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THE QUESTION OF AN ISLAMIC FUTURES MARKET

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ABSTRACT

This paper criticizes the tendency to characterize an Islamic futures market mainly in terms of the *salam* contract (e.g. Khan, 1995). *Salam* is not only a financing mode, like banking *murŒbaúah*, but it is basically a means of hedging for capital providers not producers. The financing function of *salam* implies 'discounted' expected future prices, and hence *salam* is not an ideal means of projecting future prices. Alternatively, the *isti§nŒ*^{c} contract is presented as the appropriate backbone of the Islamic futures market. *Isti§nŒ*^{c} is uniquely characterized by the built-in flexibility of providing two simultaneous functions: a partial financing function and a partial hedging function. When the partial financial function is eliminated and total weight is placed on the hedging function, *isti§nŒ*^{c} boils down to a forward contract. Accordingly, a good anchor will be established for future price movements not particularly affected by an implied 'discounting' process. The *isti§nŒ*^{c}-based forward contract is proposed here as an ideal risk managing structure for a bankable profit and loss sharing (PLS) scheme. Although this article adopts the currently accepted juristic opinion, it is concluded by highlighting the need for a more up-to-date *ijtihŒd* to develop an Islamic futures market capable of capturing the merits of modern future markets and avoiding their demerits. It raises critical issues in relation to the juristic description of the forward contract as a prohibited *debt for debt sale*, with a special appeal to the critical juristic works of Kamali (2000), Muhiuddin (1986) and Hammad (1984).

JEL classification: G20

Key words: Forward contract, *Isti§nŒ*^{c}, *Salam*

1. INTRODUCTION

The economics of the futures market remains among the least trodden fields in Islamic economics. Among the few interesting contributions in

this respect are Khan (1995), discussing the nature of the Islamic futures market, and Kamali (2000) discussing Islamic commercial law with special emphasis on the analysis of futures and options. The earlier works of Hammad (1984) and Muhiuddin (1986) focused mainly on the juristic position as regards the idea of forward contracting. The crux of the matter from a juristic viewpoint is the fact that modern futures markets are centred around the concept of a forward sale contract, where both the price and quantity of a good are deferred to a future date. Such simultaneous deferment of both price and quantity tends to be characterised by jurists as a prohibited *bayᶜ al-kĒli bi al-kĒli* in a reported *úad¥th*, which is commonly interpreted as the prohibition of *debt for debt sale* (*bayᶜ al-dayn bi al-dayn*). However, Kamali provided a critical appraisal of the current non-favorable juristic opinion as regards futures and options. Muhiuddin verified the non-authenticity of the above mentioned *úad¥th* about *bayᶜ al-kĒli bi al-kĒli*. Working independently, Kamali and Muhiuddin demonstrated the relevant sources regarding the jurists' evaluation of the modern forward contract, arguing that the prohibition of the forward contract does not rely upon firm juristic grounds. Hammad has also established the non-authenticity of the above *úad¥th*. Although he seems to confirm the jurists' prohibition of the modern forward contract, he approves of its possible adoption with reference to the 'special need' criterion of Islamic jurisprudence. Khan, on the other hand, departs from the traditional opinion, which identifies the modern forward contract with the prohibited *debt for debt sale*. Alternatively, he provides a model of an Islamic futures market that is based upon *salam* as the core principle of Islamic futures markets, together with *isti§nĒᶜ*, and *juᶜĒlah*.

Our main objective in this article is to share the deep concerns expressed by Kamali, Muhiuddin, Hamad and others for a needed juristic appreciation of futures markets. Ebrahim and Shafiqur Rahman (2003) argued that the modern futures contract is preferable to *salam* in the sense of the Pareto-optimality criterion. We believe there is a genuine economic need for an Islamic futures market that captures the merits of the modern futures market and avoids its damaging demerits. Future contracts are vital for securing an uninterrupted flow of raw material to industrial firms at reasonably predictable prices as well as the ability to plan for the production and sale of future output. The contemporary challenge of a typical industrial firm is to compete for sustainable market

shares, not only on the immediate horizon, but also through deeper penetration into futures markets with binding forward contracts specifying both quantities and prices.

However, rather than questioning the jurists' position in relation to the forbidden 'debt for debt sale', this paper is based on the currently accepted practice of the *isti§nŒ*^{c} contract. The idea is to prove that *isti§nŒ*^{c} can be developed into a price-hedging tool like the modern forwards at least for the *isti§nŒ*^{c}-related class of goods. In this sense, it will be proved that *isti§nŒ*^{c}, rather than *salam*, constitutes the core of the Islamic futures market.

1.1 WHY NOT THE *SALAM* CONTRACT?

A futures contract is a means of hedging against the risks of cyclical or seasonal price volatility rather than offering a financing service. Most basically, it is a producer's tool to meet future production targets at the least possible risk of adverse price movements. The modern forward contract originally emerged as a hedging tool to protect large scale agricultural production against the collapse of prices during harvest seasons, particularly when markets become flooded with mountains of agricultural output.[1] From this perspective, *salam* cannot be viewed as the contemporary Islamic counterpart to the futures contract, as Khan does, since the *salam* contract is basically a financing contract. It is simply the reverse of *murŒbaúah* where price is deferred but goods are given spot. *MurŒbaúah* provides a financing service to the good's buyer, while *salam* provides the financing service to the good's seller. We can only classify *salam* as a futures contract if *murŒbaúah* is similarly classified, which is obviously not the case.

On the other hand, the juristic provision that the full price of *salam* must be paid spot means that *salam* can be a good hedge for the buyer – the capital provider – not the producer. To the capital provider, *salam* acts mainly as a hedge against a possible future rise in crop prices. This will result in a *salam* price which, in general, tends to act as a discounted present value of an expected future price, hence introducing into *salam* a downward bias against the expected future price.[2] The unfortunate experience of the *salam* agricultural financing in Sudan is a case in point where farmers suffered huge financial damage during the late nineties, reflected in harsh prison penalties for many defaulted

debtors. In his appraisal of the *salam* financing crisis in Sudan, Ahmed (1998, 77) believed that unpredictable price volatility proved to diminish the viability of *salam* financing in agriculture. He rightly attributed farmers' resentment directed at Sudan's Agricultural Bank to the sharp price movements which reached a typical 138 percent rise during the contracted period of *salam* finance. In recognition of this problem, the Sudanese authorities devised a formula of the so-called benevolence item (*bund al-iúsŒn*) in order to compensate farmers for the sharp drop in their real incomes. The *bund al-iúsŒn* formula was effectively a compromise solution which resulted in the scaling down of farmers' *salam* obligations to the Agricultural Bank in terms of a suitable price deflationary factor.

It is beyond the scope of this paper to discuss possible remedies to hedge farmers' real income positions in *salam* financing. Partly, the problem could be attributed to the very nature of *salam* financing in the received jurisprudence which necessitates that the price of a future delivery be paid spot. Deference of price in *salam* financing is particularly prohibited in order to avoid the problem of debt-for-debt sale. Debt is already created through *salam* financing in terms of the future delivery of *fungible*[3] agricultural or naturally produced goods (*mithliyŒt*); and hence if the price is also deferred, it will create a parallel debt.

1.2 WHY *ISTIêN•*^{c}?

The *isti§nŒ*^{c} contract involves a product demander (*musta§ni*^{c}) and a maker (*§Œni*^{c}) who has the skill to produce the required product in accordance with the technical specifications of the product demander. Like *salam*, *isti§nŒ*^{c} is currently practised as a binding sales contract between the two parties once concluded, but with the special flexibility that the full price of contracted industrial products need not be paid spot at the time of contract. The basic idea is that industrial products are classified as *non-fungible* goods (*qaymiyŒt*) and, therefore, the problem of debt-for-debt sale will not arise in the first place. This juristic point will shortly be elaborated upon, but it is interesting to appreciate the *isti§nŒ*^{c} jurisprudence from a historical perspective. The emergence of *isti§nŒ*^{c} reflects a watershed in Islamic jurisprudence where changes in economic conditions were recognized by Muslim scholars as sufficient

justification to warrant a financial innovation.

Duniya (1990) attributed the late historical appearance of *isti§nŒ*^{c} to the fact that technical production became more common in the Islamic State at a later stage. Admittedly, from the earlier centuries technical products were already known by people in terms of clothing, furniture, ornaments, shields, swords and others, but the critical question relates to the size of the market and the means of supply of technical products. In particular, when the common practice was to buy finished products rather than engage in a contract with a product maker, the basic issues about *isti§nŒ*^{c} contracting would be of too little relevance in people's lives. There is some evidence that *isti§nŒ*^{c} was known during the Prophet's time (peace be upon him) when a ring was reported to have been made for him,[4] but too little is known about the contractual terms of this transaction to resolve the wide controversy regarding the jurisprudence of *isti§nŒ*^{c}. There is no wonder, therefore, that the growing importance of *isti§nŒ*^{c} was attributable to later developments within the Islamic State when the market for technical production became much wider and more sophisticated.

The historical juristic controversy over the nature of *isti§nŒ*^{c} – whether it should be viewed as a sales contract with a sight option, a special form of work leasing contract (*ijŒrah*), or merely a promise – reflected those earlier stages in which the definite character of *istisnŒ'* was still in the process of taking shape.[5] Although many ˆ anafites, including Ab´ ˆ an¥fah himself, viewed *isti§nŒ*^{c} as a non-binding contract, Ab´ Y´suf (a student of Ab´ ˆ an¥fah) approved of *isti§nŒ*^{c} as being a binding sales contract on both the maker (*§Œni*^{c}) and demander (*musta§ni*^{c}), apart from the sight option granted to the buyer.[6] Incidentally, the *Majelle* adopted Ab´ Y´suf's opinion on this matter,[7] but denied the pre-stipulation of time in the *isti§nŒ*^{c} contract unless it boiled down to the restrictive rules of *salam*. In his *ˆ ashiyah*, Ibn ^{c}• bidin explained what used to be the mainstream ˆ anafite position, namely that any stipulation of time in *isti§nŒ*^{c} beyond one month would reduce the *isti§nŒ*^{c} contract to the rules of *salam*.[8]

However, it has been rightly appreciated in the current practice of Islamic banks that *istisnŒ*^{c} would not serve as a bankable mode of financing unless a definite provision for the time factor is freely allowed. Thus, to restructure *isti§nŒ*^{c} into a readily bankable mode, current Islamic banking practices have resorted to the opinion of Ab´ ˆ an¥fah's two

prominent students (Muúammad and Ab´ Y´suf) who, in recognition of the common practice (*ᶜurf*), approved freely of the time factor in *isti§nŒᶜ*.[9] This provision has been an important landmark in the evolution of *isti§nŒᶜ* to its current bankable form. It has accounted for the current practice of *isti§nŒᶜ* as a *salam*-like mode of financing without being subjected to *salam*'s most restrictive condition of full capital payment at the contract session. As it will be argued in the present article, such a historical capability of *isti§nŒᶜ* to evolve in response to the calls of *ᶜurf* is the fundamental feature which qualifies *isti§nŒᶜ* as the appropriate backbone of an Islamic futures market. To approach this question, we shall first review some alternative juristic opinions about the daunting issue of 'debt for debt sale'. Then, we shall move to our basic inquiry of how *isti§nŒᶜ* may be readily adaptable to perform the function of a forward contract.

2. DEBT-FOR DEBT SALE: A JURISTIC APPRAISAL

It is worth noting that the currently labelled Islamic financial structures originated historically from the concerted efforts of anonymous trade practitioners, no matter whether Muslims or non-Muslims, in an effort to meet their mutual economic interests in the market place. Necessity has remained the mother of invention not only for technical products, but equally well for methods of economic exchange capable of satisfying newly arising needs. The scholarly juristic role in this process is mainly to screen people's practices and expose them to the basic *Shar¥ᶜah* criteria (prohibition of *ribŒ*, *gharŒr*, or other illegitimate practices). The end result could either be the acceptance of the practice as it is, or a marginal adjustment to meet a relevant *Shar¥ᶜah* criterion, or an outright rejection. The Prophet's approval of the *muèŒrabah* contract is a case in point, since *MuèŒrabah* used to be a well-established practice during the pre-Islamic *JŒhiliyyah* period.

Salam financing is another example as it was also an established practice well before the Prophet's *Hijrah* (migration) to Mad¥nah. While in Mad¥nah, the Prophet noticed people's practice of *salam* financing, which he approved of in principle apart from making a marginal adjustment to eliminate an element of future *gharŒr*. In the reported *úad¥th*: "Whoever offers *salam* he should offer it in well defined volume and well defined weight for well defined time," the Prophet tightened

the *salam* contract against the indeterminacy of quantity and time. As regards the juristic condition that the full price of *salam* should be paid spot at the time of contract, this was based on people's actual practice of *salam* as approved by the Prophet, rather than the Prophet's *úad¼th* which incidentally makes no explicit mention of payment conditions. It was only the term "offers" in the phrase "whoever offers *salam*" that was held to indicate the act of paying the *salam* price spot. It remains to be ascertained whether the term "offers" was an order or a mere description of that given practice. Apparently, it was a description rather than being an order because orders were explicitly stated in relation to the important provisions of 'well-defined' volume, 'well-defined weight', and 'well-defined time'.

The basic juristic problem with the modern forward sales contract is the violation of the *salam* condition that the full price of future goods must be fully paid at the time of the contract. It is worth noting that such a 'spot payment condition' relates only to *salam*-specific goods which, from a juristic perspective, must be fungible goods (*mithliyŒt*), including agricultural crops and natural products like minerals. In the received jurisprudence, fungible goods are taken as the right objects of debt, and therefore, the spot payment condition in *salam* is a means of avoiding the problem of debt-for-debt sale. Accordingly, the juristic controversy about the modern forward contract revolves around the prohibition of the debt for debt sale in relation to fungible goods. By contrast, technical products are considered non-fungible goods (*qaymiyŒt)* and hence they are not taken juristically as objects of debt. In this sense, the problem of debt-to-debt sale will not arise in *isti§nŒ*^{c}. As it was mentioned above, this is the basic flexibility which endows *isti§nŒ*^{c} with an innovative potential. Our current objective is to develop this potential into the Islamic backbone of an Islamic futures market.

However, it can be argued that the traditional criterion of classifying *salam*-specific goods as fungible (*mithliyŒt*) and *isti§nŒ*^{c}-specific as non-fungible (*qaymiyŒt)* is no longer valid with the increasing dominance of highly refined industrial standards. Ironically enough, the quality of industrial production has become even more strictly identifiable and predictable than that of agricultural production. Agricultural production has also become so industrialized that it is not always easy to draw a sharp distinction between agricultural and industrial output. Hence, to maintain a consistent position, we may either relate *isti§nŒ*^{c} to the juristic

rulings of *salam*, or proceed with the flexibility of *isti§nŒ*^{c} as granted in the received jurisprudence. But the right approach, as we see it, is to maintain the received jurisprudence of *isti§nŒ*^{c} as it is, while calling for a more up-to-date *ijtihŒd* for the juristic appraisal of the debt-for-debt in the forward contracting on fungible goods. In this context, reference can be made to Muhiuddin (1986) and Kamali (2000) who critically evaluated various juristic sources which apparently disapprove of the modern forward contract. These juristic sources can be grouped as follows:

a. *bay*^{c} *al-kŒli' bi al-kŒli'* in a reported *úad¥th*
b. sale of the non-existent
c. sale of non-acquired goods
d. sale of absent goods
e. price indeterminacy
f. deviation from *salam* condition, and
g. Commitment between two parties without benefit (Ibn Taymiyyah's opinion).

As regards the appeal to the *úad¥th* of *bay*^{c} *al-kŒli' bi al-kŒli'*, which is juristically taken to mean the *debt for debt sale*, there is virtually an overall consensus that it is a non-authentic *úad¥th*. Nonetheless, there appears to be a juristic consensus on the prohibition of debt for debt sale, a topic that was discussed by Muhiuddin in the context of *bay*^{c} *al-kŒli' bi al-kŒli'*. However, we are not going to elaborate on the first five sources above since they are fully discussed within the original juristic sources. The most relevant point for our present analysis is the sixth point above: the non-obedience of the modern forwards contract to the price payment condition in *salam*.

To better appreciate the relevance of *salam* rulings, it is worth noting that the *salam* contract is viewed by the main schools of Islamic jurisprudence as an exception to the general juristic rule *that one cannot sell goods he does not possess*. The central juristic question, however, has been how to interpret the necessary condition of "goods' possession". Ibn Taymiyyah has offered a sensible interpretation of the condition of "goods' acquisition", which is effectively the one currently adopted in the Islamic banking experience. Namely, he interpreted the concept of goods' possession as the *ability to affect*

delivery rather than the simple physical possession of goods at the time of sale. The general criterion of goods' possession for Ibn Taymiyyah and his student, Ibn al-Qayyim, was the *ability to affect delivery* rather than the physical acquisition of the good. On this ground, they disagreed with all the other scholars who believed that *salam* financing was an exception to the general rule.[10]

Incidentally, if we accept Ibn Taymiyyah's opinion about *salam*, then the same rationale should apply to forward contracting when the ability to deliver is guaranteed. In the final analysis, the ability to affect delivery is what future markets are all about! The forward contract shares with *salam* the guaranteed future delivery of the good, differing only with respect to the future payment of price. This is perhaps the reason why Ibn Taymiyyah did not associate forward contracting with any serious juristic charge apart from what he believed to be a mutual commitment between two parties *without benefit* (seventh source above). Yet, al-ëar¥r[11] rightly objected to Ibn Taymiyyah's opinion on the grounds that it is up to the contracting parties to assess their own mutual benefit. It is very likely that Ibn Taymiyyah was making a positive statement about the state of affairs during his own time, when the benefit of forward contracting was not properly appreciated. We must appreciate the fact that earlier jurists often appealed to people's common practice when it did not violate a fixed *Shar¥ªah* parameter. In particular, price hedging could not have been a popular economic practice, but the benefit of forward contracting in the modern mass production markets cannot be exaggerated.

There is yet another point as regards the juristic definition of the debt for debt sale. This point relates to how the concept of debt-for-debt sale is defined across the different schools of jurisprudence. Muhiuddin demonstrated various jurists' definitions of the concept of debt for debt sale but it turned out that there was a wide range of juristic interpretations of this concept. Furthermore, not all versions of debt for debt sale were prohibited. For example, the Ĥanbalite School approved of the debt off-setting process, although it was one of the *debt for debt sale* versions. With this indeterminate juristic background to the meaning of debt for debt sale, Muhiuddin discredited the contemporary objections to the modern forward contract.

At any rate, there is no charge of *ribŒ* against forward contracting, and the worst charge that can made is that of *gharŒr* for which there

is room for discretionary judgement. Again, the charge of *gharŒr* is dependent on economic volume as it was already admitted by Imœm Mœlik when he allowed the sale of goats' milk from a number of goats but disallowed it from a single goat.[12] Hence, the modern production technology and the associated phenomenal growth, targeting both present and future demands, cannot be assumed to have left our traditional concept of *gharŒr* unaffected. It is beyond question that there are many undesirable speculative and gambling features in the Western futures market, but the basic forward contract has proved a powerful stabilising feature in the industrially developed economies.[13]

3. THE HEDGING POTENTIAL OF *ISTIêN•C*

People's actual practice of the *isti§nŒc* contract, which was juristically approved by the î anafite School, reflected rational economic behavior. For when there is uncertainty about quality at the time of delivery, people would rationally abstain from making full payment to a product maker. This is effectively the same reason why the jurisprudence of *isti§nŒc* wavered the *salam* price payment condition. The basic idea is that *salam* goods are fungible while those of *isti§nŒc* are non-fungible, and therefore, disagreement might arise at the end of the contract as regards the quality of the good. By choosing to pay part of the price to the product maker and defer the other part for the time of delivery, people were effectively hedging against a quality risk. In this manner, *isti§nŒc* fulfilled two functions simultaneously: a partial financing function for the supply side product maker, and a partial quality hedge for the demand side client. The î anafite approval of *isti§nŒc* has, thus, embodied an implicit recognition of a useful hedging function against a future risk.

Alternatively, if *isti§nŒc* was subjected literally to *salam* rules, as claimed by the other schools of jurisprudence, people would rather purchase ready-made products than engage in otherwise highly risky *isti§nŒc* contracts. The end result would be a drastic cut in *isti§nŒc* contracts and greater dependence on ready-made goods. It just remains to assess the extent of economic damage to Muslim economies when they depend on the provision of ready-made products from other economies where more flexible *isti§nŒc* rules prevail! The î anafite approval of *isti§nŒc* on the basis of *istiúsŒn* was effectively a far-

sighted vision which encouraged Muslims to finance their own industrial activity rather than depending upon the purchase of finished products from non-Muslim communities.

3.1 REDUCTION OF *ISTIêN•C* TO A HEDGING TOOL

Isti§nŒc, in the way it is currently practised, is a flexible tool. It is easily customizable to represent the relative strengths of either of its two main functions: the financing function and the quality hedging function. Depending on the interests of the contracting parties, no hard and fast criteria exist for how to strike a balance between the financing service and the hedging service. If the financing service predominates, *isti§nŒc* becomes much closer to *salam*, while if the hedging service predominates, it becomes closer to the forward contract. In both cases the problem of the debt for debt sale does not arise, given the currently accepted juristic position of *isti§nŒc*. Therefore, if we assign the total weight to the hedging service, the *isti§nŒc* contract will then become a simple form of the modern forward contract. In fact, this is the basic flexibility of *isti§nŒc* which makes it the appropriate backbone of an Islamic futures market.

Furthermore, when the partial financial function is eliminated, no discounting of expected future price will take place and, hence, a good anchor for future price movements will be in place. However, two main concerns might be raised at this stage: first, the hedging function of *isti§nŒc* will change from its traditional quality hedging to price-hedging. Second, to dedicate the use of the *isti§nŒc* contract as a hedging tool, means having to look for an alternative financing mode for industrial activity.

As regards the first concern, no juristic problem should ever arise as a result of changing the nature of the hedging function, because the nature of the hedging service is only implied, not explicitly related to the formal juristic structure of the contract. Whatever hedging function is implied by *isti§nŒc* is a matter of mutual understanding between the two contracting parties, not part of the formal contract. Nonetheless, it is understandable that the traditional 'quality hedging' service is no longer a matter of major concern since quality assurances are sufficiently provided through the provision of industrial warranties and quality guarantees. The *isti§nŒc* contract will act purely as a *de facto* price

hedging tool rather than one of quality assurance.

As regards the second concern, we have to admit the fact that *isti§nŒ*[c] in its traditional structure is not the ideal mode of financing industrial activity. In the contemporary Islamic banking experience the *isti§nŒ*[c] contract is heavily relied upon for the financing of real estate construction and, to a limited extent, industrial production. As we shall shortly explain, the *isti§nŒ*[c] mode proves too restrictive for the financing of industrial production, though it may still prove useful for the financing of single bulky products like real estate construction projects. Therefore, it is interesting to explore the possibility of reducing *isti§nŒ*[c] to a supportive price hedge service for an alternative financing scheme to the industrial production of consumer goods, while restricting its financing function to real estate construction.

3.2 TOWARDS AN ALTERNATIVE SCOPE

As we have seen, the jurisprudence of *isti§nŒ*[c] has evolved historically from a much earlier non-binding and almost timeless contract to its current *salam*-like form that is strictly binding for both the product maker and client once the contract is concluded. Admittedly, the *isti§nŒ*[c] contract played a commendable economic role in the promotion of technical production at an earlier historical stage of Muslim civilization. However, for our present industrial financing challenges it may no longer continue to be the ideal financing tool. It is worthwhile considering the possibility of exploring a new specialized function for *isti§nŒ*[c], namely that of acting as price hedge for industrial production. The question is: how commendable is it to restrict *isti§nŒ*[c] to a price hedging function while searching for an alternative financing mode for industrial activity?

In particular, the needed finance is seldom offered directly to the industrial firm in the current Islamic banking practice of *isti§nŒ*[c] financing, except in rare cases where the industrial firm acts as an agent for the bank. The agency arrangement which could have been adopted requires the industrial firm to act as an agent for the bank in the sense that it acquires the bank's financing on the basis of *isti§nŒ*[c] and then sells the produced output at profit on behalf of the bank to third parties. However, this idea is seldom adopted in actual practice since there is no guarantee to the bank that the output will be sold by its agent at the expected profit. On the other hand, the agent cannot

indemnify the bank against market uncertainty, hence invoking the classical principal/agent problem. This explains the reason why Islamic banks would prefer the alternative structure of *isti§nŒc-and-parallel-isti§nŒc* contracts. In this structure, the bank assumes the role of product maker in the first *isti§nŒc* contract with its client, and then it assumes the role of product demander in the parallel *isti§nŒc* contract with the ultimate product maker. However, this dominant structure suffers from three main limitations as follows. First, *isti§nŒc* financing would be earmarked to a single specified product (e.g., a real estate compound, a ship, etc.) or only a few such products. This is, indeed, the major limitation of the common practice of *isti§nŒc* since industrial entrepreneurs would normally prefer unrestricted cash financing for the production process as a whole. Second, it involves the intrusion of the bank into the technical operations through a complicated structure of two parallel *isti§nŒc* contracts: client/bank and bank/producer, whereas industrial entrepreneurs would prefer straightforward financing without the involvement of the bank in the technical process. Third, the bank is assigned the status of commodity producer in the client/bank contractual relationship, which is an obvious artificiality! Even in the case where the industrial firm acts as an agent for a bank to sell off the financed *isti§nŒc* product, there is still an artificial description of a bank as the demander for the industrial product. In fact, we are only echoing people's usual concerns about the need for a more flexible industrial financing mode.

3.3 A MORE GENUINE APPLICATION OF *ISTIêN•C*

The alternative idea is to utilize the price hedging property of *isti§nŒc* as a trade hedging device in industrial production where firms can now sell their output in future markets. Although firms will be selling forward, the juristic problem of the debt for debt sale will not arise since, in principle, it is irrelevant for *isti§nŒc*-related goods. The bank need not be involved in the *isti§nŒc* contract to behave artificially as a product maker, since the firm will not seek finance from the bank on the basis of *parallel isti§nŒc*. In this manner, the artificiality of the bank as a product maker will be avoided and the *isti§nŒc* contract will represent a set of genuine relationships between true demanders of the output and the true producer. This means that the above mentioned *isti§nŒc*-

and-parallel-isti§nŒ^c will no longer be the firm's source of finance. The firm will seek finance directly from the bank through an alternative mode of financing – not from the demanders of the future output – and, therefore, the *isti§nŒ^c* contracts will only serve as a tool for price hedging for both the producer and the demanders. The alternative mode of financing will turn out to be a profit-and-loss sharing contract (PLS) between the producing firm and the bank, where banks can now seize the opportunity of a closed position in future markets provided by the *isti§nŒ^c* hedge. The main attraction of the *isti§nŒ^c*-based PLS is that it makes it possible to lock in the future prices in terms of *known* volumes of goods to *known* parties at *known* prices. The added advantage of this alternative arrangement is that the PLS finance could cover as broad a range of output as possible rather than being earmarked for one or a few big items.

As it appears, the above structure would result in an optimal combination of the PLS scheme and *isti§nŒ^c*, exploiting the ideal financial features of each. By optimally combining a PLS financing scheme with *isti§nŒ^c*-based forward contracts, an Islamic bank is able to participate in almost assured future revenues coming from strictly binding future volumes and strictly binding prices. On the one hand, the *isti§nŒ^c* contract is applied as a genuine relationship between the producer and demander of a product. On the other hand, a good potential for a bankable PLS is made possible for the finance of industrial production. The idea is to devote the banking effort to the provision of industrial finance while confining *isti§nŒ^c* to the parties typically engaged in it. With such financial transparency Islamic banks should be well motivated to provide working capital for industrial firms through the PLS system so that the bank shares the profit of the firm for a contracted period of time. However, risks cannot be ideally controlled without a well regulated market to ensure the commitment of sellers and buyers and cover risks of default in the face of unforeseen losses. It is for this reason that a well regulated market mechanism will be needed to administer the flow of *isti§nŒ^c*-based future contracts.

4. CONCERNS ABOUT FUTURES MARKET MECHANISM

It is beyond the scope of this paper to appraise the Western futures market or to detail the necessary structure of an Islamic futures market,

but there are basic principles that are worth noting. The need for an intermediary vehicle to ensure the matching of potential sellers (holders of short positions) with potential buyers (holders of long positions) cannot be overemphasized. Understandably, the organizational complexity of a futures market and its level of sophistication depend, among other things, upon the volume and extent of the market, though we can mention some basically desired components of a structured futures market. A typical futures market consists of three main components: futures merchants to deal directly with customers' orders, future exchanges or *contract markets* to execute customers' orders, and clearance houses associated with the exchanges to clear all their related transactions (see Edward and Ma, 1992). Market intermediation in futures markets provides the same kind of services as in the commonly known market intermediation, e.g., banking, mutual funds, commercial distribution, etc. Basically, it reduces the cost of searching for the contracting parties, creates a convenient market place where prices are negotiated, provides efficient management services for contracting parties and furnishes the necessary information about daily price movements and expectations. Since any two parties cannot meet face-to-face to negotiate their preferred forward contract, the intermediary vehicle will find it imperative to standardize the potential futures contracts to suit various possible tastes. Hence, the mere standardization of futures contracts should not invoke any particular juristic concerns. Like any *market-maker*, such a vehicle, will bear the total risk of the dealings, since it effectively assumes the position of seller against all potential buyers and the position of buyer against all potential sellers. Hence, to ensure the timely execution of contracts and cover itself against the risk of default by either of the parties, which is highly likely due to unforeseen losses, it is understandable that the intermediary vehicle will have to open and manage margin accounts for its clients.

It appears that the basic appeal of a well structured futures market can be acceptable from an Islamic perspective provided that two main conditions are satisfied: first, the juristic approval for forward contracting, which we believe is already provided in industrial activity through the *isti§nŒ^c* contract. However, more *ijtihŒd* is needed to probe into the problem of debt-for-debt sale. Second, the market mechanism should have to obey ethical Islamic values which are already acknowledged in the literature on Islamic financial markets (e.g., see Tag El-Din, 1996).

Most particularly, there are two main concerns about the current practices of future markets that need to be carefully considered from an Islamic perspective:

- Concerns about speculative practices in financial markets are extensively discussed in the current literature of Islamic economics. However, not all speculative motives are harmful since the very concept of trade involves a speculative element. Traders in the past used to travel long distances in the pursuit of expected profits which may or may not materialize. Naturally, the modern forms of speculation do not take as much time and physical effort as those of the previous traditional trade, but this should be attributed to the development of fast technology rather than a difference in the basic speculative motive. Therefore, 'speed' of speculative behavior cannot be taken as the yardstick to distinguish between acceptable trade and harmful speculation. The problem to be settled from a juristic perspective is to decide on workable criteria to help to clearly distinguish between harmful speculative practices and tolerable ones – regardless of the element of speed. There is a general agreement that trade speculation can be reduced to a form of repugnant gambling, which is particularly the case when wild hunches rather than reliable information seem to guide a participant's decisions. Hence, the question about suitable criteria must relate to the quality of the information network which guides the process of exchange in futures markets.

- There are genuine concerns about the daily management and variations in the initial margin accounts. Although the opening of a margin account is necessary to cover risks of default by the contracting parties, the currently practised idea of *marking to the market*[14] generates on a daily basis an unexpected stream of profits and losses to the parties. This process exposes the parties' fortunes to unpredictable outcomes, rendering the engagement with the futures market more of a gambling vehicle than a means to achieve the basic objectives of matching the needs of two parties. It defeats the very purpose of the intermediary vehicle, particularly when a party becomes compelled to liquidate his position as a result of a sharp drop in his margin account before meeting his future target.

In this sense, the opening of margin accounts becomes an end rather than a means of yielding an efficient management for genuine future contracts.

The above three points are of particular interest for the development of an Islamic futures market in an effort to adopt the merits of the Western futures market and avoid its demerits. The focus of this paper has been mainly on the principles but further work is needed to translate the principles into a working mechanism.

ENDNOTES

1. Edward and Ma (1992, 5).

2. It is generally recognized in jurisprudence that the buyer of *salam* will benefit from the prospect of paying a lower price than the expected future price. See for example, Ibn Qud∈mah, *al-Mughni*, Vol. 6 (1997, 384).

3. Goods' items which tend to be very similar except for slight variations (e.g., rice, wheat) are called *fungible* goods or *mithliy∈t*. Debt can be created in terms of fungible goods On the other hand, non-fungible goods (*qaymiy∈t*) cannot act as objects of debt since their items could differ substantially.

4. See *al-Maws´ᶜah al-Fiqhiyyah*, Vol. 3 (1993, 327).

5. For the various opinions about *isti§n∈ᶜ*, see *al-Maws´ᶜah al-Fiqhiyyah*, Vol. 3 (1993, 326-7), or al-Zuúayl¥ (2002, 3642-4).

6. The sight option (*khiy∈r al-ru'yah*) is the juristic provision that the *istisn∈'* product must satisfy the demander's contracted specification, or otherwise he is legally not bound to take it.

7. See *The Mejelle* (1967, 57).

8. Ibn ᶜAbid¥n (1979, 223-4).

9. See al-Zuúayl¥, (2002, 3653).

10. Ibn Taymiyyah, *Fat∈w∈ Ibn Taymiyyah*, Vol. 20 (1995, 529).

11. See al-ë ar¥r (1976, 316).

12. Ibn Rushd al-Qur‹ub¥, Vol. 2 (n.d., 259). It reads: "M∈lik has approved the sale of milk for a few days if what is milked [out of goats] is normally known

from experience, but he disapproved the sale of the same from a single goat." See how the probability of the 'Law of Large Numbers' has been recognized in the assessment of *gharŒr*.

13. The existence of a futures market can act as an anchor for future price volatility to the extent that price expectation becomes governed by an organized market rather being left to subjective hunches of individuals.

14. *Marking to the market* is the process whereby the 'margins' accounts are constantly revalued on a daily basis in response to actual price movements. The net result will be either a profit or a loss to be payable to, or chargeable against, the holder of the 'margin' account at the end of the accounting day.

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