

THE ISLAMIC ETHICAL PRINCIPLES IN COMMODITY DERIVATIVES CONTRACTS

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ABSTRACT

Islamic ethics is essential for derivatives contracts as Islam emphasizes its significance for the development and betterment of individual and society. From the Islamic worldview, ethics deals with the issues of what is right and what is wrong as well as a code of conduct in the marketplace to ensure the proper practices of commercial dealing and the prevention of unethical doings. Initially, the main purpose of derivatives contracts is risk-hedging. However, the application of derivatives in hedging has caused several arguments and disputes among the majority of Islamic jurists. Thus, this article aims to analyze the concept of Islamic ethics in commodity derivatives contracts. It uses a thematic analysis approach to analyze the content obtained from the related literature. This study found three main principles of Islamic ethics in commodity derivatives contract which are the availability of goods during the contract, taking possession (qabd) in the contract and conformity of contracts with the objectives of Islamic law (maqasid al-shariah).

Keywords: Islamic Ethics, Islamic Dealing, Derivatives, Contract, *Maqasid al-Shariah*.

INTRODUCTION

Ethics is a branch of philosophy that examines what is right and what is wrong. From the Islamic *weltanschauung*, Islamic ethics is transcendental in nature because of its ultimate source is the Creator—Allah the Almighty who determines what is ethical and what is not as well as what is proper and what is not (Hashi, 2011). Initially, ethics governs all aspects of life without any exception. The prerequisite of achieving true success in Islam is the same for every Muslim in carrying out their daily activities including conducting their business activities (Beekun, 2006). Islam provides a proper ethical framework to cultivate good moral conduct and behaviors among its believers (Mohammad et al., 2001). In the context of contractual obligation, Islamic ethics outline practices that are aligned with good moral conduct in order to prevent dishonesty and fraud. Notwithstanding the extensive literature that supports hedging as the main motive of using derivatives, the application of derivatives in hedging has triggered some arguments and disputes among the majority of Islamic jurists (Azlin et al., 2015). A derivative is defined as a financial contract which derives its value from the underlying assets such as securities, currencies, interest rates, commodities or price indexes. The most common types of derivatives are futures, options, forwards and swaps (Hull, 2003). The transactions or contracts have to be Shariah-compliant not

only in their forms and legal procedures but also in terms of their economic substance which should be consistent with the objectives delineated by the Shariah (Asyraf & Bouheraoua, 2011). Therefore, this article aims to examine the ethical principles in derivatives contracts in the light of Islamic worldview and it focuses on a commodity as the underlying asset. The writing begins with the methodology and the next section discusses the principles of Islamic ethics in commodities derivatives contract.

METHODOLOGY

This study adopted a qualitative approach using document analysis method that by referring to both primary and secondary sources. The data was obtained from the classical and contemporary works based on the Holy Quran, the Sunnah (translation), and Islamic jurisprudence. Results from data collection were then thematically analyzed. According to Braun & Clarke (2006), thematic analysis as an independent qualitative descriptive approach is mainly described as a method for identifying, analyzing and reporting patterns (themes) within data.

RESULTS AND DISCUSSION

Initially, ethics and divine law in Islam are mentioned in the inverse form, so that all manners were judged as either obedience or disobedience to the divine law (Hourani, 2007). This highlights that the divine or Islamic law as a significant source for Islamic ethics. This works in parallel with the aim of Islamic law to preserve the balance of well-being of a man as well as fulfilling his needs as a human being. The objectives of Islamic law or Shariah are consistent with Islamic ethics, which is, developing human life on the foundation of virtues (*ma'rufat*) and purifying it from vices (*munkarat*). A Muslim is able to get clear a picture of what the virtues and vices are within the ambit of Shariah, and these are the norms to which the individual and societal behavior should adhere to. Hence, both Shariah and Islamic ethics are inseparable (Adibah, 2013). In Islam, both morality and law are derived from religious sources and religious teachings are practiced through morality and law (Hashi, 2011). In sum, commercial transactions are expected to be guided by the principles of Islamic ethics and it is imperative to observe its subsequent ethical standards (Paul & Elder, 2006; Tzafestas, 2016). This article recommends three main principles of Islamic ethics in commodities derivatives contract. It is as follows:

The Availability of Goods during the Contract

According to Shariah, in order a contract to be valid, the goods must presently exist in its physical, sellable form while the seller ought to have legal possession on the product in its final form. The issue of *gharar* (risk or uncertainty) or *bay' al-ma'dum* (sale of non-available goods) will occur if the goods are not available, or the seller and/or buyer have no knowledge about such goods. One implication of *gharar* is that derivative contracts such as futures, options, and swaps are prohibited as these do not fulfill the conditions of the presence of commodity and brings uncertainty by postponing the exchange at a future date. Consequently, some scholars categorize derivatives contracts similar to *bay' al-ma'dum*, which is forbidden in Islam as it may cause conflicts and losses to the buyer. These conditions for the validity of a sale would obviously render the trading of derivatives as impossible (Islamic Fiqh Academy, 1992). Nevertheless, several Shariah scholars offers exceptions to these general principles to enable deferred sale when needed. They legalize the derivatives contract with the requirement to outlining the

detailed specification of the commodity such as quantity, size, and weight, without having the need for the commodity to be present and visible at the period of signing the contract. This is because, the commodity is readily available in the market even though the seller is yet to be able to deliver the specified commodity (Securities Commission, 2006). This matter also considers the view of Ibn Qayyim (1993) regarding the prohibition of *gharar*, which is imposed on goods which cannot be delivered irrespective of their existence. The prerequisite of a contract is the ability of delivery and if the seller is unable to do so, then the element of *gharar* exists. Thus, the matter of prohibition in the Shariah is not selling goods which do not exist, but rather the risk involved in a contract where the contracting parties may be unable to fulfill their commitments (Habib, 2014).

Taking Possession (*Qabd*) in the Contract

Shariah requires actual or legal possession before the sale takes place to ensure delivery. The seller is obliged to bring the product, and the buyer is obliged to make the payment. The matter of deferment of both counter-values (*ta'jil badalayn*) is when the price will be paid or the commodity will be delivered in the future (Abdul, 2005). The issue mainly revolves on commodity that acts as an underlying asset which requires for the commodity to be delivered upon the signing of a contract. Delay or deferment related to the issue of *gharar* is the uncertainty of payment receipt and/or acceptance of commodity delivered. Contracting parties are also unsure of whether the contracts will be executed. This could bring conflicts or disputes between the contracting parties. Additionally, referring to the definition of *gharar*, most scholars agree that it is related to the failure to deliver goods and the uncertain outcome of a contract. Most Shariah scholars also consider derivatives contracts as non Shariah-compliant because of the deferment in the counter values and in most futures transactions, whereby the delivery or possession of the underlying asset is not intended (Sherin & Balachandran, 2010). The issue of *ta'jil al-badalayn* can also be viewed from the part of the buyer's ability to make payment to the seller and the seller's ability to deliver the commodity to the buyer. This is because; the *illah* (legal reason) behind the prohibition of deferment or *al-badalayn* (both counter-values) is that the contracting parties are oblivious with the consequence i.e., the uncertainty if the contract will be honored. After receiving the delivery notice, the buyer must make payment to mark the receipt of delivery of the commodity or their possession is not intended. If the seller and buyer can guarantee the delivery and payment, then *qabd* (taking possession) in a contract is no longer an issue (Nadhirah et al., 2014).

Conformity of Contracts with *Maqasid al-Shariah*

The contract must be in accordance with the standards of the Islamic law (*Shariah*) as well as its objectives (*maqasid al-shariah* or *qasd shara'*). Thus, both purpose and means (way) of a conduct must be good or virtuous in nature. Mere good intention is never enough to change any immoral act into a good one. Meanwhile, good outcomes cannot justify the morality of immoral means. As such, Islamic ethical system is neither consequential nor utilitarian (Hashi, 2011). Notwithstanding, hedging activities are permissible in Islam although the presence of gambling and speculation in derivatives contract is strictly forbidden. One of the most important arguments against derivatives is that they promote speculative activities in the market. It has been observed from various financial markets throughout the world that actual delivery of the

underlying assets barely constitute one or two percent out of the total traded derivative instruments. Speculation in the derivatives market is done because of profit and not to assist trading or facilitate real business activity (Nadhirah et al., 2017). The risk of excessive speculation has been well-documented, such as in relation to multitude of financial crises (Jobst, 2013). According to *maqasid al-shariah*, derivatives contracts that could lead to speculative activities are prohibited in Islam because this is considered as an exploitation of other people or an improper method in obtaining wealth (Adibah, 2013).

CONCLUSION

From the Islamic worldview, ethics, religion, and jurisprudence (*fiqh*) are complementary in nature and do not contradict to each other. So that, what is morally wrong is also illegal and the law permits only what is moral. In sum, the commodity derivatives contracts should meet three underlying Islamic ethical principles which are the availability of goods during the contract, taking possession (*qabd*) in the contract and the consistency of contracts with the objectives of Islamic law (*maqasid al-shariah*).

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