

*DISCUSSION AND COMMENTS*

**Comments On Muhammad Akram Khan's  
"Commodity Exchange and Stock Exchange  
in an Islamic Economy"**

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I wish to comment on a number of issues relating to futures trading which were raised in the paper entitled "Commodity Exchange and Stock Exchange in an Islamic Economy". My comment is only on the commercial needs, usage and operations of a futures market as described in the paper. It is not for me to comment on the Islamic Law pertaining to transactions in a futures market because I am not competent to do so. Notwithstanding this, I am generally of the opinion that the author should not make a hasty conclusion to say "hedging in the futures market is not lawful". This opinion is based on the author's superficial treatment of many aspects of futures trading which I will endeavour to explain below.

In order to understand futures trading better, let me first briefly describe the historical development of a futures market. The futures market evolved from a forward market, the earliest known forward contracts originated at the Champagne Trade Fairs of Medieval Europe. Over the years, several refinements of trading and contract terms were made to the forward contracts to facilitate transactions. But all these developments did not solve the problems faced by the trading community, such as unreliability of deliveries, varied terms of payment, lack of quality standards and disputes, contracts not easily resaleable, defaults, prices not widely disseminated, etc. This led to the development of terminal markets or futures markets which offer standardised contracts with clearly specified quantity, quality parameters, delivery points and procedures, clearing and guarantee arrangements, settlement of disputes, negotiable storage receipts or warrants, etc.

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The availability of this easily resalable standardized futures contracts facilitates and strengthens forward trading, for example, a palm oil refiner who has sold his refined palm oil in forward to his regular customer overseas can easily and quickly cover the forward position by buying Crude Palm Oil in the futures market (hedging) and, as soon as he is able to buy Crude Palm Oil in the physical market, he will then close out his bought futures contract (a process referred to as unwinding a hedged position in the futures market). If for some reasons or other, his overseas customer reneges on the forward contract (default), he can again use the futures market by selling into the market and thus protect his exposed position. The fact that the contract is easily resalable, the futures contract market tends to attract speculative interest. This in itself is desirable because it enhances liquidity and makes it easier for hedgers to enter and exit the market without much price distortions. The presence of a liquid futures market with prices readily available and quickly disseminated, makes it attractive and convenient as a central focal point for benchmark pricing by producers, manufacturers and merchants. Since trading in the futures market is done at very competitive prices and the fact that these prices are used widely for pricing purposes, and price differences from the norm between geographical locations in both the spot and forward physical markets will not remain long because of arbitrage activities. All this makes the spot and forward markets work more efficiently for the benefit of society at large.

The author is right in saying that, without a futures market, a trader can still hedge in the forward market, eg., the Refined Bleached Deodorized (RBD) Palm Oil string contract. But a default could occur in the string and if that happens there will be a lot of dissatisfaction and disputes. In a futures market, there is the guarantee mechanism which will assure parties to a contract guarantee of financial performance in case of defaults. This guarantee is given by the Clearing House.

Let me now refer to the general principles of market in Islam as described by the author, and in particular when he says that, "The market in the Islamic economy operates on the free-will of buyers and sellers. All production and consumption decisions are made by individuals and institutions on the basis of their respective judgements. The prices are determined by the free flows of supply and demand, except where a seller may be able to fix price on the basis of cost plus mark-up due to imperfect market conditions. In general, the state does not intervene with market operations, except where economic justice is at stake or where the general public is facing hardship due to natural calamities or

because of manipulations of the economically powerful segments of the market."

I should emphasise that these principles are regarded as the corner-stone of futures trading which are:-

- (1) Trading is by open and competitive bidding called "open outcry" where buyers and sellers trade in a free and competitive environment;
- (2) There are adequate safeguards to protect users of the market for, eg., time stamping of orders, prohibition of trading ahead of clients' orders, trading against clients' orders, segregation of clients' accounts, reportable position and position limit, etc;
- (3) There is free flow of information into and out of the market and such information are available on real time basis around the world; and
- (4) There is no government intervention in the market place, except when there is a major financial crisis.

Because of the above features, many people prefer futures trading to a perfect market situation in economic theory. In addition to the above features, contracts are standardised in very specific terms with regard to quantity, quality, delivery points, etc., this is to avoid any dispute that may arise. However, if there are disputes in respect of delivery, then such disputes will be handled by an Arbitration Panel.

I would like to now touch on an issue relating to physical delivery of a futures contract. The author states, "The Islamic position on futures market is quite clear. To start with, the commodity is non-existent and then it does not involve physical transfer of commodities and successive sales are made without anyone actually owning the commodity. Thus from the Islamic point of view, all the transactions in this chain are unlawful." The author also states, "Not more than 1% of the contracts actually mature into physical delivery. The rest of the contracts are purchases and sales in the future by book transfers. In the case of forward market, physical delivery does take place".

The above two statements are not clear and appear to be contradictory. I do not intend to debate on the contradiction but what is important to emphasise here is that there is physical delivery of a commodity upon maturity of a futures contract. This has to happen because a futures contract is a promise to buy or to sell a commodity at a future date and the contract is legally

enforceable. In other words, a person who has a sold contract can deliver the commodity if he wishes to and the buyer can likewise take delivery if he decides to do so. The fact that the percentage of delivery in a futures market is small is due to the fact that commercial or trades use the market for hedging purposes. When we say hedging, it means that a trader will use the futures market as a "temporary substitute" to protect his exposed position in the physical market. It is not the intention of a hedger to deliver or to take delivery of the commodity because the quality parameters and delivery specifications and procedures do not fit in with his requirements, eg., a trader in Malaysia has sold forward his RBD Palm Oil to his client in Europe and to protect his exposed position he buys Crude Palm Oil from the Kuala Lumpur Commodity Exchange (KLCE) Crude Palm Oil futures market (hedging). Since RBD Oil prices generally move in line with Crude Palm Oil prices, his hedging operation is somewhat protected. He is not interested in taking delivery of Crude Palm Oil because that is not the grade he requires and the location he prefers. Therefore, what he will do is to close out his hedged position in the Crude Palm Oil futures market as soon as he has bought RBD Oil from a refiner who is his regular supplier. Hedging operations on the futures market are substantial and if the quantities of hedged transactions are considered as delivered then the percentage of delivery on a futures market can be considered to be very high. The fact is, these hedgers do not use the futures market to deliver or take delivery, the percentage of delivery on a futures market is small.

Traders normally try to cover their exposed position in the forward market first, but this may not be possible all the time. Therefore, they will use the futures market first as a temporary substitute. The futures market is an additional facility for the traders to use when an opportunity or a need arises. In my opinion, there is no real difference in hedging in either a forward or futures market, though in the forward market a hedger is more likely to land up in delivery. Sometimes hedging in a forward market may not end up in delivery if the original seller buys back a link contract. In view of these comments and clarifications, I feel the author should not make a conclusion to say "There is nothing unIslamic about hedging in the forward market. But hedging in the futures market is not lawful".

Hedging also helps make the marketing system work more efficiently to the benefit of producers and consumers alike, e.g., a chocolate manufacturer who has hedged on a futures market by buying cocoa beans futures contracts for positions twelve months forward, can then price his chocolate at a stable price for the year for the benefit of consumers.

In addition to hedging, the fact that in a futures market prices of a commodity are easily and readily available to the public, monopolistic or oligopolistic or monopsonistic situations prevailing in an economy will break down. In the forward market, prices are not easily available to the public because these prices are on negotiation basis between buyers and sellers.

I would like now to comment on the author's statement about "cornering". He says, "The futures market does not visualise physical delivery of any commodity. The non-delivery aspect of the market gradually evolved in response to the actions of certain large buyers who would continue buying large quantities of the same maturity. Ultimately, the sellers were "cornered" because of shortage of the actual commodity. As a redress to this situation, the sellers are allowed to deliver the grade of the commodity other than the one agreed upon. Thus, the buyers were pressurised to accept unwanted grades. To protect the buyers from this pressure, they were allowed to re-sell the futures contract without getting delivery. Thus, the forward contract led manipulations by the buyers, which led to options for the sellers to vary the grade or place of delivery which led to the buyers not accepting the delivery. Thus the vicious circle was completed."

This reflects less than full understanding of a futures contract and operations of the futures market. A futures contract is always structured to ensure a balance between sellers and buyers interest. The contract will not be viable if there is an imbalance. A futures contract can be closed by offset or by delivery. The choice is on the seller or the buyer and there is no compulsion. If he is a hedger, he will close out the futures contract when his position in the physical market is no longer exposed to price risk. If he is a speculator, he will offset his position before the contract matures and takes profit or pays for the loss. If he is an arbitrageur he will take advantage of price differentials between futures and physical markets by delivering to or taking delivery from the futures market. The activities of the arbitrageur keep prices in the futures market in line with those in the physical market. In the futures market or even physical market, there is bound to be people who want to profit by manipulating or cornering a market. This happens when the manipulator knows that there is a shortage of the commodity in the market. In a futures market, there are in-built mechanisms to prevent occurrence of manipulations. It does not mean that manipulation cannot happen but its occurrence will be minimised. Most futures market prescribe mandatory reportable position whereby a member has to report to the Exchange a position of any of its client who has a position in excess of a reportable level. This acts as an early signal to an Exchange of any attempt by any

person to manipulate a market. In addition to this, most Exchanges prescribe position limit whereby no person can have a position in excess of a certain level called the speculative position limit. A hedger is however exempted from the speculative position limit, but he is required to prove to the Exchange that his positions are hedged transactions. These two measures are intended to avoid squeezes, or attempt to manipulate or corner a market and hence maintain integrity in the marketplace.

The question of a buyer being pressured to accept unwanted grades of a commodity does not arise because a seller has to deliver the commodity according to prescribed quality parameters, otherwise his commodity will not be accepted as good for delivery. If a seller cannot deliver the commodity on the expiry date for delivery or on tender date, then he is deemed to have defaulted, in which case, the Clearing House will invoice back the futures contract between the defaulting seller and the buyer with whom the contract has been matched and will compensate the buyer financially for the losses incurred. The Clearing House will then recover the losses from the seller. However, if the buyer defaults, the Clearing House will sell the commodity in the open market and recover the losses from the buyer.

I agree with the observation made by the author that, "In actual practice the settlements are made through the Clearing House. The dealers pay into or receive from the Clearing House without even knowing the name of the other party. In the final analysis it is a zero sum game. Losses of one are gains of another." But I need to clarify the statement so as not to confuse readers. Trading on a futures market is impersonal that is, the seller does not know who his opposite party is. It is not necessary for a seller or buyer to know his counter party in futures transactions because the Clearing House assumes the opposite position once it has registered a contract. It will guarantee the financial performance of a defaulting party (its member) to all other parties (its members). This guarantee provision makes a futures contract attractive vis-a-vis a forward contract.

I hope the above comments and clarifications will serve to give a clearer understanding of the usage and operations of a futures market which could contribute towards a more constructive and balanced discussion on futures trading within the Islamic legal framework.