DERIVATIVE INSTRUMENTS: CRITERIA FOR SPECULATION IN ISLAMIC FINANCE

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ABSTRACT

Derivative instruments were created as a risk management tool for the financial market. Hence, the majority of market players used it as a tool for carrying out speculative activities. The Islamic shariah concept rejects the element of speculation that exists in the financial market by allowing the implementation of derivative instruments only for hedging purposes. This qualitative study used the content analysis method on relevant documents to identify the characteristics of speculative activities that implement derivative instruments, which are prohibited in Islam. Findings indicate six characteristics related to speculative activities in the derivative market that are prohibited in Islam, such as reaping profits caused by price differences, short selling trading, absence of the physical exchange of goods, one party experiences losses, manipulation of market price, and information on market price obtained from hear-say (rumours) or based on an in-depth study of the market.

Keywords: Derivatives, Speculation, Hedging, Risk, Islamic Finance.

INTRODUCTION

Derivatives are one of the most important contracts in the financial system and it is getting much more popular. This is reflected in the instrument's rate of growth compared to other securities or assets in the global economy. A derivative contract is one of the risk management instruments in investment (Al-Amine, 2013). A variety of risk management instruments produce a capital market that is overall more efficient, together with the existence of derivative instruments that increase the liquidity of the cash market. The derivative instrument is flexible or user friendly because users can easily buy and sell this instrument compared to other commodities or underlying financial assets, such as agriculture commodities, metal, energy, currency and share index (Hull, 2012). Derivatives can be defined as a financial instrument whose value depends on the value of the underlying assets, such as commodities, shares, interest rates and foreign currency. Derivative instruments comprise futures, futures trading, options and swap instruments. Derivatives differ from the cash market because in the cash market, handing-over of goods and payment is made when the contract is signed and sealed (Obiyathullah, 2017).

Generally, the derivative instrument emerged during the transaction of conventional products; therefore, the concept and framework of the derivative instrument is not shariah-compliant. Contemporary Islamic financial scholars have heaped criticisms on the implementation of the derivative instrument because of several Shariah issues. One issue frequently discussed by contemporary Islamic financial scholars and related to the derivative market is speculation. Generally, the word speculation is a new term in the fields of economy and modern Islamic finance. The term speculation has never been used by previous Islamic scholars in discussions related to Islamic financial transaction. Hence, although the term speculation has not been discussed or debated in their literary work, it does not mean that the issue of speculation did not occur at that time, namely in the traditional market. Characteristics of speculation that exist presently have actually been discussed by previous scholars, especially when they discussed specific terms such as al-ihtikar (monopoly), gharar (uncertainty), al-tanajush, ghish (deceit or fraud), tadlis (misrepresentation during the sales of goods) and mudharabah ^{c}ala al-as^{c}ar (Mubarak, 2005). Some scholars have termed speculation as al-mudharabah fi al-Ashum or al-Muqamarah (Al-Ahmad, 2009).

METHODOLOGY

This was a qualitative study that applied the content analysis method. Data were obtained from primary and secondary sources, which were then analysed according to themes and determined based on the objectives of the study.

RESULTS AND DISCUSSION

Contemporary Islamic financial scholars differ in their views regarding the characteristics and form of speculative activities in the financial market. Based on the content analysis carried out on previous studies, this study identified several characteristics that could help identify speculative activities that occur in financial markets, mainly in the derivative market. The characteristics here refer to the intention to use derivative instruments for reaping profits due to differences in prices, short selling, absence of the physical exchange of goods, losses suffered by either one party, manipulation of market prices, and information about market prices based on hear-say (rumours) or an in-depth study of the market.

According to Mahyu (1995), Al-Masri (2007), Mubarak (2005), & Al-Saati (2003), the first characteristic of a speculator in the financial market is the intention to reap profits from the fluctuation of prices. Speculators are those who are willing to face the risk of incurring losses and they believe that the higher the risk in an investment, the higher the return on investment (Furqan & Mirza, 2015). Hence, profit is the speculator’s main motive in using derivative instruments in the financial market. Fahim, (1995), Obaidullah (1998), Salamon, (2015) & Tamer, (2005) also agreed that speculation occurs in the derivative market when parties to a contract are solely interested in fluctuation in prices and will close out a contract. Moreover, most contracts do not involve the physical surrender of goods.

The second characteristic of speculation is short selling trading between the parties to a contract. When there is movement in prices that can profit the speculator, they will usually terminate the contract (close out) prematurely before the date of maturity, which is a date of contract settlement in the future. This shows that the speculator spends a short time in the derivative market, beginning from the date of entering into the contract until the contract ends. Terminating a contract before the date of maturity is like an imaginary contract, which involves an action that has no contractual intention between the parties to the contract. Moreover, it would eventually lead to problems concerning the ownership of goods, which leads to the third characteristic of speculation, whereby there is no physical exchange or surrender of goods.

Activities leading to a close out is the main cause of speculation because it offers an opportunity to the speculator to terminate the contract before the date of maturity. According to Al-Suwailem, (2006), this situation strongly suggests that 99% of futures contracts are sealed before the due date and the total number of derivative instruments exceeds the true value found in the cash market. According to Nordin & Asmak (2011), derivative instruments, such as that in futures contracts, are used for reaping short-term profits. Moreover, it is common for terminating contracts within a short period without the physical delivery of the commodity to the rightful contracting party.

The third characteristic of speculation in the derivative market is the absence of the physical exchange of goods between the contracting parties. When either party terminates the contract before the date of maturity, the exchange of commodities or assets fails to materialise because the party to the contract does not wish to own the commodity. They might also wish not to physically exchange goods since the actual intention is to secure a price or reap profits from fluctuating prices based on the price mentioned in the contract. Usmani, (1999) was against this concept appearing in any derivative instrument because the intention of the investor is to reap profits from fluctuating prices and not to surrender or exchange any goods

The fourth characteristic of speculation is the presence of elements zero sum game, whereby one-party experiences losses, while the other party gains profits. Al-Masri, (2007) stated that speculation is a form of gambling because only a few of the lucky participants gain profits, while the majority experience losses. For example, futures trading instruments that are used in the future are terminated by the speculator when the price increases because if the contract is not terminated and is waited upon until the date of maturity, then there is a great possibility of experiencing losses. Therefore, speculators take this action to avoid losses incurred due to the sale of instruments at a much lower price in the future. This situation is seen as a risky gamble with the intention of seeking quick profits compared to waiting for dividends, as in a normal investment.

As for the fifth characteristic of speculation, the speculative activity is categorised as manipulating market prices. According to the Securities Commission of Malaysia, market manipulation portrays an active market as well as confuses the financial market. It will create a situation where market players are attracted to fluctuation in prices and react by entering the market or terminating the contract. Manipulation of market prices is aimed at controlling the market by dominating demand and confusing other market players through various methods, such as falsifying products and prices or purposely spreading false information about a certain company in order to lower the company’s share prices (Al-Masri, 2007; Buharawah, 2010). Speculators often try to control the financial market by using the transaction falsifying technique as well as the spreading of negative and rumours concerning certain parties with the purposeful intention of destroying their reputation. These actions will cause a drop in the company’s share prices because the aim of the speculator is to buy the shares in bulk when they are at a low price (Zamir & Abbas, 2011). According to Razif et al. (2017), market price manipulation activities differ according to investment activities although both have similarities in technique and risks. Investment activities are based on actual and ready information in the market, whereas, information related to manipulation is created and designed.

The sixth characteristic is the speculator's prediction of changes in future prices based on rumours, information, studies or just pure luck. According to El-Ashkar, (1995), speculators will carry out studies to plan and make predictions about changes in market price. They will analyse various selected data based on several factors, such as the government's political, financial and economic position and enforcement at the local and international levels. All these processes need in-depth studies, expertise as well as a high level of skills in interpreting the results produced. The following process is to make decisions based on the studies carried out. Kamali, (1999) was of the view that speculative activities require knowledge on future market prices based on present or previous information that must be examined and analysed. This view was supported by Al-Masri, (2007), who stated that the speculator's action is a reverse process, whereby the buying and selling or a derivative instrument is based on information and knowledge. However, there are speculators who only aim for quick profits without first examining the financial market. These types of speculators only examine trends in price movements and market sentiments. Even worse than this are decisions that are made based on hear-say (rumours) and presumptions (Salamon, 2015). As for Obaidullah, (1998), transactions such as this can be termed as excessive speculation because one lays hope on "*lucky*" market prices. The Table 1 below refers to discussions by previous researchers related to the characteristics of speculation in the financial market.

Table 1
CHARACTERISTICS OF SPECULATION IN THE FINANCIAL MARKET

NAME/YEAR	CHARACTERISTICS OF SPECULATION IN THE FINANCIAL MARKET					
	Reaping Profits Due to Price Differences	Short Selling Trading	No Exchange of Physical Goods	Zero Sum Game	Market Price Manipulation	Market Price Based on Hear-Say or In-Depth Market Study
Mahyu al-Din (1995)	√	√	√			
El-Ashkar (1995)						√
Fahim (1995)						√
Obaidullah (1998)						√
Usmani (1999)			√			
Kamali (1999a)						√
Obaidullah (2001)						√
Mubarak (2005)	√	√	√			
Al-Suwailem (2006)		√				
Al-Masri (2007)	√	√	√	√	√	√
Al-Saati (2007)	√	√	√			
Buharawah, (2010)						√
Nordin & Asmak (2011)		√				
Solomon (2015)						√
Razif et al. (2017)						√

CONCLUSION

Based on discussions by contemporary financial scholars, the majority of them reject speculative activities because the characteristics of speculation have an element of gambling (maysir), which is prohibited in Islam, in the form of reaping profits due to fluctuation in prices, short selling trading, absence of the physical exchange of goods, one party experiences losses, market price manipulation, and information about market prices obtained either by hear-say (rumours) or an in-depth market study.

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