanmugam, *Islamic Banking System Concept and Application*, p. 139.

<sup>7</sup> See *ʿAbhāth al-Muʿtamar al-Thānī li al-Maṣrif al-Islāmī*, Kuwait, 1983, p. 131.

<sup>8</sup> Accounting and Auditing Organization for Islamic financial institutions, *Sharīʿa Standards 2004–5*, Standard no. 1 Trading in Currencies, p. 5.

spot and no credit must be involved.<sup>9</sup> Moreover, there is a consensus among Muslim jurists that such a transaction is not allowed in Islam in the exchange of gold and silver. However, some differences have been reported concerning *fulūs*. These differences are based on the different opinions about the *'illah* or the rationale of gold and silver as explained above. Thus, some classical scholars are of the opinion that it is legal to exchange *fulūs* in the contract of *salam*.<sup>10</sup> What concerns us more here is the opinion of some modern jurists who seem to have extended the application of this opinion to paper money.<sup>11</sup>

However, as we have indicated above, the idea of considering *fulūs* commodities and non-*ribawī* items is based on the assumption that the *'illah* in gold and silver is weight (*wazn*) or *thamaniyyah qāshirah*, which could not be extended to items other than gold and silver. We have already demonstrated the weakness of this argument. Moreover, we may find some excuses for the classical scholars in connection with this issue. First of all, at that time, gold and silver were still the major medium of exchange while today they have been totally replaced by paper money. Second, *fulūs* are used only in the sale and purchase of minor items, which is not the case with modern currencies. In other words, *fulūs* did not possess at that time, according to the proponents of this view, the characteristics of money or *thamaniyyah* in full and were hardly used as a store of value or unit of account and were more in the nature of a commodity. Hence, there was no restriction on their purchase on a deferred basis as is the case with gold and silver. Based on this argument, it is reported from different scholars belonging to the different Islamic schools of law that it is not possible to use *fulūs* as capital in *muḍārabah*,<sup>12</sup> (a contract between a capital owner and an investment manager to share profit) but this is not the case with paper money, which is nowadays the sole medium of exchange.

<sup>9</sup> Muslim, *Saḥīḥ Muslim with Sharḥ al-Nawawī*, Mu'assasat Manāhil al-'Irfān, Beirut, 1986, vol. 11, p. 37; see also *Fath al-Bārī Bi Sharḥ Saḥīḥ al-Bukhārī*, Dār Iḥyā' al-Turāth, vol. 4, p. 304.

<sup>10</sup> See, for instance, Ibn al-Humām, *Fath al-Qadīr*, vol. 5, p. 327.

<sup>11</sup> Muhammad Taqī al-'Usmānī, "Aḥkām 'Awrāq al-Nuqūd wa al-'Umulāt" *Majallat Majma' al-Fiqh al-Islāmī*, no. 3, vol. 3, 1987, pp. 1704–1705; Mohammad Sulaimān al-Ashqar "al-Nuqūd wa taqallub al-Umalah," *Buhūth Fiqhiyyah fi Qadāyā Iqtisādiyyah*, Dar al-Nafā'is Ammān, 1998, vol. 1, p. 289.

<sup>12</sup> See for instance, Ibn al-Ḥumām, *Fath al-Qadīr*, vol. 6, pp. 168–170; Al-Khirshī, *Sharḥ Mukhtaṣar Khalīl*, vol. 6, p. 205; al-Buhūti, *Kashshāf al-Qinā'*, vol. 3, p. 498, al-Mirdāwī, *al-Inṣāf*, vol. 5, p. 411.

Thus, to allow *salam* on paper money nowadays based on the above argument is a false analogy. The present day currencies have all the features of *thaman* and are meant to be *thaman* only. Therefore, to consider them similar to *fulus* is a false analogy and disregards the basic reality of modern life.

However, the idea of deferring one of the countervalues in foreign currencies has unfortunately attracted some Muslim economists despite its legal weakness. Thus, Mohammed Obaidullah endorsed this position on the assumption that *bay al-ṣarf* means the exchange of gold and silver only. He said, “*bay al-ṣarf* is defined in *fiqh* literature as an exchange involving *thaman ḥaqīqī*,” defined as gold and silver, which served as the principle medium of exchange for almost all major transactions. He went on to say “the tradition mentioned about *ribā*, and the sale and purchase of gold and silver which may be a major source of *ribā*, is described as *bay al-ṣarf* by the Islamic jurists. It should be noted that in *fiqh* literature, *bay al-ṣarf* implies the exchange of gold and silver only, whether these are currently being used as the medium of exchange or not.”

Based on this argument Obaidullah tried to prove that there is no *ribā* in such a transaction from a practical point of view. Thus, he said in his conclusion,

The second types of contracting with deferment of obligations of one of the parties to a future date falls between the two extremes. While *sharī ah* scholars have divergent views about its permissibility, our analysis reveals that there is no possibility of earning *ribā* with this kind of contract. The requirement for settling the obligation of at least one party imposes a natural curb on speculation, though the room for speculation is greater than under the first type of contract. The requirement amounts to the imposition of a hundred percent margin, which, in all probability, would drive the uninformed speculator from the market. This should force the speculator to be a little more sure of his expectations by being better informed. When speculation is based on information it is not only permissible but desirable too. *Bay al-salam* also allows participants to manage risks. At the same time, the requirement of settlement from one end would dampen the tendency of many participants to seek a complete transfer of perceived risk and encourage them to make a realistic assessment of the actual risks.<sup>13</sup>

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<sup>13</sup> Mohammed Obaidullah, “Islamic Contracts for Currency Exchange: Divergent Views and Implications,” *Journal of Objectives Studies*, Institute of Objectives Studies, India, vol. 9, no. 2, July 1997/1416H, pp. 24–46.

However, as we have mentioned above, the divergence of opinion among classical scholars regarding the legality of exchanging *fulūs* on a *salam* basis could not be extended to modern paper money due to the clear differences between the two types of currencies. Obaidullah's analysis may have some basis from a practical point of view, but its legal grounds are very weak and his conclusion is unacceptable. Thus, we may conclude that *salam* or the deferment of one of the countervalues, while the other is delivered at the time of the contract, is illegal and some of the practical advantages advanced in favor of such a transaction cannot overrule this legal position. The present paper currencies have effectively and completely replaced gold and silver as the medium of exchange. Hence, by analogy, exchange involving such currencies should be governed by the same *sharī'ah* rules and injunctions. Therefore, if deferred settlement by either party to the contract is permitted, this would be a clear form of *ribā al-nasī'a'h*.

Obaidullah did not limit this permissibility just to *salam* but extended it to options. Thus, he maintained in his article, "Ethical options in Islamic Finance" that the currency option poses some challenges for scholars and researchers and there are divergent views on the issue of the prohibition of *ribā* in currency exchange. The divergence is due to the process of analogy (*qiyās*) in which the efficient cause (*'illah*) plays an extremely important role. The process of analogy is needed since gold and silver, which performed the function of money in the early days of Islam, have been replaced by paper currencies. It is an efficient cause (*'illah*) that links the object of the analogy with its subject in the exercise of analogical reasoning. The appropriate efficient cause (*'illah*) in the case of currency exchange contracts has been variously defined by the major schools of *fiqh*. Accordingly, some jurists equate currency exchange with *bay' al-ṣarf* in which spot settlement or *qabḍ* by both the parties is insisted upon. Hence, options are automatically ruled out. Others, primarily belonging to the Ḥanafī school, permit deferment of obligation by one party or *bay' al-salam* in currencies and thus admit the possibility of options.<sup>14</sup> This conclusion is also based on the above-mentioned basis and it is unacceptable. However, we will

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<sup>14</sup> Mohammed Obaidullah, "Ethical Options In Islamic Finance" *Journal of Objectives Studies*, Institute of Objectives Studies, India, vol. 10, no. 1, January 1998/ 1418–H, p. 79.

discuss the issue of options in currencies when we tackle options trading in general.

Another issue raised by Obaidullah which is also unacceptable is the claim that the different currencies existing nowadays are only *athmān* within the boundaries of the country concerned, unlike gold, which is *thaman* in all places. Therefore, the rules of gold should not be applied to these currencies. Thus, he argued that

A unique feature of *thaman ḥaqīqī* or gold and silver is that the intrinsic worth of the currency is equal to its face value. The question of different geographical boundaries within which a given currency, such as the *dinār* or *dirham*, circulates is completely irrelevant. Gold is gold whether in country A or country B, and any deviation of the exchange rate from unity or deferment of settlement by either party cannot be permitted as it would clearly involve *ribā al-faḍl* and *ribā al-nasīʾah*. However, when the paper currency of country A is exchanged for the paper currency of country B, the case may be entirely different. The price risk (exchange rate risk), if positive would eliminate any possibility of *ribā al-nasīʾah* in the exchange on a deferred basis. However, if the price risk (exchange rate risk) is zero, then such an exchange could be a source of *ribā al-nasīʾah*.<sup>15</sup>

Once again Obaidullah based his argument on the Ḥanafī view, although he described it as the opinion of the large majority of scholars. He maintained that the *ribā* prohibition would require a search for efficient cause (*ʿillah*) in the case of exchange involving paper currencies belonging to different countries. Currencies belonging to different countries are clearly distinct entities; these are legal tender within specific geographical boundaries with different purchasing power. Hence, a large majority of scholars perhaps rightly assert that there is no unity of (*jins*). Additionally, these are neither weighable nor measurable. This leads to a direct conclusion that none of the two elements of efficient cause (*ʿillah*) of *ribā* exists in such an exchange. Hence the exchange can take place free from any injunction regarding the rate of exchange and the manner of settlement. The logic underlying this position is not difficult to comprehend. The intrinsic worth of paper currencies belonging to different countries differs as these have different purchasing power. Additionally, the intrinsic value or worth of paper currencies cannot be identified or assessed unlike gold and silver, which can be weighed. Hence, neither

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<sup>15</sup> Mohammed Obaidullah, "Islamic Contracts for Currency Exchange: Divergent Views and Implications," p. 35.

the presence of *ribā al-faḍl* (by excess), nor *ribā al-nasīʾah* by deferment can be established.<sup>16</sup>

As we have mentioned above, Obaidullah's argument is based on the Ḥanafī' approach in deducing what is the *'illah* in gold and silver and arguing that these modern currencies are neither weighable nor measurable. However, we have already examined the weakness of this approach in deducing the *'illah* and the difficulty faced by the Ḥanafīs themselves in defending it concerning the legality of *salam* in weighable items such as metal. On the other hand, to discern the difference between what is *ribawī* and what is not on the basis of the assumption that the exchange rate risk is positive or it is zero may not be correct all the time. Moreover, even the rate of exchange between gold and silver fluctuated from time to time throughout the Muslim history, but this did not prevent the application of the rules pertaining to *ribā*. Although it is not so volatile as it is in the case of paper money, there is still some fluctuation. Lastly, the claim that these currencies are only legal tender within their geographical boundaries and, therefore, should not be considered like gold and silver in the area of currency exchange, may not be correct in all aspects. Indeed, the currency of country A may not be accepted as a medium of exchange in country B, but it is still recognized as a store of value and can be exchanged with the currency of the first country without any reluctance, as long as it is still the legal tender in its country of origin. For instance, the Saudi riyal may not be accepted as a medium of exchange within Malaysia, but it is recognized as a store of value and not just ordinary paper and can be exchanged with the Malaysian ringgit at any time and any place. It is similar to the case when one country is using gold as the medium of exchange while the other is using silver. Both are regarded as stores of value and the mediums of exchange in their respective countries, and one medium of exchange may not be accepted as legal tender in the other country, but they could not be exchanged unless it is hand-to-hand. From the above, we could say that to exchange different currencies on the *salam* basis is illegal and there is no difference between the deferment of one of the countervalues or both of them due to the clear *ḥadīth* stated before.

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<sup>16</sup> Ibid., pp. 28–29.

However, recognizing the benefits of forward currencies trading in the modern economic system<sup>17</sup> and being aware of the general agreement that a deferred contractual obligation in foreign currencies is illegal in Islamic law, Muslim scholars are striving to find the suitable Islamic alternative, which can secure some of the benefits of the forward currency exchange without contravening Islamic rules. Thus, the idea of mutual promise in currency exchange has been developed.

### *Mutual Non-Binding Promise in Currency Exchange*

The need for mutual non-binding promise for currency exchange in modern transactions is evident in the import and export sectors due to unpredictable currency and exchange rate fluctuations. Thus, for instance, a Malaysian exporter opens a credit in favor of an Egyptian importer for the purchase of, say, palm oil. The rate of exchange of the ringgit to that of the Egyptian pound may differ from the date of the opening of credit until the receipt of the value of the said credit. The Egyptian importer wishes to avoid the rise or fall of the exchange rate while this promise will be executed on a future date agreed upon between the parties after a real contract. Therefore, he would prefer to carry out a promise of exchange of currencies by executing a promise

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<sup>17</sup> It is worth mentioning that some scholars have totally excluded any benefit for forward currency trading. Thus Sāmi Hamoud held that "It is well known fact that in practice dealing in exchange on the basis of the forward rate represents neither the need of commerce nor the ordinary commercial activity, but is more or less a speculation in the rate of currencies and of interest in the main international centers. For this reason the local banks of many countries neither involve themselves nor deal in this risky kind of exchange, which is rather an act of gambling." This statement may have a kind of objectivity with regard to those entering the forward currency market as speculators, but it would be totally unfounded in the case of genuine traders trying to hedge themselves against any currency fluctuation in the future. Moreover, the reasons for which he is defending the concept of mutual promise in foreign exchange trading are the same reasons for forward currency trading as practiced in the conventional system of finance. It may be somewhat acceptable to say the harm in such a transaction is greater than the benefit if it is used for speculative purposes. Therefore, it should not be allowed in Islamic law. It could also be argued that it is against the principle of currency exchange in Islam according to the majority opinion. For instance, in principle a *ṣarf* transaction should be hand to hand and therefore, it should be prohibited. However, to pass a general judgment that there is no benefit in such a transaction is far from reality. Moreover, some commentators followed this opinion without any effort to investigate the issue or to analyze it. See, for instance, Abd Allāh Abū Umair, *al-Tarshīd al-Sharī lil Bunūk al-Islamiyyah*, International Association of Islamic Banks, p. 280.

for the purchase of the equivalent amount of goods at the rate of exchange prevailing on the date of opening the credit. Thus, this is a mutual promise of exchanging currencies at the spot rate. It does not involve delivery on the part of either party: it just involves a promise to purchase, on a future date, at a rate fixed in advance.

The majority of Muslim scholars consider any promise to conclude a foreign exchange transaction followed by a real contract to confirm it later as an illegal transaction.<sup>18</sup> Thus, for instance, Ibn Juzai cited three opinions on the matter: the abhorrence (*karāha*) of the promise of exchange, which is also the most renowned opinion; permissibility (*Ibāhā*); and banning (*ḥurma*).<sup>19</sup> Ibn Rushd (the grandfather) maintained that in the exchange of gold for silver, as well as in the sale of gold for gold and silver for silver, mutual promise, option, guarantee and assignment (transfer) are not permissible; only the immediate delivery is possible. Also, al-Khirshī considered such kind of exchange as void; he cited an example where a man tells another: “Let us go to the market and take your *darāhims* with you; if they are good I will take them from you so many for so many *dirhams*.” Then he quoted the view of Ibn Shass to the effect that if such a case is permissible in marriage during the ‘*iddah* (the waiting period for a woman who has been divorced before marrying another person) it would be even more appropriate in this case.<sup>20</sup>

Some modern Muslim scholars have also opposed the idea of mutual non-binding promise in dealings involving foreign currency. Aḥmad Muhy al-Dīn argues that such a promise is, in reality, a contractual obligation, since the agreement must be executed at its maturity date. Moreover, such a promise is not always concluded with good Muslims since commercial deals could also be concluded with non-Muslims and some morally corrupt persons who may not worry about defaulting on their obligations as there are no legal consequences for such a default. Besides, such a mutual promise contradicts the principle of immediate or hand-to-hand delivery stipulated in the *ḥadīth* which is unanimously agreed upon as a condition in *ṣarf* or currency trading. In addition,

<sup>18</sup> See for instance Mohammad Qadri Bāshā, *Murshid al-Ḥairān*, p. 63. Ulesh, Sharḥ, *Mīnah al-Jalīl’alā Mukhtaṣar khalīl*, vol. 2, p. 510. Ibn Rusd, *al-Muqaddimāt*, Dār Sādir, Beirut, vol. 2, pp. 507–9.

<sup>19</sup> Ibn Juzai, *al-Qawānīn al-Fiḥiyyah al-Shar’iyyah*, Beirut, Maktabat ‘Ālam al-Fikr, 1975, p. 263.

<sup>20</sup> Al-Khirshī, *Sharḥ Mukhtaṣar khalīl*, vol. 5, p. 36.

if we consider this transaction as a mutual promise while in fact it is honored like a real contract, it would no longer be a promise because “What is honored by custom is like what is stipulated as a condition.” And “Consideration in contracts is to be given to the meaning and not the form.” Furthermore, the objective of such a deal is to fix the exchange rate at an agreed rate until the time of delivery and this could not be done unless there is a contract, as is the case in the conventional practice. Therefore, to apply the idea of mutual promise in *ṣarf* as cited from al- Shāf‘ī and Ibn Ḥazm is an invalid analogy.<sup>21</sup>

However, the permissibility of the mutual promise in *ṣarf* or currency exchange is reported from al- Shāf‘ī, Ibn Ḥazm al-zāhirī, and Ibn Nāfi‘ from the Mālikī school. They regarded it as a legal transaction without any reservation, while some other Mālikī scholars have divergent opinions on the issue. Thus, al- Shāf‘ī said: “If two persons make a promise to each other to exchange foreign currency in the future, there is no problem.”<sup>22</sup>

The main argument is that a promise is not a contract and there is no textual evidence that disallows such a transaction. Thus, Ibn Ḥazm stressed that “to make a promise to someone to buy or to sell gold for gold, silver for silver, and the four other items cited in the *ḥadīth*, is legal whether the parties confirm this promise by a contract later or not. This is because exchanging promises is not a contract and there is nothing which prohibits it.”<sup>23</sup> Ibn Nāfi‘, a Mālikī scholar, has a similar opinion.<sup>24</sup> Ibn al-Qāsim, another Mālikī scholar, pointed out that such a promise should be discouraged, but if a contract has been concluded later on the basis of this promise, it would be legal and should not be dissolved.<sup>25</sup>

The same line of argument among the classical scholars is manifested in the writing of modern scholars. Thus, considering the complexity of modern financial transactions, the need for a better planning in international trade, and bearing in mind the general agreement among Muslim jurists that a forward contract to exchange different foreign currencies is illegal in Islam, some modern Muslim jurists have suggested

<sup>21</sup> Aḥmad Muḥyi al-Dīn, *‘Amal Sharikāt al-Istithmār al-Islāmiyyah Fi al-‘Aswāq al-‘Ālamīyyah*, pp. 340–344.

<sup>22</sup> al-Shāf‘ī, *al-‘Umm*, vol. 3, p. 32.

<sup>23</sup> Ibn Ḥazm, *al-Muḥallā*, vol. 2, p. 513.

<sup>24</sup> Al-Ḥattāb, *Mawāhib al-Jalil li-Sharḥ Mukhtaṣar khalil*, vol. 4, p. 513.

<sup>25</sup> Ulesh, *Sharḥ Minaḥ al-Jalil ‘alā Mukhtaṣar khalil*, vol. 2, p. 510.

the adoption of the concept of promise to exchange different currencies followed by a real contract to confirm it as a solution to the modern problem of currency fluctuation.

Thus, the *sharī'ah* boards of several Islamic financial institutions have opted for the approval of this kind of transaction. For instance, in the first al-Barakah seminar a question was addressed as to the legal position of making a promise to buy different currencies at the rate of the day of agreement (the day of mutual promise) on the condition that the mutual delivery of the exchange will occur later. This exchange in the future will be hand to hand, considering that such a promise could be binding or not. The answer was,—“If such a mutual promise is binding on both parties, it falls under the general prohibition of selling credit for credit, and it is not permissible. However, if it is not binding upon the two parties, then it is permissible.” (First Albaraka Seminar, Fatwā no. 13).

A similar question was again raised in the sixth al-Baraka seminar as to the position of Islamic law on the issue of mutual promise concerning currency exchange. The answer was

The rule in this issue is to confirm what is stated in the resolutions adopted by the Second Conference of Islamic Banks held in Kuwait, March 1983. The arrangement for the sale of currencies with deferred payment is permissible provided the promise is not binding (This is the opinion of the majority). If the arrangement is binding, it is not permissible. (Sixth al-Baraka Seminar, Fatwā no. 23).<sup>26</sup>

The question was addressed to the *sharī'ah* board of the Kuwait Finance House, as to what is the *sharī'ah* position on the possibility of making a mutual promise to buy foreign currencies with the price determined today and the mutual delivery will take place later. The board's answer was. “This kind of transaction is a mutual promise to buy, and if the transaction is executed as it is formulated in the question, then there is no legal problem. However, if the mutual promise is related to anything that makes it binding, then it will be a kind of *bay' al-kālī' bi al-kālī'*, which is prohibited.”<sup>27</sup>

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<sup>26</sup> Dallh Albaraka, *Fatwa: Sharī'ah Ruling on Economics*, Dallah Albaraka Research and Development Department, Jeddah, Saudi Arabia, 1414/1994, pp. 71–72.

<sup>27</sup> Bayt al-Tamwīl al-Kuwaitī, *al-Fatāwā al-Sharī'yyah fī al-Masā'il al-Iqtisādiyyah*, Kuwait, 1986, vol. 1, p. 50.

The problem was addressed to the *sharī'ah* consultant of the Jordanian Islamic bank in connection to the problem of currency fluctuation facing those who want to perform *hajj*. The question was, "To facilitate the issue of pilgrimage for those who are willing to visit the holy sites, the Ministry of Awqāf would like to make an agreement (mutual promise) with the Jordanian Islamic bank to purchase Saudi riyal at the price fixed at the exchange rate of the day of the mutual promise, while the mutual delivery will take place six months later. The Islamic bank will deliver to the Ministry a cheque bearing the amount needed in Saudi Riyal, and the Ministry for its part will deliver the amount in Jordanian dinār." Is it legal to make such a deal?

In his reply to this question the *sharī'ah* advisor said

The mutual promise to exchange different currencies with the exchange rate fixed on the day of the mutual promise and the mutual delivery to take place later without any regard to the exchange rate of the day of delivery is legal. This could be accommodated in what is reported in *Nayl al-Awtār* where the Ḥanafīs and Shāf'ī's are of the opinion that it is possible to exchange different currencies at the exchange rate of the day, more or less. This approach may contravene what Ibn 'Umar reported to the effect that the legality of such a transaction is limited only to the exchange rate of the day. However, it seems that the two Imams (Shāf'ī and Abū Ḥanifā) have based their opinions on the general *ḥadīth* in which the prophet said, "If these items [the six different items mentioned in the *ḥadīth of ribā*] are different, then, you can buy and sell if it is hand to hand. Therefore, I consider such a deal, based on the Shāf'ī and Ḥanafī opinion, as legal."<sup>28</sup>

However, a close look at what is reported in *Nayl al-Awtār* shows that the case to which the *sharī'ah* advisor is referring is about someone collecting his debt in a specific currency, which he gave as credit but would like to receive it now in another currency. In such a case it is possible to get it back in another currency whether it is more or less than what is in the liability of the debtor, because since it is an exchange of different currencies, there is no need for equality. But it should be hand to hand. Therefore, it seems that the *sharī'ah* consultant formed his opinion by making an analogy with this case since what is reported in *Nayl al-Awtār* is about collecting a debt and not about currency exchange.

<sup>28</sup> Jordan Islamic Bank, *al-Fatāwā al-Shar'iyyah*, vol. 2, p. 11.

The advocates of this opinion argued that there is nothing that could prohibit such a transaction, since there is no *ribā*, *gharar*, or *jahālah*. On the contrary, the transaction serves a real public interest.

Sāmi Ḥamoud, one of the first advocates of this alternative, argued that if we look into the facts of the case and take into consideration the service which the importer receives from the transaction (in the case of the mutual promise to buy) and the service which the exporter receives (in case of the mutual promise to sell), we find that the reinsurance made to the importer in regard to the price which he will pay, and to the exporter for the price he shall receive, is a matter which has its importance. Where the bank has to perform extensive transactions it will be able to balance the mutual promise of sale and purchase transaction *per se* where no real dealings of imports and export are involved.<sup>29</sup>

Farḥān al-Abbār argued that the concept of mutual promise is outside the boundaries of the texts prohibiting the exchange of currencies unless they are exchanged on the spot. The objective of these texts is to prohibit the deferment of one of the countervalues while the second is present. This difference of time is the cause of *ribā*. This is totally different from the mutual promise where both countervalues are exchanged later at the same time and on the spot. What is agreed upon through the mutual promise is just the exchange rate<sup>30</sup> and not the formation of a contract of currency exchange.

ʿAbbās al-Bāz argued that the objection of those who reject the mutual promise to sell foreign currencies will be correct if the parties in the contract consider it a binding obligation, which may fall within the ambit of *bayʿ al-kāliʿ bi al-kāliʿ*. However, what the advocates of this opinion propagate is just a promise and a promise is not a contract. Furthermore, to consider the fulfillment of the promise as obligatory or *wājib* if the second party enters into another deal based on this promise will not transform the promise into a contract. Therefore, any request for damages if one party is affected by the default of the other will be based on the failure to fulfill his promise and not the failure to fulfill his contract. In practice, the different parties would strive to fulfill their commitment not because they consider it a contract but just to safeguard their reputations and to win the confidence of other

<sup>29</sup> Sāmi Ḥassan Ḥamoud, *Islamic Banking: The Adaptation of Banking Practices to Conform with Islamic Law*, Arabian Information, London, 1985, p. 180.

<sup>30</sup> Farḥān al-ʿAbbār, *Qadā yā Muʿāshirah fi al-Nuqūd*, p. 322.

market players in a competitive market. In addition, if we look to the *ratio* behind the prohibition of such kinds of transaction, it is about preventing people from using money as a commodity for trade. In the case before us, the objective of the parties is not to trade in currency but just to manage any risk arising from currency fluctuations and to safeguard the mutual interest of the parties. Finally, it is evident from practice that such a deal has not been the cause of financial crises and none of the parties will use the transaction to monopolize the currency demanded.<sup>31</sup> El-Gārī had a similar opinion if the promise was not binding<sup>32</sup> and Rafiq al-Miṣrī also shared the same opinion if the mutual promise was not obligatory. In the same context, it should be noted he considers the prohibition of deferment in currencies on the same basis of sale of debt for debt and not as a case involving *ribā*.<sup>33</sup> Some other scholars also endorsed the idea.<sup>34</sup>

The AAOIFI's Shariah standard on currencies trading states the following: "A bilateral promise to purchase and sell currencies is forbidden if the promise is binding, even if for the purpose of hedging against currency devaluation risk. However, a promise from one party is permissible even if the promise is binding."

However, despite the arguments advanced by the proponents of the idea of mutual promise, it has been criticised by other scholars, some of whom we have mentioned above. Mindful of these criticisms, some scholars have come up with new suggestions to resolve the problem.

### *Mutual Loan and Currency Risk Management*

Some have advanced the idea of mutual loans. It should be noted once again that Muslim scholars are only concerned with the problem facing genuine traders and how they could manage their investment risks without compromising *sharī'ah* rules. It is with this vision that the idea

<sup>31</sup> See 'Abbās Aḥmad al-Bāz, *Aḥkām Sharf al-Nuqūd wa al-'Uumlāt fi al-Fiqh al-Islāmī*, Ammān, Dār al-Nafā'is, 1999, pp. 130–131.

<sup>32</sup> Mohamed 'Ali El-Gārī, "al-Aswāq al-Māliyyah", *Majallat Majma' al-Fiqh al-Islāmī*, p. 1626.

<sup>33</sup> Rafiq al-Maṣrī, *al-Jāmi' fi Aḥkām al-Ribā*, p. 148.

<sup>34</sup> 'Abd Allāh 'Abd Al-Rahīm al-'Abādī, *Mawqif al-Sharī'ah min al-Maṣārif al-Islāmiyyah*, pp. 318–319; Mustaphā 'Abd Allāh al-Hamsharī, al-Maktab al-Islāmī, Beirut, 1986, pp. 378–9, and Jihād Abū 'Umair, *Al-Tarshīd al-Sharī' lil Bunūk al-Islāmiyyah*, International Association of Islamic Banks, p. 204.

of mutual loan or “*al-murābahah al-islāmiyyah*” or the Islamic swap, as it was described by Jamāl al-Dīn ‘Aṭiyyah, has been advanced. In this transaction the Islamic bank and the genuine investor will exchange an equivalent amount of money in different currencies for a specific period as a mutual loan (*qardḥ ḥasan*). During this period each party has the right to use the amount of money he received in his respective investment and will refund his original money on the agreed date.

To illustrate the situation we may take the following example. A particular investor has, for instance, the amount of US \$1 million that he wishes to invest in Germany. However, he is afraid of the fluctuation of the German mark during the period of the investment. Thus, to manage this risk he may enter into an agreement of mutual loan with the Islamic bank. He gives his US \$1 million to the Islamic bank as a *qardḥ ḥasan* and he will receive the equivalent of this amount in German marks from the Islamic bank as a *qardḥ ḥasan* as well. Each one has the right to invest what he has received during this period and at the agreed date each of them will refund his original amount of money or his *qardḥ ḥasan*. Thus, this investor will have hedged himself against any fluctuation of the German mark during this period at least for his original capital.

However, it should be noted that the profit that may be generated from this investment falls outside this approach of hedging.<sup>35</sup> On the other hand, the new formula will be useful only if both parties have already at hand the required amount of money before entering the mutual exchange of *qardḥ ḥasan*. Moreover, the Islamic banks may not be willing to cooperate; this is as it should be with these investors, since there is no real benefit for the Islamic bank in such a deal. Furthermore, it may face the risk of default from these customers.

### *Currency Basket and Risk Management*

A third solution regarding the problem based on the concept of currency basket has been advanced by Saud Mohammad. He argued that

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<sup>35</sup> Jamāl al-Dīn ‘Aṭiyyah, *al-Bunūk al-Islāmiyyah Bainā al-Hurriyyah wa al-Tanzīm; al-Taqlīd wa al-Ijtihād; wa al-Nazariyyah wa al-Taṭbīq*, kitāb al-Ummah, Qaṭar, Ri‘āsat al-Mahākīm al-Shar‘iyyah wa al-Sh‘ūn al-Dīniyyah, Qaṭar, 1988, p. 163. Also see Abū al-Majd Ḥarak, *al-Bunūk al-Islāmiyyah ma lahā wa ma ‘Alayhā*, Dār al-Ṣaḥwah, Cairo, n.d., p. 87.

an importer who faces the risk of currency fluctuation may make an arrangement with the owner of the commodities to be imported that the settlement of the price will be made in several different hard currencies. It could be, for instance, the American dollar, the German mark, the Swiss franc, and the Japanese yen. Thus, any depreciation in any one of these currencies will be balanced by the appreciation of others and it is unlikely that the package of currencies selected will depreciate all at once. Thus this investor may be able to manage the risk of currency fluctuation to some extent. However, it should be noted that this formula could be of some help only for importers. Regarding exporters, it is argued that those involved in export oriented trade should invest in countries which do not place a lot of conditions on exports. Consequently, at any period where there is currency depreciation in these countries, this investor will be able to increase his exports since his products will be more competitive on the international market.<sup>36</sup>

#### *Managing Price Fluctuation through Deposit*

Another solution proposed for an importer to protect himself against currency fluctuation is that he should buy the amount of currency needed for the settlement of his obligation and deposit it in the Islamic bank and withdraw it when the time to settle his obligation comes.<sup>37</sup> It is clear that this solution will be useful only if the investor concerned has the money at hand at the beginning. Moreover, through this mechanism he will be prevented from investing this money in another planned project.

#### *Cooperative Funds and Currency Risk Management*

A final solution to this real problem is that the different parties involved in the import-export trade may establish a cooperative fund in which the different parties would deposit a certain amount. An Islamic bank,

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<sup>36</sup> Saud Mohammad al-Rubaia', *Tahwīl al-Maṣrif al-Ribawī ilā Maṣrif Islāmī Wa Muqta-dayātuḥu*, Markaz al-Makhtūtāt wa al-Turāth wa al-Wathā'iq, n.d., pp. 299–300.

<sup>37</sup> Ibid., p. 298. Also see 'Abbās Aḥmad al-Bāz, *Aḥkām Ṣarf al-Nuqūd wa al-Umlāt fi al-fiqh al-Islāmī*, 'Ammān, Dār al-Nafā'is, 1999, p. 131 and Jihād Abd Allāh Ḥussein, *al-Tarshīd al-Shar'ī lil Bunūk al-Islāmiyyah*, Matbū'āt al-Ittiḥād al-Dawlī lil Bunūk al-Islāmiyyah, p. 204.

for instance, could manage the fund on their behalf. The parties would share the profits, if any, and at the same time they would be able to face any risks associated with currency fluctuation.<sup>38</sup>

Thus, it seems that all these solutions have some advantages but also some limitations. Nevertheless, one could say that the idea of mutual promise may not be the perfect solution to the problem and it may not be without criticism. However, it could be considered as a suitable temporary solution to the problem until a perfect one is discovered.

Our choice of this method would not be complete, however, unless we state the *sharī'ah* position regarding such a promise. Muslim scholars agreed that if the promise is related to permissible matter, then, the one who makes a promise should fulfill it. However, they disagree as to whether such a fulfillment is obligatory or just recommended. For the majority it is just recommended to keep a promise. Therefore, if someone fails to keep his promise, he will just miss the reward he may get in the Hereafter.<sup>39</sup> However, Ibn Shubruma regarded the fulfillment of a promise as compulsory and if the one who makes the promise fails to do so, he will be forced by the court to fulfill his obligation. This opinion has also been attributed to the companion Samura Ibn Jundub, 'Umar Ibn 'Abdul Azīz, the fifth rightly guided caliph, al-Ḥassan al-Baṣrī, Ishāq Ibn Rūhawaih, Sa'īd Ibn Omar Ibn al-Aswa', al-Bukhārī, and Ibn Qayyim. After attributing this opinion to this large number of scholars, al-Qaraḍāwī maintained that it is clear that to attribute this opinion to just Ibn Shubruma and some Mālikīs, as it is alleged by some commentators, is unfounded. On the other hand, refuting the claim that what is reported about the obligation to fulfill a promise is just limited to the promise related to charity and *ma'rūf*, al-Qaraḍāwī said:

This is an unacceptable distinction. The legal evidence in the issue is general and there is no evidence to restrict it to one area or another. However, if we have to make a distinction between what is charitable and the one involving financial transactions, it seems that the opposite of what is claimed is right: it is logical to consider such a promise binding in the area of financial transactions rather than that of a charity. This is so because the financial harm which will be inflicted on the one entering the deal as a commercial partner, who relies on this promise, will be much greater than that with the one who is depending on charity. Therefore,

<sup>38</sup> Qhassān Burhān al-Dīnqal'aji, *Taqwīm Adā' al-Nashāt al-Maṣrifī al-Islāmī*, p. 107.

<sup>39</sup> See, for instance, al-Nawawī, *al-Azkār al-Muntakhaba min Kalām Sayyed al-Abrār*, p. 282; Ibn Ḥazm, *al-Muḥallā, bi al-Athār*, vol. 8, p. 513.

the need to consider the promise as binding, especially if the party who receives the promise is involved in a financial obligation, should not be a point of disagreement.<sup>40</sup>

The Mālikīs are the most explicit in their support for the legal status of a promise status and discussed it in detail. Thus, according to Mohammad Ulesh, “There is no disagreement that the fulfillment of a promise is recommended. However, there is disagreement concerning its obligation. Is it obligatory to fulfill any promise or is it just recommended?”<sup>41</sup> The widely accepted opinion is that if the other party, while relying on this promise, enters into some financial obligation based on that promise, then the one who makes the promise should be obliged by the court to fulfill it as his obligation.<sup>42</sup> Thus, the final resolution of the Islamic *Fiqh* Academy in its fifth session, Decision no. 2, held in Kuwait, stated that a promise is binding from the religious point of view except when there is an acceptable excuse. It is also binding in the court of justice if the promise is dependent on certain reasons and the one promised has incurred some costs as a result of the promise.

On the other hand, despite the fact that the modern spot transaction in foreign exchange mentions that delivery will take place immediately, in practice this is not the case in most instances, specially when the different banks are located in different countries. Generally, a spot foreign exchange is defined as an agreement to deliver a specified amount of foreign currency at an agreed price, usually within one or two business days and sometimes on the same day.<sup>43</sup> However, this delay of two days does not prevent a western scholar from considering it as a contract of immediate delivery. However, in Islamic law such a delay may pose some legal problems and could be considered as a forward contract rather than a spot one.

Saud Mohammad argued that considering such a transaction as a spot transaction is misleading from the Islamic point of view, since

<sup>40</sup> Yousuf al-Qaradāwī, “al-Wafā’ bi al-Wa’d,” *Majallat Majma’ al-fiqh al-Islāmī*, vol. 1 no 6., pp. 849–856. For similar opinion and investigation see also ‘Abd- Allāh Ibn Manī’, “al-Wafā’ bi al-Wa’d wa ḥukm al-Ilzām bihi”; Harūn Khalīfa, “al-Wafā’ bi al-wa’d fi al-Fiqh al-Islāmī”; Ibrahim Fāḍil al-Dabu, “al-Wafā’ bi al-wa’d” in the same journal.

<sup>41</sup> Mohammad ‘Ulesh, *Fatḥ al-‘Alī al-Mālik fi al-fatwā ‘alā Madhhab al-Imām Mālik*, vol. 1, pp. 254–258.

<sup>42</sup> See, for instance, Shihab al-Dīn al-Qarāfi, *al-Furūq*, Dār al-Ma’ārifah, Beirut, vol. 4, pp. 21–25.

<sup>43</sup> Peter S. Rose, *Money and Capital Market—The Financial System in the Economy*, Business Publications, 1986, p. 791.

delivery will take place after two working days. The exchange of offer and acceptance by telex or any other electronic media could not be considered as delivery because a real delivery will take place only when the other party has withdrawn the exchanged money from his account or he is in position to do so. Therefore, the modern spot foreign currency exchange could not be considered as a spot currency transaction. It is, then, an illegal transaction according to the Qur'ān and Sunnah.<sup>44</sup> However, Saud went on to suggest that the delay of two days in such a transaction could be minimized by the opening of a mutual current account with all the banks that the Islamic bank deals with. Thus, after a spot transaction, both banks will be able to transfer immediately the exchanged amount to the account of its counterpart.

Commenting on such a situation, Akram Khān wrote

The contemporary practice of allowing a two-day lag cannot be accepted in the Islamic framework. One alternative could be that the exchange is effected simultaneously by involving correspondent banks or agents at the same situation. For example, suppose a bank in Ottawa wants to exchange US dollars for Australian dollars, and the Australian bank is based in Canberra. The Canberra bank may authorize a corresponding bank in Ottawa to carry out the above transaction on its behalf simultaneously or the Canadian bank may authorize a corresponding bank in Canberra to execute the said transaction on its behalf. In brief, some mechanism will have to be devised to execute the transaction simultaneously.<sup>45</sup>

However, in this particular case since the concept of account record or *al-qabḍ al-ḥisābi*, which is recognized by many contemporary Muslims as a legal one the issue could be accommodated under it. Moreover, such a transaction has become a necessity and we should not stick to the literal meaning of the *ḥadīth*. Furthermore, the whole concept of *qabḍ* is based on custom and, therefore, whatever means judged by the experts to be so should be accepted.

More importantly, the Islamic Fiqh Academy in its resolution 55/4/6, March 1990, regarding “*Al-qabḍ* or Taking of Possession, its New Forms, and Their Rules,” maintained that:

<sup>44</sup> Saud Mohammad al-Rubaya, *Tahwīl al-Maṣrif al-Ribawī ilā Maṣrif Islāmi Wa Muqṭadayātuḥu*, Markaz al-Makhtūtāt wa al-Turāth wa al-Wathā'iq, vol. 1, p. 278.

<sup>45</sup> Muhammad Akram Khān, “Commodity Exchange and Stock Exchange in Islamic Economy,” p. 103.

1. Taking of possession of properties could be through handing over, scaling, measuring, or by transferring the purchased item to the buyer's possession. It could also be *ḥukmī* (constructive) by enabling the buyer to do any action he wants with the property bought even if there is no physical taking of possession. Furthermore, the way of taking of possession could differ according to the subject matter of the contract and the change of custom on what could be considered as taking of possession.
2. Among the forms of *al-qabḍ al-ḥukmī* (constructive) recognized by *sharī'ah* as well as by custom is *al-qabḍ al-ḥisābī* or account record in the account of a client in the following situations:
  - By depositing the specific amount of money in the client's account whether directly or through money transfer.
  - The client concluding a spot currency exchange with the bank and that to be deposited in his account.
  - The bank deducting a specific amount of money from the client's account, under his direction, to place in another account in the same bank or another bank, for himself or for another person, and the Islamic financial institutions observing the rules of *ṣarf*.

The delay in recording for a period, which disallows the beneficiary from really taking possession, according to market practice is not considered a problem. However, the beneficiary should not make use of the money during this period until he receives the confirmation of real delivery.<sup>46</sup> Similarly, *al-Majma' al-Fiqhī al-Islāmī* in Makkah in its resolution in the eleventh session, 1989, considered account record as a *qabḍ ḥukmī* in money exchange and transfer.<sup>47</sup>

In conclusion, it may be said that although some scholars, if not the majority, are still reluctant to admit the legality of the forward contract in the commodity market, the general principles of Islamic law do not reject it. Yet, some scholars, such as Nazīh Ḥammād, approve it but under the principle of *ḍarūrah* or necessity. Perhaps it was on this basis that Aḥmad Ḥassan tried to restrict the use of this contract in his book *al-Awrāq al-Māliyyah* just for the use of exports and imports, and maintained that it could not be extended to the stock market, for

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<sup>46</sup> See *Majallat Majma' al-Fiqh al-Islāmī*, no. 6, vol. 1, 1990, pp. 771–772.

<sup>47</sup> *Ibid.*, pp. 734–735.

instance. It should be noted that he strongly defended the legality of this contract without any restrictions in his book *'Amal al-Sharikāt al-Islāmiyyah*. However, as we have demonstrated above, the admission of forward contracts in commodity trading in particular is not contrary to any principle of Islamic commercial law, but is based on the ordinary norms of the *sharī'ah*. It is not, then, an exceptional case of necessity or *ḍarurah*.

However, one may ask why the futures contracts are needed if forward contracts are sufficient for risk management purposes. It should be noted that despite the fact that the forward contract is a useful tool for risk management, it has its own shortcomings and is sometimes associated with practical problems that could only be overcome through the futures contracts. The three main problems that are associated with the forward contract are as follows:

The first problem may be classified as the problem of double coincidence. Here a party to a forward contract would have to find a counterpart who not only has the opposite needs with the underlying assets but also with regard to time and quantity. The counterpart must demand the product in the right quantity, at the right time. Thus, a number of factors have to coincide before a forward contract could be made. The second problem with the forward contract often lies with the way the forward price is arrived at. Typically, the forward price is arrived at through negotiation, depending on the bargaining position of the parties. Therefore, it is possible that a forward price is forced upon the other party. This may be due to the urgency of one party (e.g., perishable goods) or, more commonly, due to asymmetric information. The third and probably the most important problem with forward contracts is the counterpart risk. Counterpart risk refers to the default risk of the counterparts in the contract. Though a forward contract is a legally binding arrangement, legal recourse is slow, time-consuming, and costly. Default in forward contracts arises not so much from dishonest counterparts but from increased incentive to default as a result of subsequent price movements. When the spot price rises substantially above the forward price, the short position (seller) has the incentive to default. The long position would have the same incentive to default if the opposite happens and the spot price falls sharply.

As these shortcomings of the forward contract became apparent over time, a new instrument that would provide the risk management benefits of forward contracts while simultaneously overcoming their problems was needed. The resulting innovation was the futures contract. A futures contract is essentially a standardized forward contract. It is standardized with respect to contract size, maturity, product quality, place of delivery, etc. With standardization, it is possible to trade them on an exchange,

which in turn increases liquidity and, therefore, reduces transaction costs. In addition, since all buyers and sellers transact through the exchange, the problem of double coincidence is easily overcome. One would transact in the futures contract maturity as many contracts as needed to fit the underlying asset size.

With the exchange trading, the second problem with forward contracts, that is of being possibly locked into an unfair price, would not exist. This is because each party is a price-taker with the future price being that which prevails in the market at the time of the contract initiation. As exchange quoted prices are market-clearing prices arrived at by the interaction of many buyers and sellers, they would by definition be “fair” prices.

The problem of counterparty risk is overcome in futures contracts by means of the innovation principle. The exchange, being the intermediary, guarantees each trade by being the buyer to each seller and the seller to each buyer. What this means is that each party transfers the counterparty risk of forward contract onto the exchange in the case of futures contracts. This transfer of risk to the exchange by the parties in the futures contract has to be managed by the exchange, which now bears the risk. The exchange minimizes the default risk by means of the margining process and by daily marking to the market. The basic idea behind the margining and marking to market process is to reduce the incentive to default by requiring initial deposits (initial margins) and recognizing losses as they accrue (margin call). This margining and marking to market process has been refined and fine-tuned over the years by futures exchanges to such an extent that incidences of systematic default have been reduced to negligible rates.<sup>48</sup>

Seyed ‘Abd al-Jabbār, the chief executive of the Kuala Lumpur Commodity Exchange, pointed out one of the shortcomings of the forward market in his comments to Akram Khān’s study and said, “The author is right in saying that, without a futures market, a trader can still hedge in the forward market, e.g., the Refined Bleached Deodorised (RBD) Palm Oil string contract. But a default could occur in the string and if that happened there will be a lot of dissatisfaction and disputes. In a futures market there is the guarantee mechanism, which will assure

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<sup>48</sup> See Obiyathulla Ismath Bacha, “Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration,” p. 5.

parties to a contract guarantee of financial performance in the case of defaults. The clearinghouse gives this guarantee.”<sup>49</sup>

In the next part of the study we will address the issues related to futures contracts in commodities markets, such as their concept and scope from an Islamic point of view, the issue of sale prior to taking possession, the issue of just looking for price differentials, speculation and selling with margins. In addition, the issue of sale of debt for debt or *bay' al-dayn bi al-dayn* and its effects in the development of an Islamic futures market will be addressed. Moreover, the study will expound on futures markets' regulation, the market offenses and how the Futures Industry Act in Malaysia, in particular, deals with them.

Still, the issue of looking for price differentials remains an important issue not only for the development of a viable Islamic futures market but also for the development of an Islamic financial system in general. Is looking for price differential a kind of gambling or speculation? Is it possible to use hedging in Islamic finance? How could we differentiate between speculation and hedging? Is it possible to make such a distinction by looking to the behavior of the market participants? What is the role of brokers in these markets? Is it in line with Islamic principles? What is the role of the clearinghouse? Is it necessary for a clearinghouse in an Islamic market to be different from that in a conventional market? These issues will be investigated next.

Concerning the possibility of a futures market in currencies from an Islamic perspective, as we have seen in this part, even the conventional forward contract in currencies is illegal in Islamic law, and because of that Muslim scholars have resorted to other alternatives. Therefore, to think of a futures market is out of context. Moreover, the larger part of the currency market transactions at present is done under the forward market followed by the spot market and lastly the futures market.<sup>50</sup> Therefore, any Islamic alternative in the currencies market should focus on the forward market. Some alternatives have already been suggested, as we have explained above, but more innovations are still needed.

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<sup>49</sup> Seyed 'Abd al-Jabbār Shahabudin, “Comment on Akram Khān's ‘Commodity Exchange And Stock Exchange in Islamic Economy’,” *Journal of Islamic Economics*, International Islamic University, Malaysia, vol. 1, no. 2, July 1988, p. 72.

<sup>50</sup> The forward contract dominates the currency market with seventh-three percent of the total market. It is followed by the swap market with eighteen percent, the options market at 3.5% and the futures market at one percent. See S. Sagha Balvinder, “Financial Derivatives: Applications and policy Issues”, *Business Economics*, The Journal of the National Association of Business Economists, vol. xxx, Jan 1995, p. 48.