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An Appraisal of Shari'ah-Compliant Commodity Options for Islamic Banks

Zaharuddin Abdul Rahman[a], Maya Puspa Rahman[b*]

[a] *Independent Researcher*
[b] *College of Economics and Management, Al Qasimia University, Sharjah, United Arab Emirates*

**Corresponding author: mrahman@alqasimia.ac.ae*

Abstract

This paper aims to explore the potential structures of Shari'ah-compliant commodity options that would provide better alternatives for market participants in mitigating the risks associated with economic and commercial transactions. It appraises the current commodity options practiced in the conventional market and puts forward five conceptual alternatives in structuring Shari'ah-compliant commodity options while still retaining the main purpose and benefit of commodity options. Several nominated contracts in classical Islamic literature may be used to replicate certain features of conventional commodity options. The existence of these contracts is also similar to the main purpose of the options where the risk of volatility of the future commodity price is being shared with, reduced or transferred to the third party. Among the concepts are *'urbun*, *hāmish jiddiyyah, wa'ad* and sale contract such as *istijrār, bai' al-ikhtiyār, salam* and *murabahah*. Hence, this paper offers novelty in its approach to evaluating the commodity options from Shari'ah perspective, and subsequently, put forward five alternatives that can be practiced by Islamic banks all over the world.

Keywords: *Islamic derivatives*, *commodity, options, urbun, istijrār*

1. Introduction

One of the main goals for having commercial transactions called *muamalat* in Islam is to add value, create wealth and increase the economic well-being of Muslims in general. In attaining this goal, one must not ignore the existence of risks and uncertainties embedded in these commercial transactions. While uncertainty is random and cannot be predicted, the measurable unknown; called risk, can be controlled with appropriate measures.

In consideration that risk in economics represents a possible loss of wealth, the quantification and tools to control risk are also in line with the principle of *maqasid*; where one is required to take all precautions to safeguard present and future wealth. As such, in the financial market, the risk is mitigated through hedging. Hedging refers to a "transaction that offsets an exposure to fluctuations in financial prices of some other contracts or business risk" (Gupta, 2006, p.99) where one takes the necessary actions to reduce his exposure to possible loss of income and asset value in the future. ISRA (2011) on the other hand, defines hedging as taking an offsetting position in a derivative[1] to balance any gains or losses to the underlying assets.

In conventional finance, there are four basic types of derivatives namely, forward, futures, option and swap contracts. It is observed that most of the Islamic financial institutions (IFIs) are still operating on traditional instruments and claimed to be unable to satisfy the need of the market in terms of liquidity as well as risk and portfolio management, from the Shari'ah perspective. Several researchers have previously explored the permissibility of the use of options in Islamic finance (see, for examples; Dali, et al., 2005; Obiyatullah, 2023

[1] A derivative is a financial instrument whose value depends on the value of other, more basic variables such as grains, crude oil, palm oil, currencies or indices in the market.

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and Smolarski et al., 2006). On evaluating the challenges and prospects of Islamic derivatives, Sakti et al. (2016) provide renewed discussions on the subject matter by obtaining feedback from Shari'ah scholars from Malaysia and Singapore. Much interestingly, Chen et al. (2022) provided a new perspective on the study of volatility in the commodity market from an options view during the pandemic in China while El Hajaji et al. (2023) presented mathematical modelling of *ʿurbūn* which regarded as mirroring a call option against different asset types. However, there is still lacking in terms of discussions on the alternative structures to match the use and benefit of options that are particularly linked with commodities, particularly from the Shari'ah perspective.

Hence, this research focuses on the options derivative, particularly the commodity option, by proposing some conceptual and potential structures of commodity options which would provide better alternatives for market participants in mitigating risks associated with economic and commercial transactions, in line with the Shari'ah principles.

The next section highlights the mechanism of commodity options currently practised in the conventional market, followed by the details on the potential structures proposed for Shari'ah-compliant commodity options. The mechanism of each of the potential structures is deliberated in detail and supported with appropriate diagrams and illustrations for ease of understanding.

2. The Commodity Option Market

The commodity options market is simply a market in which producers may purchase the opportunity to sell or buy a commodity at a certain price. In the conventional market, commodity options are used to provide assurance against price declines, protect purchased products from price increases, and allow for speculation to generate profits.

Just as a farmer may purchase the right from an insurance firm to collect on a policy in case his buildings burn down, he can purchase the right to sell his commodities at a specific price if the market prices fall below the specified price. A separate market exists to purchase the right to buy commodities at a specified price if the market prices are higher than the specified price (McKissick and Shumaker, 1990).

Purchasers in this options market have the 'opportunity' but not the 'obligation' to exercise their agreement. As it is an option and not an obligation, this market is called the 'options market' with two basic types of commodity options, namely the 'call option' and the 'put option'. The 'call option' provides the holder with the right, but not the obligation, to buy the underlying commodity from the option seller at a specified price on or before the option's expiration date. The 'put option' on the other hand gives the holder the right, but not the obligation, to sell the underlying commodity to the option seller at a specified price on or before the option's expiration date. It is important to highlight that the call option and the put option are two different contracts and not the opposite of each other. A payment of premium is required to acquire this right under this option.

Let us look at an example of call options trading in wheat. If the strike price is MYR70 for a bushel of wheat, the buyer of this contract profits if the actual market price of wheat is greater than MYR70 per bushel, say MYR74. It is profitable as the call option allows this person to buy the wheat at MYR70 so he may enjoy the profit of MYR4 per bushel, aside from the ability to purchase the commodity at a lower price. However, if the market price is lower than MYR70 per bushel, then the option holder will not exercise the option but will face a minor loss for the option price, the premium that was paid upfront. On the contrary, the call seller or option seller would gain as he is attaining either the premium or the ability to sell the commodity higher than the market price. The same trade principles apply to the put option but only in the opposite direction where the buyer of the put option would profit from the downward price movement and the seller of the put option profits from the upward price movement.

3. The Potential Structures

Unlike the financial option, structuring the Shari'ah-compliant commodity option is more straightforward. Rightfully, gold, silver and currencies cannot be listed as acceptable commodities for this instrument due to their usurious (*ribawi*) nature. Suitable commodities or assets can be in other forms, such as:

a. Real estate
b. Shari'ah-approved shares
c. Crude palm oil, natural gas, plastic, copper, coal, aluminium, etc.
d. Shari'ah-compliant indexes
e. Ṣukuk (Islamic bonds)

In accordance with the previous explanation of the conventional option, a relatively similar instrument could also be structured and executed for IFIs. As an alternative, several contracts have been identified to suit the option's features which may be beneficial for Islamic financial industries.

3.1. Hybrid of either ʿurbūn or iqālah and parallel salam

Urbūn is a contract in which a deposit is paid by the prospective buyer on an item that he may purchase at a later time. Should the buyer decide not to complete the purchase, the deposit will be retained by the seller. Imam Mālik gave a general definition of *ʿurbūn*, which from his view can be used in a sale and a lease contract. It occurs when a person buys or rents an animal and says to the seller, "I will give you one dinar or one dirham or more or less and if I ratify the sale or the rent contract, the amount that I gave will be part of the total price. And if I cancel the deal, then what I gave will be for you without any exchange" (Al-Baji, n.d.). AAOIFI (2017) in its standard defined *ʿurbūn* as;

> "Earnest money is paid by the buyer to the seller at the time of at the time of contract on the basis that the buyer has the option to revoke the contract on the basis that the buyer has the option to revoke the contract during an agreed period of time. If he confirms the contract, contract during an agreed period of time. If he confirms the contract, the earnest money is credited towards the price. If he does not confirm the earnest money is credited towards the price. If he does not confirm the contract or fails to pay the remaining price during the stipulated time, the seller is entitled to forfeit the earnest money" (p 1236)

Various discussions have been held about the legality of the *ʿurbūn* concept, but the majority of contemporary scholars have accepted the concept; therefore, *ʿurbūn* may be used in the Shari'ah-compliant call and put options. However, there is general agreement among Shari'ah scholars that the *ʿurbūn* cannot be used in currency exchange or *sarf* because the delay of full payment on any of the usurious items would lead to *ribā al-nasiah* (Al-Darir, 1992; Al-Masri, 1992) and it is also important to highlight that from a practical perspective, *ʿurbūn* is not tradable according to Standard 53 of AAOIFI (2017).

Iqālah's terminology in Islamic law is derived from its original literal Arabic, which means a 'removal' or 'reversal'. Hence, Shari'ah scholars define *iqālah* as a means of revoking an exchange contract for both sale and *ijārah* by agreement from both parties (Hammad, 2008). The annulment of the contract must also be mutually agreed by the transacting parties. This concept theoretically may fit in the Shari'ah-compliant option in the situation where the holder of the options decided on non-exercise, he may apply the *Iqālah* concept; consequently, both parties who initially agreed with the forward sale contract agrees to withdraw and the paid deposit will be forfeited.

Salam or *salaf* literally means forward payment, but according to its Islamic lexical and juristic meaning, it is the sale of a deferred item in exchange for an immediate price, which means that it is the sale of a liability of which its characteristic is described in exchange for a price or capital sum paid in advance (Al-Zuhayli, 2003).

A simple illustration of the commodity option using these hybrid concepts is as below:

Transaction date:	28 September 2023
Buyer (option writer):	Client
Seller:	XYZ
Commodity:	Wheat
Option type:	Call option (to buy)
Expiration:	23 January 2024
Strike price:	MYR70 per bushel
Total bushel:	10,000 bushels
Urbūn payment:	MYR0.5 per bushel
Total *ʿurbūn*:	MYR5,000

For the client to hedge its position from a price increase in the next two months, he executes a so-called call option with XYZ. For that, the client needs to enter a sale and purchase a contract where he must pay an *ʿurbūn* payment totalling MYR5,000. In return, he will be able to gain an option of whether to conclude the purchase at the expiration date. In the event that the wheat market price is lower than MYR70 per bushel, the client will abandon the purchase but will lose the premium, which in this case is the MYR5,000 *urbūn* money.

Even though the above illustration seems straightforward and easy to transact, it is only perfectly suited when the transaction is direct between the buyer and the seller. Our question now is how IFIs can play their role in providing financing and hedging at the same time. To provide both functions to the client, IFIs have to act as a middleman between the two clients. The transaction is shown in Diagram I below:

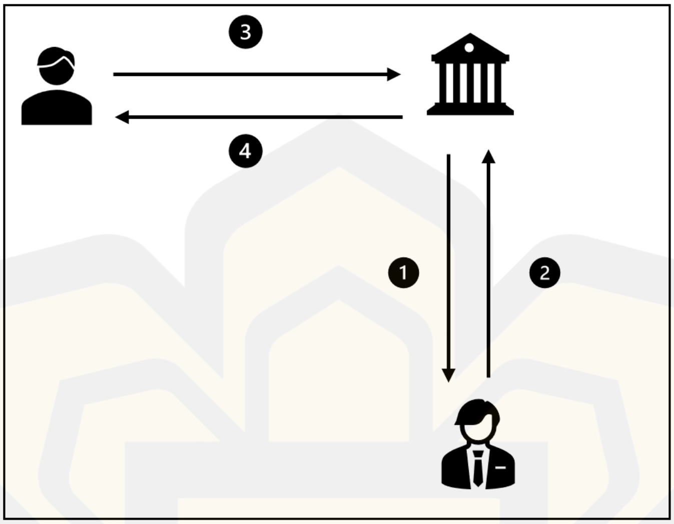

Diagram I: Hybrid of either *ʿurbūn* or *iqālah* and parallel *salam*

Explanation

1. On 28 September 2023, the client executes a *salam* contract to purchase wheat from the bank at an agreed price (MYR70 per bushel), quantity (10,000 bushels) and delivery date (23 January 2024). By the *salam* requirement, the price must be paid in full hence the client will pay MYR700,000 for a total *salam* payment to the bank. However, there will be a clause in the agreement that includes the buyer's right to call off (called *iqālah*) the purchase on the delivery date, leaving the amount of the *ʿurbūn* to the bank. The *ʿurbūn* in this regard is considered compensation to the seller (Rahman, 2014).
2. On 29 September 2023, the bank executes another *salam* purchase contract with the seller at a similar price and quantity (by way of either appointing the client to deal with the seller or by a direct deal), and the delivery date will be slightly earlier than in the first contract. As the contract is based on *salam* sale, the bank will have to channel the total payment of MYR700,000 to the seller.
3. At the expiry date, if the market price of a bushel is below MYR70, the buyer (client) will give a cancellation notice to the bank. Similar action will also be carried out by the bank to the seller. As such, both the client and the bank will receive their money except for a portion that can be regarded as compensation for the termination.
4. In the event of the client deciding to revoke the contract as the price is not in his favour, the bank will reimburse the payment less than the amount of compensation.

This structure would enable the client to hedge his position from the commodity price increase at a future date. It will also give him a choice to withdraw from the sale if the opposite price scenario occurs. The structure should also facilitate the bank to play its role as a financial intermediary in the transaction. However, it is prohibited for the bank to enable the transaction by using its own money because that would resemble a loan with interest transaction.

Despite the above description, the application of the *ʿurbūn* principle in this transaction may still trigger specific practicality issues, as well as the Shari'ah law. The practicality of the transaction might be questioned regarding how the bank will utilize the commodity before the expiry date of the client's call option. This is because transactions of commodity *murābahah* are typically executed with conventional sellers who do not possess any knowledge of Islamic law. They are just ordinary sellers listed in the London Metal Exchange

(LME); as such, if any Islamic bank requires the seller to follow the *salam*, *iqālah* and *ʿurbūn* conditions and all of their requirements, it would be a great challenge to be observed.

Moreover, most of the commodity sellers, even if the buyer is from the Bursa *Suq al-Sila'* in Malaysia, certainly would not want to expose themselves to any additional risks from the transaction. Thus, should the bank as a buyer of the commodity be required to accept the ownership of the commodity, what would the bank do with it? The bank would avoid any storage of any commodity as in practice, the commodity is hardly ever delivered to any buyer in this transaction. Hence, in an ordinary application, the bank would immediately sell the purchased commodity to another buyer for a certain price. Assuming that the client would like to conclude the purchase, the bank would liaise with the original seller to execute a completely new and immediate purchase contract for the equivalent sale price. If that happens, the whole structure will fall under the legal ruses (*ḥīlah*) category.

3.2. Hybrid of 'urbun, iqālah or faskh compensation and murābahah

In the previous structure, the parallel *salam* sale is used to purchase a specific kind of commodity, which usually is an agricultural-related product. Muslim jurists have detailed that the *salam* commodity must not be of a constructed and manufactured type, as that is the distinctive characteristic of an *istiṣnaʿ* sale. Hence, if there is an application from the buyer to purchase a completed or ready asset in the future, knowing that the price could escalate or plunge due to various external factors, *murābahah* or a regular sale could serve the purpose.

The commodity or asset in this contract could be in the form of real estates, shares, indexes, sukuk, etc. If the buyer is seeking to protect his purchase from the price risk volatility, by amalgamating any of the three principles above with the regular sale contract or *murābahah*, similar features of options could be created.

A simple illustration of the commodity option using these hybrid concepts is shown below:

Transaction date:	28 September 2023
Buyer (option writer):	Client
Seller:	XYZ
Commodity:	Land with a specific size
Option type:	Call option (to buy)
Expiration:	23 January 2024
Strike price:	MYR10 million
Compensation cost:	MYR25,000

The client is planning to purchase a piece of land at a specific venue, and it is anticipated that the land will be used for a new university campus. As such, there is a strong possibility that the price of the land will increase due to the nature of the project. However, the announcement and the project itself will only be confirmed in the next two months, by 22 November 2023. In order to preserve the land and concurrently impede other buyers from offering similar bids, the client enters into a normal purchase contract with either one of the two arrangements below:

a. First arrangement

The full price is paid upfront, but the land ownership will be processed only after the sale confirmation on the expiration date. The transaction will consist of a particular feature, where both parties agree that the buyer has the right to terminate the contract on or before the expiration date. If by the expiration date, the buyer is not completely satisfied with the situation, he can cancel the purchase and obtain a refund of the purchase price, less a set amount. This amount will be subject to the compensation of either *iqālah* or *fasakh* (termination) law.

Accordingly, the buyer would enjoy the benefit of assurance in price; meanwhile, XYZ can find another buyer for the land and at the same time could receive a compensation fee for the cancellation. It is believed that this structure will replicate some features of the conventional call option, but with the distinction that the buyer has already made the payment in full with the condition of reimbursement. In the conventional call option, the buyer is only required to pay the option premium at the time of the contract.

b. Second arrangement
The buyer pays part of the purchase price, which is the *ʿurbūn*, and in return, the seller acknowledges the purchase and immediately begins the ownership transfer process.

In summary, by using *ʿurbūn* and normal sale, or the *murābahah* concept, the following features would emerge:

- The price does not have to be paid in full at the beginning of the transaction.
- Only a portion of the price is paid to the seller, which is considered as the *ʿurbūn*. However, the seller is obliged to complete the transaction as and when the buyer decides, at least within a specific period of time.
- The transaction should not be considered as *bai' al-kāli' bil al-kāli'* (a sale in which both the delivery of the object of sale and the payment of its price are delayed) as the buyer is not obliged to complete the purchase. In essence, it is relatively similar to the non-binding bilateral promise.
- By the *ʿurbūn* principle, if the buyer opts not to complete the transaction, the *ʿurbūn* payment will be forfeited to the seller (Rahman, 2014).

Based on the above principle and application, the transaction should not require any financial intermediaries. This is because the buyer typically is not looking for financing from the bank as he already has the cash in place. As such, it is quite difficult to see the rationale for how Islamic banks could play their role in such cases, except as receiving and transmitting banks, comparable with the role they play in the issuance of letters of credit. The bank would obtain profit from the *wakālah* fee because its involvement in the transaction could increase the formality of the transaction and offer more security for the parties, especially when they happen to be in two different countries, for example, Kingdom of Saudi Arabia and Malaysia.

One practical issue that is worth exploring is that the above option could cause a problem as the total price will already be paid upfront, together with the *ʿurbūn*. However, in the original feature of *ʿurbūn*, there will be no total price paid at the beginning. This could mean specific practical issues, especially from the buyer's perspective because the requirement for full payment would lead to additional risks, such as difficulties of preparing the cash and obtaining the refund if the decision is made to revoke the contract.

If any financial intermediaries are interested in offering such a structure to their clients, we could also say that they will find it unrealistic because the actual purchase contract would not be suitable at the time of undertaking as the bank does not yet possess the asset; hence, it is impossible to conclude the *murābahah* sale. This will create a question: on what grounds is the *ʿurbūn* payment carried out? As a matter of fact, to apply the *ʿurbūn* principle in such a situation is unlawful. Thus, the structure may be appropriate for a direct transaction between the seller and the buyer, without the financial intermediaries, unless the original buyer or seller is the bank itself.

3.3. Hybrid of waʿad, hāmish jiddiyyah and murābahah

This concept uses the *hāmish jiddiyyah* principle. *Hāmish jiddiyyah* is a concept of a security deposit, which is paid before the conclusion of the sale contract (Rahman, 2014). Following the various resolution and juristic verdicts given by Shari'ah scholars, it is different from the *ʿurbūn* concept for two reasons:

a. *ʿUrbūn* is made at the time when the purchase contract is executed, whereas *hāmish jiddiyyah* is just like a booking fee, which is paid before the execution of the purchase contract (AAOIFI, 2007).
b. *ʿUrbūn* is regarded as part of the purchase price, whereas *hāmish jiddiyyah* is not.
c. Should the buyer decide to not proceed with the purchase, the *ʿurbūn* payment will be retained by the seller. While scholars differ in their opinions concerning *hāmish jiddiyyah*, the majority are of the view that the seller must refund the whole amount. However, several scholars discuss the issue of whether or not the seller could retain some of the amounts against an actual loss arising from the cancellation. In the light of those who allowed the actual loss, it cannot emulate the option premium as it could be more than the actual loss (Rahman, 2014).
d. Unlike the *ʿurbūn*, the price of the subject matter excludes the *hāmish jiddiyyah* amount.

Based on a similar illustration to that given above, the terms below are suggested:

Transaction date:	28 September 2023
Buyer (option writer):	Client
Seller:	XYZ
Commodity:	Land with a specific size

Option type:	Call option (to buy)
Expiration:	23 January 2024
Strike price:	MYR10 million
Compensation cost:	MYR25,000

To apply the structure, the client could pay a security deposit (*hāmish jiddiyyah*) to the seller (XYZ). Assuming that on the expiry date, 23 January 2024, the buyer withdraws its purchasing intention, the seller must refund the security deposit but retains a small portion of it as compensation for an actual loss.

There are differences in opinion concerning the repayment of *hāmish jiddiyyah*, which have already been pointed out. In summary, the majority of Shari'ah scholars seem to agree that the principle could be employed to replicate the conventional option premium.

Again, for the actual loss computation, assuming that the agreed price is $10 million if, at the time of revocation, the market price indicates $10.25 million, $250,000 would be the actual loss on the seller's part. However, if the *hāmish jiddiyyah* payment is more than $250,000, all of the surplus money needs to be refunded to the payer. With the actual loss of the seller, the Central Bank of Malaysia Shari'ah resolution states that the seller is allowed to retain the entire amount, but it is silent on whether the seller has the right to demand the remainder. The resolution also stresses that the entire treatment must be initially agreed upon by the transacting parties at the beginning of the contract (BNM, 2010).

3.4. Hybrid of baiʿ al-ikhtiyār (specification sale) and a standard sale

Previously, several writers (Al Amine, 2000; Kamali, 1997; Kunhibava and Shanmugam, 2010) have proposed *khiyār sharṭ* to be the structure in an Islamic option; but it raises debates on whether the concept could be employed for more than three days. Instead of using the contentious principle, the Mālikis School of Law has a unique type of sale, namely *bayʿ al-ikhtiyār* (Hammad, 2008), defined as:

بيع أحد شيئين أو أكثر بثمن معلوم, على أن للمشتري حق اختيار واحد منها خلال مدة محددة

Meaning: *Selling one of the two or many goods with each price of which is mutually agreed upon, but the buyer will have the right to choose the goods within a specific period.*

This type of sale is acceptable by the Ḥanafi, Maliki and certain Ḥanbali scholars (Abu Ghuddah, n.d). The Shāfi'i scholars reject the sale as the subject matter is unknown (*jahālah*) and indefinite at the time of the sale, hence they deem the sale to be void and null (Al-Nawawi, n.d; 1997). The proponents of the *ikhtiyār* sale rely on the legal reasoning evidence (*qiyās*) for it has the essence of *Khiyār al-Sharṭ*. Moreover, there are needs for such an arrangement to ease the sale transactions. Hence, Ḥanafi jurists argue that it is allowable, which is evidenced by the *istihsān*. While they admit the elements of ignorance and the unknown (*jahālah*) in the sale, they believe that the elements are trivial (*yasīr*) and tolerable, as they typically do not lead to arguments from both parties (Humam, 1898).

Illustrating an option-like structure, similar sample terms would be used:

Transaction date:	28 September 2023
Buyer (option writer):	Client
Seller:	XYZ
Commodity:	Land with a specific size
Option type:	Call option (to buy)
Expiration:	23 January 2024
Strike price:	MYR10 million
Compensation cost	MYR25,000

Firstly, two separate assets need to be identified, one is the land and the other (say a computer or any other item which is suitable to match the premium amount) will be used for the choice.

Secondly, when the client decided to purchase the abovementioned land, with the special option features, he can approach the seller (XYZ) and purchase both assets. Based on the *Bayʿ al-Khiyār* or *Khiyār al-Ta'yīn* prescriptions, the buyer will have the right to decide which asset he would like to conclude at an agreed date, which will be 23 January 2024.

Thirdly, should the anticipation occur (that is the land will be developed for a housing project for example) instead of the computer, the buyer would decide to choose the land. If the opposite occurs, the buyer concludes the purchase of the computer.

Hence, the seller will either receive full payment for the land, of which the premium cost is already priced into the purchase amount, or he will gain a minor profit from the selling of the computer, which equals the option premium payment. In this structure, replicating the effect of premium, that is by way of embedding the price of the computer as the *Khiyār al-Ta'yīn* arrangement (but the price will not be paid upfront as per the nature of premium). Instead, the price will only take effect when the client decides not to exercise the purchase of land. Consequently, he is choosing to purchase the computer. That is to replicate the effect of the premium in the conventional structure.

From a practical perspective, the only minor obstacle about the structure is that there must be an alternative asset, having the same value as the desired premium payment. However, for the structure to be suitable for the financial intermediaries' derivatives product, several practical difficulties and Shari'ah issues are anticipated. This is because the bank needs to have both assets in its possession at the time the *bay' al-Khiyār* takes place and this could be difficult as it would expose the bank to a new risk of ownership of both assets and having no prior knowledge as to which of the assets will be sold. Notwithstanding this fact, it is also anticipated that the bank can manage such a risk by hedging or performing a similar and parallel structure with another financial institution. As such, if the buyer decides not to choose the primary asset, it will be sold immediately to the other party.

3.5. Hybrid of 'urbūn, istijrār and murābahah

An *istijrār* sale has been defined as:

أخذُ المرءِ الحوائجَ من البيّاع شيئاً فشيئاً، ودفع ثمنها بعد ذلك

Meaning: *Taking (purchasing) necessities from a seller on an ongoing basis, and making the payment later on* (Hammad, 2008).

Al-Maṣri (2006), who summarised the definitions of *istijrār* from various scholars, concludes:

أن يأخذ المشتري ما يحتاج إليه من سلع من البائع، ويطلب منه قيدها عليه بثمن السوق، وهو لا يعلم هذا الثمن، بل يأتمن البائع عليه

Meaning: *A buyer is purchasing goods from a seller, and at the same time, asking for the price to be based on the reasonable market price even if he does not know the actual price, as he has put his trust in the seller.*

Bank Islam Malaysia Berhad (n.d.) defines *istijrār* as a contract between a supplier and a client whereby the supplier supplies a particular item on an ongoing basis for an agreed mode of payment until they terminate the contract. It is equally applicable to a contract between a wholesaler and a retailer for the supply of some agreed assets.

Scrutinising the discussion of classical Shari'ah scholars, it can be understood that the key features of the *istijrār* sale are:

a. Price and payment

- Could be made upfront or deferred to a later date.
- The price will only be known in its exact amount at the time of payment.
- The price on the purchase date will be known by the seller but not the buyer.
- The price will be tied to the reasonable market price (*Thaman al-Mithl*), but it may also be known by the buyer if the price is already stamped on the goods' package.
- The method of payment is also determined at the purchase date. The payment could be made weekly, monthly, quarterly, etc. based on the agreement.
- To secure the seller's benefit, the client will have to pay a deposit based on the '*urbun* principle. This payment plays a role in the option's premium. However, this part requires Shari'ah deliberation.

b. The rulings

The Shari'ah scholars are divided into two groups concerning the ruling on an *istijrār* sale as shown below:

- Permissible: An *istijrār* sale has been allowed by the Ḥanafi jurists based on the juristic preference (*istihsān*). A similar verdict is reached by Ibn Taymiyyah and Ibn Qayyim (Ibnu Abidin, p. 37).
- Prohibited: The majority of the Islamic Schools of Law prohibit the *istijrār* sale for containing extreme ignorance of the sale price, payment date and payment method (An-Nawawi, 1997; Al-Baji, n.d.).

Before moving forward with the practical illustration of these hybrid concepts, previously the usage of the *istijrār* principle was suggested by some scholars, among others Obiyathulla (2023). To comprehend his proposal, it is worth simplifying his example with the scenario below:

Client:	Seeking short-term capital to finance the purchase of a commodity
Commodity:	Raw material for construction
Islamic Bank A:	Financier
Transaction date:	20 January 2023
Expiry date:	20 April 2023 (3 months from the initiation date)
Resale price:	Will be determined by the bank based on the *istijrār* concept
Client's target price:	MYR200,000
Option's type:	Call option (right to buy) and put option

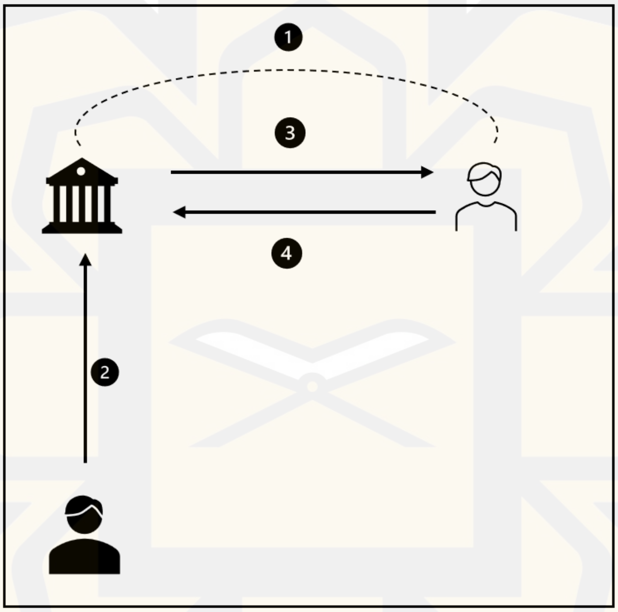

Diagram II: Hybrid of *'urbūn*, *istijrār* and *murābahah*

Explanation

1. To manage the risk, the bank only purchases the material after obtaining an undertaking to purchase from the client.
2. An Islamic bank buys an asset in the form of raw material from a third party at X price.
3. The Islamic bank supplies the material on an ongoing basis to the client at a price to be paid at a specific date in the future. The actual price will depend on the underlying price's movement from the day of the contract initiation to the day of maturity. Islamic Bank A has the option to fix the price if it falls such that it breaks the lower bound before the date of maturity (put option).
4. The client has the option to fix the price of the commodity before the maturity date if the price of the commodity moves upward to a pre-determined level (call option).

Obiyathulla (2023) later explains:

> "If the spot price at any time breaks through the upper bound, the buyer will get worried, but whether he will exercise or not depends on his expectations of the spot price over the remaining period of the contract. Should spot prices be falling such that they break the lower bound, the seller, in this case, the bank, would have the option to fix the settlement price at the market price".

Comments on the proposal and suggested improvements

By scrutinizing Obiyathulla (2023) suggestion, it is easy to find several contentious issues:

a. In the light of the *fiqhi* view, it is evident that there is an element of an *al-ʿInah* sale, which is prohibited by the majority of classical and contemporary scholars, including the AAOIFI, the OIC International *Fiqh* Academy, etc. Obiyathulla (2023) proposes that the bank should purchase the raw material from the client and resell it at either a higher price or a lower one based on the market value on the maturity date. In this paper, the authors are of the opinion that the prohibiting view is stronger, thus rejecting Obiyathulla's original proposal. As an alternative, the structure should be changed, where the bank has to purchase from the original seller directly or through the agency of the client, which would emulate the *Murābahah Li al-Āmir bi al-Shira*[2] structure, which is unanimously agreed upon the contemporary Shari'ah scholars.

b. In the light of the practical banking issue, it is not possible to resemble the option's feature as the proposal granting both parties the right to exercise, whereas it is known in the option concept that one party will have the right and the other will bear the obligation to deliver for the premium taken. However, Obiyathulla (2023) proposal is silent on the premium feature. At the end of his proposal, he also admits that the *istijrār* contract in its entirety from an option's viewpoint is complicated since it has two different exercise styles rolled into one. Such an instrument would be unusual in conventional finance.

c. It is understood that this is because the original principle of *istijrār* allows the seller to trade the asset at a market price with the client. Therefore, he suggests that both parties have the right to exercise whenever they desire, which deviates from the original concept of *istijrār*, where the buyer should already purchase the commodity without knowing the price as the past and current market price will be taken as a benchmark in the future. However, according to Obiyathulla's suggestion, the buyer's purchase is still not concluded, leaving both parties without certainty. Any inability of the buyers to settle the payment, an arrangement to postpone it or settle it with another debt can be made. It could, therefore, be regarded as *baiʿ al-kāliʾ bi al-kāliʾ*.

d. Thus, for the *istijrār* to fit the key feature of the conventional option, it may be suggested that the *ʿurbūn* is paid by the client, and in return, the bank would agree to deliver the asset as and when the client decides to exercise at an agreed price by way of analyzing the previous price and the current market price. However, the *ʿurbūn* feature cannot fit into this structure as the original concept of *ʿurbūn* is to recognize it as a part of the sale price paid by the potential buyer to the seller, who already possesses the commodity. In the given structure, the asset is not yet in the bank's or the seller's possession, thus leaving the issue of selling something before its ownership. However, such limitations are still open to *fiqhi ijtihad* and discussion.

e. One may ask that as *ʿurbūn* could not be included, what if *hāmish jiddiyyah* is used for the purpose. However, that is also not a solution as *hāmish jiddiyyah* is only a security deposit and not a sale contract.

f. Notwithstanding the above fact, the amalgamation of *ʿurbūn* and *istijrar* principles is appropriate to replicate an option only if the seller is the original seller, who possessed the commodity at the time both contracts were being transacted. Hence, for the structure to apply to Islamic financial institutions, they need to venture into additional risk and quite a drastic change regarding the commodity. As such, it is believed that some bankers would apply Obiyathulla (2023) original structure, which is based on *al-ʿInah* sale, where the bank would purchase and resell the commodity to the buyer.

[2] A transaction where a prior promise is made *(wa'd)* from the buyer to purchase the asset from the seller, when the seller has acquired the asset from the supplier.

g. Obiyathulla's *istijrār* structure also seems to be a hybrid of financing and hedging at the same time, while the option, in general, is constructed to provide a hedging purpose only.

However, we do not see any significant problem at this point. If only the seller's issue can be resolved, for example, it is a direct transaction between the seller and the buyer of a commodity, then they could replicate the option feature by using *ʿurbūn* and *istijrār*. Diagram III presents the possibilities for both the buyer and the seller.

Following the usual possibility of the option contract, the strike price would be the target price given by the buyer, based on its anticipation. In our example, the client's target price for the material in the next three months is MYR200,000. If the market price at the option expiry date is MYR202,000, that means the price is at the higher bound for the buyer but at, the lower bound for the seller. In such a case, the client is likely to exercise, as it would be able to buy the material at a lower price; however, the client still has to take into account the premium amount. While the upper bound could save a few thousand, the premium must always be calculated.

If the market price indicates MYR199,000, the seller will be at the upper bound but has no right to proceed before any agreement from the client. As for the client, he needs to strike a balance between the lower market prices and the premium paid. If it is not worth it, the client would terminate the purchase, lose the *ʿurbūn* (as the premium) and opt for the market.

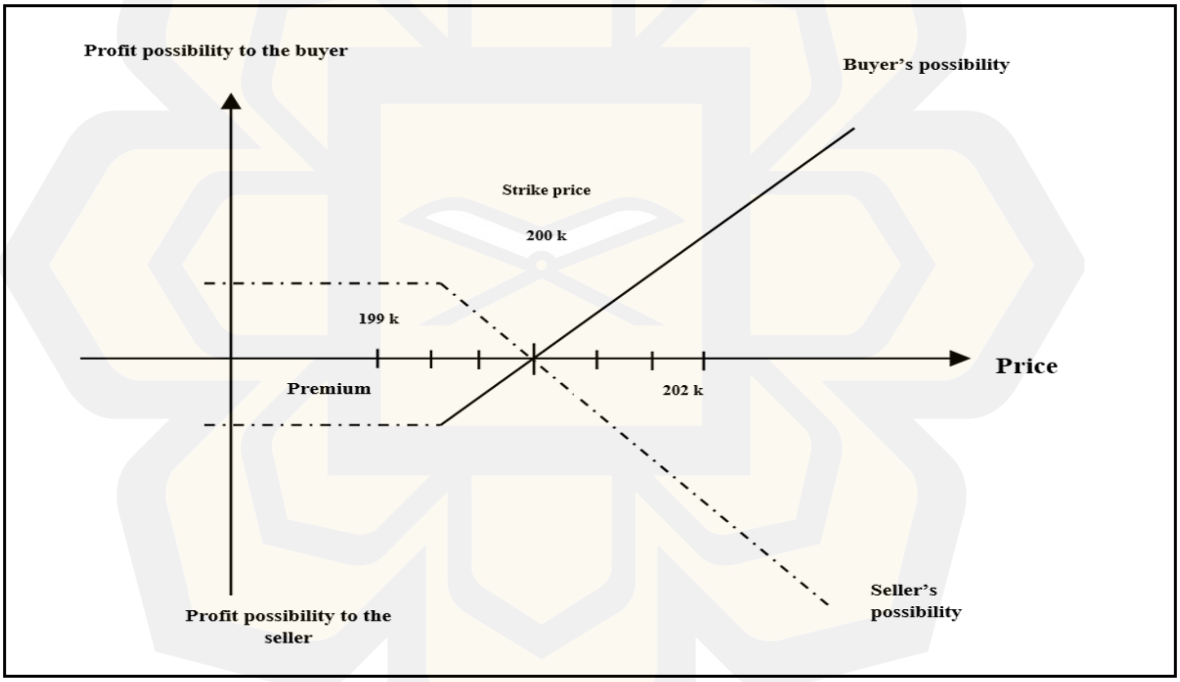

Diagram III: Proposed possibilities for both buyer and seller

In summary, it can be considered that the hybrid of *ʿurbūn*, *istijrār* and *murābahah* can be one of the alternative structures for IFIs in creating a hedging mechanism for their clients, albeit with a few additional risks. That is from the aspect of Shari'ah compliance, on the contrary, the practice of those structures from the systemic and industrial players' perspective is not discussed in this paper.

Pursuant to the above structure (Diagram III), the client or buyer would enjoy the ability to keep the future price of the desired raw material price at an agreed level, despite knowing that the market price could fall lower than anticipated (strike price), but at least it will be secured from any increase in price. Furthermore, they still can decide whether to purchase from the market at the current lower price or to exercise the purchase via the bank.

4. Conclusion

This paper explores the potential structures of commodity option that is in line with the Shari'ah principles. Based on the appraisal, several nominated contracts in classical Islamic literature may be used to replicate certain features of the conventional commodity options. The existence of these contracts is also similar to the primary purpose of the options where the risk of volatility of the future commodity price is being shared with, reduced or transferred to the third party.

In conclusion, this paper highlights and discusses five alternatives to conventional commodity options. The workflow of each of these Shari'ah-compliant commodity options are meticulously discussed about its processes, implementations, contract flows and effects but at the same time ensuring the benefits and purposes of commodity option are retained for the benefit of the market participants.

This paper offers novelty in its approach to evaluating the commodity options from the Shari'ah perspective, which would provide better alternatives for market participants in mitigating the risks associated with economic and commercial transactions.

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