

A Critical Evaluation of the Regulatory Framework for the Application of Islamic Financial Derivatives in the Kingdom of Saudi Arabia

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Abstract

The first financial derivatives emerged in Chicago in the early 1970s in response to increasing interest rates, exchange rates and volatile prices. In the three decades before the credit crunch of 2008 and global financial crisis, financial derivatives contracts grew rapidly to constitute a major component of the U.S. financial system. However, despite their demonstrable importance for financial sector development, derivatives are few and far between in countries where capital market transactions are governed by Shariah law such as Saudi Arabia. The aim of this article is to give a comprehensive and critical review of Islamic derivatives as an alternative to conventional derivatives in Saudi Arabia, and examine whether the current uses of accepted risk transfer mechanisms in Islamic structured finance are compatible with the principles of Islamic law. The article is divided into a number of sections. The first section gives background material on financial derivatives contracts and their legality from an Islamic point of view. The next section offers a critical and comparative analysis of the principles and practices of financial derivatives. The third section gives a critical analysis of how Islamic financial derivatives work in Saudi Arabia.

1. Introduction

According to the Bank for International Settlements (BIS), financial derivatives are financial contracts whose values/prices depend on the prices of underlying assets (often simply known as the underlying).²

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² See the official website of the Bank for International Settlements (BIS), available at: <http://www.bis.org/publ/bcbs14.htm> [Accessed 07 November 2013].

For example, the changing value of a crude oil futures contract depends primarily on the upward or downward movement of oil prices.³ These contracts are legally binding agreements, made on the trading screen of stock exchanges, to buy or sell an asset in the future. The underlying asset can be anything, from a share, index, interest rate, bond, rupee dollar exchange rate, crude oil, sugar, soybean, coffee, cotton or whatever else is being traded.⁴

Financial derivatives contracts are settled at a future date, and are therefore not performed in the present market.⁵ Under paragraph 6(b) of the Financial Accounting Standards Board (FASB) Statement No. 133: a derivative requires either no initial net investment or a smaller initial net investment than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.⁶ The values of financial derivatives (gains and losses) are dependent on the prices of the underlying assets.⁷ Financial derivatives are financial agreements that are binding on both parties.

The basic purpose of derivatives is to create a mechanism to transfer risk from one party or firm that wants to avoid risk to another that is willing to absorb the risk. In this practice, one party's loss is always another party's gain.⁸

This practice is prohibited in Islamic law because it involves speculative activities that can equate to gambling.⁹ *Shariah* is derived from the Holy Book (*Quran*), the true sayings of the prophet Mohammed (*Sunnah*), the consensus among Muslim scholars (*Ijma*) and analogy (*Qiyas*).¹⁰

³ See Virginia B. Morris & Kenneth M. Morris, *Dictionary of Financial Terms*, Lightbulb Press, Inc, New York, 2003, p. 55.

⁴ See the official website of the International Monetary Fund (IMF), available at: <http://www.imf.org/external/np/sta/fd/>, [Accessed 15 August 2013]; Bishnupriya Mishra & Sathya Swaroop Debasish, *Financial Derivatives*, Anurag Jain for Excel Books India, New Delhi, 2007, p. 2.

⁵ R. Venkata Subramani, *Accounting for Investments, Fixed Income Securities and Interest Rate Derivatives: A Practitioner's Handbook*, John Wiley & Sons, Ltd, UK, Volume 2, 2011, p. 269.

⁶ See the Official Website of the Financial Accounting Standards Board (FASB), available at: <http://www.fasb.org/derivatives/issuea1.shtml>, [Accessed 15 August 2013].

⁷ R. Venkata Subramani, *Accounting for Investments, Fixed Income Securities and Interest Rate Derivatives: A Practitioner's Handbook*, John Wiley & Sons, Ltd, UK, Volume 2, 2011, p. 269.

⁸ Robert Kolb & James A. Overdahl, *Financial Derivatives: Pricing and Risk Management*, John Wiley & Sons, UK, 2009, p. 58; Habib Ahmed, 'financial crisis risks and lessons for Islamic finance' *ISRA International Journal of Islamic Finance*, Vol. 1, Issue 1, 2009, p. 10.

⁹ Andreas Jobst & Juan Sole, 'The governance of derivatives in Islamic finance', *Journal of International Banking Law and Regulation*, Vol. 24, issue 11, 2009, p. 557.

¹⁰ Muhammad Ayub, *Understanding Islamic Finance*, John Wiley & Sons, Ltd, UK, 2007, p. 41.

The basic principles of Islamic finance are the prohibitions of *riba* (usury or interest), *gharar* (uncertainty), and *maisir* (speculation or gambling), and the requirement for equity profit-and-loss sharing (PLS).¹¹ Therefore, any activities not compatible with these provisions are forbidden for Muslims.¹² There is an Islamic alternative to conventional derivatives, which is based on a mechanism of equitable risk-sharing and underlying transactions in tangible assets.¹³

With the advent of globalisation and economic liberalisation, it is becoming increasingly difficult to ignore Islamic financial derivatives. The Islamic finance market is growing at a rate of 15% per year.¹⁴ Currently, the circulating assets of Islamic finance are the equivalent of US \$ 1.4 trillion.¹⁵ There are more than 500 Islamic financial institutions (IFIs) operating in the world in over 75 countries including Western countries, so Islamic finance is one of the fastest growing financial sectors in the world, and in particular, in the Gulf Cooperation Council, due to the oil boom.¹⁶

Saudi Arabia is one of the largest markets for Islamic banking and finance in the world, accounting for a substantial share of the sector's total assets, which is valued at nearly \$1.6 trillion.¹⁷

¹¹ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer*, Vol. 30, issue 1, 2009, p. 176.

¹² Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', *Science Direct*, Vol. 17, issue 1, 2009, p. 128.

¹³ Andreas Jobst & Juan Sole, 'The governance of derivatives in Islamic finance', *Journal of International Banking Law and Regulation*, Vol. 24, issue 11, 2009, p. 557.

¹⁴ Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', *Science Direct*, Vol. 17, issue 1, 2009, p. 126.

¹⁵ Yoko Ishigaki, 'The development of the Islamic financial market-the Tokyo sukuk case study', *Company Lawyer*, Vol. 30, issue 5, 2009, p. 2.

¹⁶ Yoko Ishigaki, 'The development of the Islamic financial market-the Tokyo sukuk case study', *Company Lawyer*, Vol. 30, issue 5, 2009, p. 3; Muhammad Ayub, *Understanding Islamic Finance*, John Wiley & Sons, Ltd, UK, 2007, p. 15.

¹⁷ See the Official Website of The Islamic Development Bank (IDB), available at: http://www.irti.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IRT1/CM/downloads/IRT1_Annual_Report_1433H_2012_En.pdf, [Accessed 30 December 2013].

Currently, in Saudi Arabia, there are four Islamic banks and 11 branches of foreign banks providing Islamic banking and financial services in accordance with the principles of Islamic law.¹⁸ There is also the Saudi Stock Exchange (*Tadawul*), which is considered one of the most highly capitalised stock exchanges in the Arab world where the issuance of *sukuk* in Saudi Arabia is traded on the Saudi Stock Exchange.¹⁹ In addition, Saudi Arabia's *takaful* insurance industry is considered the largest one in the world. In 2011, Gross Written Premiums (GWP) in the Saudi insurance market reached SR 18.504 billion, up from SR 16.387 billion in 2010.²⁰

Although the Kingdom of Saudi Arabia (KSA) is considered the birthplace of Islam, is home to Islam's two holiest shrines, in Mecca and Medina, and its constitution is based on *Shariah*, there are no specific laws governing Islamic banking and financial activities, including financial derivatives. Islamic banking and financial activities are regulated and supervised side by side with conventional commercial banking businesses by the Saudi Arabian Monetary Agency (SAMA) under the Banking Control Law (BCL) of 1966. In addition to the absence of regulatory policies and supervisory harmonisation, there is no independent central *Shariah* board for validating Islamic banking and financial activities to ensure their compatibility with the *Shariah* principles. Moreover, there is no uniform guidance on *Shariah* compliance or uniform interpretation of *Shariah* principles of Islamic banking and financial activities. Furthermore, there are no commercial courts for resolving banking disputes in Saudi Arabia.

The purpose of this article is to examine to what extent the current uses of accepted risk transfer mechanisms in Islamic structured finance in Saudi Arabia are compatible with the principles of Islamic law. This article will suggest solutions to develop a legislative and regulatory framework for Islamic banking and finance in Saudi Arabia, in line with the standards of the Accounting and Auditing Organization for Islamic Financial Institutions of Islamic finance and also Malaysian experience.

¹⁸ See the official website of the Royal Embassy of Saudi Arabia in Washington, available at: http://www.saudiembassy.net/about/country-information/economy_global_trade/banking.aspx, [Accessed 26 November 2013].

¹⁹ See the official website of the Royal Embassy of Saudi Arabia in Washington, available at: http://www.saudiembassy.net/about/country-information/economy_global_trade/banking.aspx, [Accessed 26 November 2013].

²⁰ Saudi Arabian Monetary Agency, 'Insurance Supervision Department', The Saudi Insurance Market Report 2011, <http://www.sama.gov.sa/sites/samaen/Insurance/InssuranceLib/SUR_InsuMarketSurvey2011_En_2011.> [Accessed 18 May 2013].

The main reason for choosing Malaysia is that it is considered one of the most advanced Islamic finance industries in the world, particularly in terms of Islamic bonds (*sukuk*) where it is the world's largest *sukuk* market with a number of Malaysia's *sukuk* issues by 68.9%, or USD 62 billion of total global outstanding *sukuk* at the end of 2007.²¹ In addition, Malaysia has issued a number of laws and regulations related to Islamic finance and *takaful* to regulate and supervise IFIs in Malaysia. It has also established the *Shariah* Advisory Council (SAC) as the sole *Shariah* authority for the Islamic banking and *takaful* industries.²² The selected methods for this article are critical literature review and comparative analysis.

According to Gupta, there are bewilderingly complex varieties of derivatives already in existence, and the markets are continuously innovating newer ones, and therefore it is difficult to classify financial derivatives, due to the complexity of their nature.²³ This article will focus on the most commonly used financial derivatives contracts: forwards, futures, options and swaps. A forward contract is an agreement between two parties to buy or sell a specific amount of an asset to be delivered at a pre-agreed date in the future.²⁴

The purpose of a forward contract is to avoid price uncertainty and lock in a price for a future transaction.²⁵ In a forward contract, no initial payment is required. This kind of contract can be used for either hedging or speculation.²⁶

According to classical jurists of all the Islamic schools of jurisprudence, conventional forward contracts are forbidden in Islamic law, based on a Prophetic tradition.

²¹ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahimatul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 476.

²² Hjh Abd Jabbar, 'The governance of Shari'a advisers of Islamic financial institutions: the practice in Malaysia', *Company Lawyer* (2009) 30 (10) 312.

²³ For example, plain, simple or straightforward, composite, joint or hybrid, synthetic, leveraged, mildly leveraged, customized or OTC traded, standardized or organized exchange traded. See S. L. Gupta, *Financial Derivatives: Theory, Concepts and Problems*, PHI Learning Pvt. Ltd, New Delhi, 2006, p. 7.

²⁴ Marc Levinson, *Guide to Financial Markets*, The Economist Newspaper Ltd, UK, Fifth Edition, 2010, p. 221.

²⁵ Sundaram Janakiramanan, *Derivatives and Risk Management*, Dorling Kindersley (India) Pvt. Ltd, India, 2011, p. 55.

²⁶ H R Machiraju, *International Financial Markets and India*, New Age International, New Delhi, Second Edition, 2002, p. 99.

They argue that although the price to be paid in the future is known, the future quality of the specified object of sale is unknown, which is a source of uncertainty and ignorance conducive to disputation. The second reason is that the practices of conventional forward contracts are essentially the exchange of one debt for another debt or *bai-al-kali-bi-al-kali* or *bai-al-dayn-bi-al-dayn*.²⁷ In this practice, both the delivery of goods and payment are being made at a future date, which means that this practice breaches the Islamic law principle of 'do not sell what you do not own'.²⁸

As a consequence of this *hadith*, conventional forward contracts are unlawful in *Shariah* as long as both the price payment and delivery of sale object are stipulated as future liabilities.

A futures contract is a standardised contract between two parties to buy or sell a fixed quantity of a commodity or an underlying financial instrument (such as a group of stocks) at a specified price during a particular delivery month.²⁹ For example, on 15 September 2013, dealers on the London Futures and Options Exchange would pay 250.49 pounds sterling for the delivery of two ton of corn at the end of December. While the futures contract specifies that an exchange will take place in the future, the purpose of the futures exchange is to minimise the risk of default by either party.³⁰

Fundamentally, futures contracts are similar to forward contracts;³¹ however, according to Aswath Damodaran, there are three major differences between futures and forward contracts. First, futures contracts are traded on exchanges, whereas forward contracts are not. Consequently, futures contracts are much more liquid, and there is no default or credit risk.

²⁷ Mahmoud A. El-Gamal, *Islamic Finance Law, Economics, and Practice*, Cambridge University Press, New York, 2006, p. 86; See the official website of The General Presidency of Scholarly Research and Ifta, available at:

<http://www.alifta.net/Search/ResultDetails.aspx?languagename=en&lang=en&view=result&fatwaNum=&FatwaNumID=&ID=3613&searchScope=14&SearchScopeLevels1=&SearchScopeLevels2=&highlight=1&SearchType=exact&SearchMoesar=false&bookID=&LeftVal=0&RightVal=0&simple=&SearchCriteria=allwords&PagePath=&siteSection=1&searchkeyword=1001010981160321021111403209711011116104101114032100101098116#firstKeywordFound>, [Accessed 19 August 2013].

²⁸ Asyraf Wajdi Dusuki & Abdelazeem Abozaid, 'Fiqh Issues in Short Selling as Implemented in the Islamic Capital Market in Malaysia', *JKAU: Islamic Econ*, Vol. 21, issue 2, 2008, p. 63.

²⁹ Bishnupriya Mishra & Sathya Swaroop Debasish, *Financial Derivatives*, Anurag Jain for Excel Books India, New Delhi, 2007, p. 41.

³⁰ Bennett A. McDowell, *Survival Guide for Traders: How to Set Up and Organize Your Trading Business*, John Wiley & Sons, UK, 2011, p. 171.

³¹ Marc Levinson, *Guide to Financial Markets*, The Economist Newspaper Ltd, UK, Fifth Edition, 2010, p. 221.

However, this advantage has to be offset against the fact that futures contracts are standardised and cannot be adapted to meet the firm's precise needs. Second, futures contracts require both parties (buyer and seller) to settle differences on a daily basis rather than waiting for expiration of the contract. Thus, if a firm buys a futures contract for oil, and oil prices go down, the firm is obliged to pay the seller of the contract the difference. Because futures contracts are settled at the end of each day, they are converted into a sequence of one-day forward contracts. This can have an effect on their pricing. Third, when a futures contract is bought or sold, the parties are required to put up a percentage of the price of the contract at a "margin". This operates as a performance bond, ensuring there is no default risk.³²

Item 5/1/2 of Accounting and Auditing Organization for Islamic Financial Institutions Shariah Standards No: 20 states that conventional futures contracts are not permitted either through their formation or their trading because they involve *gharar* (uncertainty) in the future delivery of the underlying asset.³³ Moreover, according to Resolution No. 63(1/7) of the International Islamic Fiqh Academy, conventional futures contracts are prohibited because they involve uncertainty and the exchange of one debt for another debt or *bai-al-kali-bi-al-kali* or *bai-al-dayn-bi-al-dayn*.³⁴

An option is a contract to buy or sell an underlying asset at a specified price on or before a specified date.³⁵ For example, if IBM is selling at \$120 and an investor has the option to buy a share at \$100 (the strike price), this option must be worth at least \$20, the difference between the price at which one can buy IBM (\$100) through the option contract and the price at which one could sell it in the open market (\$120).

Such an option is said to be in-the-money. If the market price of IBM is equal to the strike price, then this option would be at-the-money. If the market price of IBM is below the strike price, the option would be out-of-the money.³⁶

³² Aswath Damodaran, *Strategic Risk Taking: A Framework for Risk Management*, Pearson Prentice Hall, New Jersey, 2008, p. 336.

³³ See the *Shari'a Standards for Islamic Financial Institutions 2010* (English Version), 367.

³⁴ See the official website of the International Islamic Fiqh Academy, available at: <http://www.fiqhacademy.org.sa/qarat/7-1.htm>, [Accessed 04 February 2014].

³⁵ M. Ranganatham & R. Madhumathi, *Investment Analysis and Portfolio Management*, Dorling Kindersley (India) Pvt. Ltd, New Delhi, 2006, p. 180.

³⁶ John R. Boatright, *Finance Ethics: Critical Issues in Theory and Practice*, John Wiley & Sons, UK, 2010, p. 229.

An option contract gives the buyer the right to sell or the right to buy.³⁷ Based on this principle, option contracts are classified into two broad categories: call option and put option. A call option gives the holder the right to buy an underlying asset by a certain date for a certain price. The seller is under an obligation to fulfil the contract and is paid a price of this which is called "the call option premium" or "call option price". A put option gives the holder the right to sell an underlying asset by a certain date for a certain price. The buyer is under an obligation to fulfil the contract and is paid a price for this, which is called "the put option premium" or "put option price".³⁸

The purpose of an option contract is to provide the offeree with time to evaluate the main contract offer.³⁹ Options are used for hedging, risk management, speculation or investment.⁴⁰ With regard to the legitimacy of option contracts in Islamic law, option contracts are forbidden in *Shariah*. According to Resolution No. 63(1/7) of the International Islamic Fiqh Academy, option contracts are not permissible because they involve interest (*riba*), gambling and pure games of chance (*maysir*), uncertainty (*gharar*) and exchange of one debt for another debt or *bai-al-kali-bi-al-kali* or *bai-al-dayn-bi-al-dayn*.⁴¹

Swaps are contractual arrangements between two parties who agree to exchange, over time and according to predetermined rules, streams of payment of the same amount of indebtedness.⁴² The basic idea behind swaps is that the parties involved obtain access to markets at better terms than would be available to each one of them individually.⁴³

³⁷ M. Ranganatham & R. Madhumathi, *Derivatives and Risk Management*, Dorling Kindersley (India) Pvt. Ltd, New Delhi, 2012, p. 134.

³⁸ Sudhindra Bhat, *Security Analysis & Portfolio Management*, Anurag Jain for Excel Books India, New Delhi, 2009, p. 540.

³⁹ Martin A. Frey & Phyllis Hurley Frey, *Essentials of Contract Law*, Delmar, Canada, 2001, p. 73.

⁴⁰ Jawwad Ahmed Farid & Fawzia Salahuddin, *Risk Frameworks and Applications*, Alchemy Technologies, Second Edition, Pakistan, 2010, p. 52.

⁴¹ See the Official Website of the International Islamic Fiqh Academy, available at: <http://www.fiqhacademy.org.sa/qarat/7-1.htm>, [Accessed 25 August 2013]; See the official website of The General Presidency of Scholarly Research and Ifta, available at: <http://www.alifta.net/Search/ResultDetails.aspx?languagename=en&lang=en&view=result&fatwaNum=&FatwaNumID=&ID=3613&searchScope=14&SearchScopeLevels1=&SearchScopeLevels2=&highlight=1&SearchType=exact&SearchMoesar=false&bookID=&LeftVal=0&RightVal=0&simple=&SearchCriteria=allwords&PagePath=&siteSection=1&searchkeyword=1001010981160321021111403209711011116104101114032100101098116#firstKeywordFound>, [Accessed 25 August 2013].

⁴² Paul Cullinane, 'Incorporating derivatives data in the National Accounts and Balance of Payments', *Economic & Labour Market Review*, Vol. 4, issue 4, 2010, pp. 44-45.

⁴³ V S Somanath, *International Financial Management*, I. K. International Pvt Ltd, New Delhi, 2011, p. 575.

Swaps objectives are stated to include hedging of financial risks, reducing financing costs, conducting large-scale operations for more and more profit, access to new markets and, mostly, undertaking speculative activities to maximise the gains.⁴⁴

Under Section 901(f) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, a swap agreement was amended to include numerous types of financial swaps commonly used in conventional finance.⁴⁵ According to Don Chance and Robert Brook, there are four primary types based on the nature of the underlying variable: interest rate swaps, equity swaps, commodity swaps, and currency swaps (also known as cross-currency interest swaps).⁴⁶

According to *Shariah* principles, conventional swaps are prohibited because they clearly involve interest payments. An Islamic profit rate swap is the alternative to the conventional interest rate swap.⁴⁷

After a brief overview of conventional derivative contracts, and why conventional derivatives are unacceptable in Islamic finance, the article will move towards exploring financial structures available within an Islamic framework.

⁴⁴ See 8th International Conference on Islamic Economics and Finance: Use of *W'ad* and *Tawarruq* for Swaps in the framework of Islamic Finance, available at:

<http://conference.qfis.edu.qa/app/media/317>, [Accessed 26 August 2013].

⁴⁵ The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Section 901(f). Section 901(f) of the Act amends the definition of "swap agreement" to include an "interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap; a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange or precious metals agreement; a currency swap, option, future, or forward agreement; an equity index or equity swap, option, future, or forward agreement; a debt index or debt swap, option, future, or forward agreement; a total return, credit spread or credit swap, option, future, or forward agreement; a commodity index or commodity swap, option, future, or forward agreement; or a weather swap, weather derivative, or weather option." See too: the United States Congressional Serial Set, Serial No. 14845, House Reports Nos. 40-50. See too:

http://www.law.ttu.edu/lawlibrary/library/research/bapcpa_library/226-801-901.htm#901

⁴⁶ Don Chance & Robert Brooks, *Introduction to Derivatives and Risk Management*, Cengage Learning, Eighth Edition, USA, 2010, p. 407.

⁴⁷ Mohammed Obaidullah, 'Financial Options in Islamic Contracts: Potential Tools for Risk Management', J.KAU: Islamic Econ, Vol. 11, issue 4, 1999, p. 18. See too 8th International Conference on Islamic Economics and Finance: Use of *W'ad* and *Tawarruq* for Swaps in the framework of Islamic Finance, available at: <http://conference.qfis.edu.qa/app/media/317>, [Accessed 26 August 2013].

2. Islamic Alternatives to Conventional Derivatives

As mentioned earlier, the basic principles of Islamic finance are the prohibition of interest (*riba*), excessive uncertainty (*gharar*), and speculation or gambling (*maysir or qimar*), and the adherence to profit and loss sharing between the parties to a transaction, as well as the promotion of ethical investments that enhance society and do not violate practices banned in *Shariah*. From these principles, as argued in the previous section, it can be deduced that conventional derivatives contracts cannot be regarded as compliant with *Shariah*.⁴⁸

There are a number of existing hedging tools that could be considered a basis for derivative contracts within the bounds of Islamic finance: *Bai Salam*, *Bai Urban*, *Khiyarat*, *Wad* and Islamic Swap (An Islamic Profit Rate Swap).⁴⁹

According to Accounting and Auditing Organization for Islamic Financial Institutions, *bai salam* is the “purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions or sale of a commodity for deferred delivery in exchange for immediate payment”.⁵⁰ It can be considered an Islamic forward wherein the price was paid in advance at the time of making the contract for prescribed goods to be delivered later.⁵¹ An Islamic forward is defined as a binding promise by the buyer, often an Islamic financial institution (IFI), to buy, and by the seller to sell a generic product of a specific quantity on a specific date in the future at an agreed-upon price.⁵²

According to Anjum Siddiqui, the purpose of a *bai salam* contract is to “meet the capital requirements as well as cost of operations of farmers, industrialists, contractors or traders as well as craftsmen and small producers”.⁵³

⁴⁸ Angelo Venardos, *Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System*, World Scientific, Singapore, 2010, p. 256.

⁴⁹ Obiyathullah Ismath Bacha, 'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration', *International Journal of Islamic Financial Services*, Vol. 1, issue 1, 1999, p. 20; Obiyathulla Ismath Bacha & Abbas Mirakhor, *Islamic Capital Markets: A Comparative Approach*, John Wiley & Sons Singapore, 2013, pp. 315-316.

⁵⁰ See the official website of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), available at: <http://www.aoofi.com/aoofi/IslamicFinancialDefinitions/tabid/209/language/en-US/Default.aspx>, [Accessed 06 September 2013].

⁵¹ Muhammad Ayub, *Understanding Islamic Finance*, John Wiley & Sons, Ltd, UK, 2007, p. 241.

⁵² Abdul Rahim Al-Saati, 'Sharia Compatible Futures', *J.KAU: Islamic Econ*, Vol. 15, 2002, p. 10.

⁵³ Anjum Siddiqui, 'Financial contracts: risk and performance of Islamic banking', *Managerial Finance*, Vol. 34, issue 10, 2008, p. 683.

According to Mohammed Obaidullah, *bai salam* is a useful Islamic forward that can potentially be used for hedging.⁵⁴

A *salam* contract is similar to a conventional forward contract, except that the buyer pays the entire amount for the product at the time of contract; in a conventional forward, either full or partial payment is allowed to be made in advance.⁵⁵

In Islamic law, one of the basic conditions for the validity of a sale is that the commodity or underlying asset must currently exist in its physical sellable form or be in the process of being made by the seller.⁵⁶ However, classical jurists agreed that the *salam* contract constituted an exception to the general prohibition of the sale of non-existent properties, as well as to the prohibition of the sale of properties that are not in the seller's possession at the time of sale.⁵⁷ Therefore, *bai salam* is a permissible sale based on certain mandatory conditions.⁵⁸

In this regard, the researcher recommends modern jurists to stipulate such conditions in *salam* contracts, to minimise the elements of *gharar* and eliminate elements of *riba* therein.⁵⁹

⁵⁴ Mohammed Obaidullah, *Islamic Financial Services*, Scientific Publishing Centre, King Abdulaziz University, Jeddah, Saudi Arabia, 2005, p. 179.

⁵⁵ Obiyathullah Ismath Bacha, 'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration', *International Journal of Islamic Financial Services*, Vol. 1, issue 1, 1999, p. 20.

⁵⁶ Jaquir Iqbal, *Islamic Financial Management*, Global Vision Publishing, New Delhi, 2009, p. 113; Obiyathulla Ismath Bacha & Abbas Mirakhor, *Islamic Capital Markets: A Comparative Approach*, John Wiley & Sons Singapore, 2013, p. 315.

⁵⁷ Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice*, Cambridge University Press, UK, 2006, p. 82.

⁵⁸ In *bai salam*, it is necessary for the validity of the contract that the buyer pays the price in full in advance to the seller at the time of effecting the contract; otherwise the contract will be void. The object of exchange must be fungible, of quality and clearly defined physically and quantitatively as to the size, volume and colour. *Bai salam* only deals with goods as long as the goods are fungible. Gold and silver are not allowed in this contract, because these are regarded as monetary value exchanges, while the aim of *bai salam* is to meet the needs of farmers who need money to grow their crops and of traders for import and export businesses. In terms of the delivery of the goods the exact date and place of delivery must be specified in the contract, because the time of delivery is an essential part of this contract. It must be ensured that the goods are able to be delivered when they are due. The customer (buyer) cannot enjoy ownership rights over the purchased commodities before taking them into possession. The goods of the *bai salam* contract should remain in the market from the day of the contract up to the date of delivery.

⁵⁹ *Ibid.*

Parallel *salam* is the replication of the *salam* transaction, where the buyer (Islamic financial institution) often enters into two different contracts, one where the Islamic financial institution acts as a seller and another in which it is a buyer.⁶⁰ The key condition of *Shariah* is that the two contracts (*salam* and parallel *salam*) must be independent of each other.⁶¹ Islamic financial institutions may use parallel *salam* if they do not want possession of the underlying commodity.⁶² According to Muhammad Ayub, the delivery date in the parallel *salam* contract can be the same as in the original *salam* contract, but not earlier than that, as this would mean the sale of commodities that one does not own.⁶³

According to Ayub, Islamic financial institutions use parallel *salam* to mitigate the risk when the Islamic financial institution enters a contract to purchase commodities, as it simultaneously enters a contract with a buyer for those commodities. While in conventional firms, the risk can be mitigated by using hedging techniques,⁶⁴ for *salam* with parallel *salam*, the Islamic financial institution may face legal risk if the commodities cannot be delivered at the specified time unless the customer under parallel *salam* agrees to modify the delivery date.⁶⁵

A *bai urban* contract refers to a sale with an earnest money deposited by the buyer with the seller as a part payment of the price in advance. Under an *urban* contract, the buyer pays a sum of money against the purchase price to the seller to indicate his intention and ability to implement the contract.⁶⁶

The contract of *bai urban* stipulates that if the buyer continues with the transaction within the stipulated time period, the deposit will become a part of the price that has already been negotiated. Otherwise, if the buyer defaults or decides not to proceed, the earnest money will be forfeited in favour of the seller.⁶⁷ According to Sidney Yankson, this practice of *bai urban* is almost identical to the option in conventional western finance.

⁶⁰ Ibid.

⁶¹ Muhammad Ayub, *Understanding Islamic Finance*, John Wiley & Sons, Ltd, UK, 2007, p. 252.

⁶² Obiyathullah Ismath Bacha, 'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration', *International Journal of Islamic Financial Services*, Vol. 1, issue 1, 1999, p. 21.

⁶³ Muhammad Ayub, *Understanding Islamic Finance*, John Wiley & Sons, Ltd, UK, 2007, p. 252.

⁶⁴ Ibid.

⁶⁵ Simon Archer & Rifaat Abdel Karim, *Islamic Finance: the Regulatory Challenge*, John Wiley & Sons Singapore, 2007, p. 127.

⁶⁶ Sidney Yankson, 'Derivatives in Islamic Finance: A Case for Profit rate Swaps', *Journal of Islamic Economics, Banking and Finance*, Vol. 7, issue 1, 2011, p. 46.

⁶⁷ Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice*, Cambridge University Press, UK, 2006, p. 91.

The key difference is that in an option contract, the premium paid for the option is not deducted from the sale price if the option is exercised, while in a *bai urban* contract it is considered a part payment of the purchase price.⁶⁸ In addition, some contemporary Islamic jurists believe that *bai urban* is similar to the call option, which is likewise binding on the seller but not on the buyer.⁶⁹ *Hanbali* jurists had even contemplated that the option period should be fixed; otherwise the seller may have to wait indefinitely for the potential buyer to decide whether or not to exercise his right.⁷⁰

There was an argument among Islamic scholars about the legality of *bai urban*, and they used three doctrines (*madhhab*) to argue against the *bai urban* contract. They declared that the *bai urban* contract is forbidden, based on a Prophetic tradition. The evidence for their argument is that the Prophet forbade the sale of *bai urban*.⁷¹ They argued that a *bai urban* contract involves uncertainty (*gharar*), risk-taking, and the taking of money without any consideration of whether the seller possesses what the buyer paid for if the buyer defaults or decides not to proceed.⁷²

In contrast to the majority of scholars, the *Hanbali* school deemed that the practice of *bai urban* is acceptable. They relied on a Prophetic tradition⁷³: The Messenger of God was asked about *bai urban*, and permitted it.⁷⁴

Classical *Hanbali* and contemporary jurists of most schools discussed the argument of the other schools. They argued that Prophetic traditions that provide support through the three schools was weak, and also that *bai urban* had become very common and provided some compensation to the seller for waiting, in case the buyer decided not to execute the sale.⁷⁵

⁶⁸ Sidney Yankson, 'Derivatives in Islamic Finance: A Case for Profit rate Swaps', *Journal of Islamic Economics, Banking and Finance*, Vol. 7, issue 1, 2011, p. 46.

⁶⁹ Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice*, Cambridge University Press, UK, 2006, p. 91.

⁷⁰ Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice*, Cambridge University Press, UK, 2006, p. 91.

⁷¹ *Ibid.*, p. 92.

⁷² *Ibid.*, p. 91.

⁷³ *Ibid.*, p. 92.

⁷⁴ Abu Dawud Sulayman ibn al-Ashath, *Sunan Abu Dawud*. Hadith number: 9964, Universal Dar for publication, Saudi Arabia, 2009, Vol. 4, p. 155.

⁷⁵ Mondher Bellalah, *Islamic Banking and Finance*, Cambridge Scholars Publishing, UK, 2013, p. 55.

Under Resolution No: 72 (3/8) [1] of the OIC at its eighth session in Brunei in 1993, the Fiqh Academy of the Organization of Islamic Conferences endorsed the opinion of the *Hanbali* school. The OIC Fiqh Academy decided that *bai urban* is permitted if a time limit is specified for exercising the option.⁷⁶ With regard to the deposit paid by the buyer to the seller in a buying and selling contract, the OIC Fiqh Academy decided that it is considered a part of the purchase price already negotiated if the sale proceeds. Otherwise, the earnest money will be forfeited as a gift (*hibah*) from the buyer to the seller if the buyer defaults or decides not to proceed.⁷⁷

The researcher believes that the opinion of the *Hanbali* school is the closest to the truth owing to the power of their argument as well as because financial transactions nowadays need such a contract, which is considered one of the prominent Islamic hedging instruments. The researcher also believes that the prohibition of this type of hedging could put a large number of obstacles in the way of the Islamic finance industry, which is seeking to become a global industry.

Islamic options (*Khiyarat*) are an Islamic alternative to conventional options that are prohibited based on resolution No. 63(1/7) of the International Islamic Fiqh Academy.⁷⁸ *Al-khiyar* is a sale with an option to one or more of the parties to accept or annul a sale contract within a stipulated time period, for example; a defect in the goods.⁷⁹ The *Shariah* demands that the seller should disclose all the defects in the article being sold, otherwise the sale is not valid.

For example, if a person makes a purchase and is not aware, at the time of sale or previously, of a defect in the article bought, then the buyer has an option to annul the contract under *al-khiyar*, whether the defect is small or large.⁸⁰

The purpose of *al-khiyar* is to protect the interests of both parties to the contract against cheating or misrepresenting the facts (*ghabn*) or risk (*gharar*).

⁷⁶ See the Official Website of the International Islamic Fiqh Academy, available at: <http://www.fiqhacademy.org.sa/qyarat/8-3.htm>, [10 September 2013].

⁷⁷ Ibid.

⁷⁸ See the official website of the International Islamic Fiqh Academy, available at: <http://www.fiqhacademy.org.sa/qyarat/7-1.htm>, [13 September 2013].

⁷⁹ Mohammed Obaidullah, 'Financial Engineering with Islamic Options', *Islamic Economic Studies*, Vol. 6, issue 1, 1998, p. 74.

⁸⁰ Muhammad Ayub, *Understanding Islamic Finance*, John Wiley & Sons, Ltd, UK, 2007, p. 150.

In *al-khiyar*, the possibility of conflicts between the parties to the contract can be reduced, to avoid any possibility of wrong committed against a party deliberately or unintentionally, through giving them a reassessment period, usually three days in Islam.⁸¹ Thus it can be said that *al-khiyar* achieves equality between the parties to the contract, and fulfilment of proper and reasonable expectations of the parties to the contract.⁸²

The difference between *Khiyarat* and conventional options is essentially ethical. While conventional options in mainstream finance include all kinds of rights without obligations that have financial implications, *Khiyarat* offers the right for one or both parties to confirm or reject the contract.⁸³

The permissibility of *Khiyarat* is inferred directly from the following hadith of the holy Prophet (peace be upon him) reported by al-Bukhari and Muslim. When Habban Ibn Munqidh complained to the holy Prophet (peace be upon him) that he was the victim of frequent fraud in some earlier transactions, the holy Prophet (peace be upon him) is reported to have said "Whenever you enter into contract, say to the other party that there shall be no fraud, and I reserve my right of *khiyar* in three days".⁸⁴ According to another hadith reported by al-Bukhari, the holy Prophet said, "the two contracting parties have a right of option as long as they are not separated or the sale was a sale of option".⁸⁵

This hadith, therefore, proves the basic validity of *khiyar al-shart* (option by stipulation) along with *khiyar al majlis* (option of the contracting session).⁸⁶

⁸¹ Mohammed Obaidullah, *Islamic Financial Services*, Scientific Publishing Centre, King Abdulaziz University, Jeddah, Saudi Arabia, 2005, p. 184.

⁸² Adnan Siddiqi & Peter Hrubí, *Islamic Investments Funds Versus Hedge Funds*, Unpublished Diploma Thesis, University of Vienna, Austria, 2008, p. 124.

⁸³ Adnan Siddiqi & Peter Hrubí, *Islamic Investments Funds Versus Hedge Funds*, Unpublished Diploma Thesis, University of Vienna, Austria, 2008, p. 124.

⁸⁴ Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim: Hadith number: 1531*, International Ideas Home for publication and distribution, Saudi Arabia, 1998, p. 620.

⁸⁵ Muhammad al-Bukhari, *Sahih Bukhari Hadith number: 2107*, International Ideas for Publishing & Distribution, Saudi Arabia, 1998, p. 397.

⁸⁶ Mohammed Obaidullah, 'Financial Engineering with Islamic Options', *Islamic Economic Studies*, Vol. 6, issue 1, 1998, p. 77.

According to classical jurists, the period of *al-khiyar* begins as soon as the agreement is formally concluded. There is an argument among jurists about the period of *al-khiyar*. According to *Hanbali* jurists, the right of option must be exercised within three days.⁸⁷ They relied on a Prophetic tradition. The Prophet said: whoever buys a sheep un milked (for a long time), has the right of option for three days.⁸⁸ According to the Hanafi and Shafii schools, however, the period of option is unlimited as long as it is known and defined at the time of contracting.⁸⁹ This opinion has become the prevailing one at the present time.

The jurists recognise several different types of *al-khiyar* including *khiyar al-shart* (option by stipulation); *khiyar altayeen* (option of determination or choice); *khiyar al majlis* (option of the contracting session); *khiyar al-ayb* (option for defect); and *khiyar al-ruyat* (option after inspection).⁹⁰ The two main options for risk management are *khiyar al-shart* (option by stipulation) and *khiyar altayeen* (option of determination or choice).⁹¹ These types will be discussed briefly in the following subsections.

According to Munawar & Tariqullah, *khiyar al-shart* is an option in the form of a condition stipulated in a sale contract, about confirming or cancelling the sale contract within a specific time. This kind of *Al-khiyarat* (options) gives the right of option to one of the two parties to the contract, and even to a third party, to confirm or cancel the sale contract within a stipulated time.⁹² According to Mohammed Obaidullah, financial markets such as the stock market use *khiyar al-shart* as an Islamic hedging instrument for managing risk in the financial markets.

For example, if party A wishes to enter into a purchase (sale) contract and stipulates a condition of option for itself for a period of two months, the delivery of price (stock X) can now be deferred until two months have expired. At the end of two months, if the price of stock X rises, then A can confirm the contract of purchase (sale) at the known contractual price and thus be immune from price risk.

⁸⁷ Ibid.

⁸⁸ Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim*: Hadith number: 1524, International Ideas Home for publication and distribution, Saudi Arabia, 1998, p. 617.

⁸⁹ Mohammed Obaidullah, 'Financial Engineering with Islamic Options', *Islamic Economic Studies*, Vol. 6, issue 1, 1998, p. 77.

⁹⁰ Ibid., p. 184.

⁹¹ Adnan Siddiqi & Peter Hrubci, *Islamic Investments Funds Versus Hedge Funds*, Unpublished Diploma Thesis, University of Vienna, Austria, 2008, p. 125.

⁹² Munawar Iqbal & Tariqullah Khan, *Financial Engineering and Islamic Contracts*, Palgrave Macmillan, New York, 2005, p. 71.

However, if the price of stock X falls, then A can rescind the contract and purchase in the market, thereby not losing the profit potential. Thus, option by stipulation may provide a benefit for the party holding the option, at the cost of the counterparty. However, the disadvantage caused to the counterparty can be compensated by a higher contractual price and need not be paid separately up front to the counterparty. It is this feature that provides an effective curb on speculating on price differences and, thus, differentiates Islamic options from conventional ones.⁹³

A question arises about the period of *khiyar al-shart*: there is an agreement among Sunni jurists that the period of *khiyar al-shart* is three days or less, but there is an argument that it is more than three days. Hanafi and Shafii jurists have held the view that there is no limit on the duration of the time period of *khiyar al-shart*, while Hanbali jurists have argued that the period of *khiyar al-shart* must not exceed three days, as stipulated in the Prophetic tradition. If the period of *khiyar al-shart* finishes without declaration from the option holder (either the seller or the buyer, or even a third party), the right of option will be invalidated, and therefore the contract will be binding on all.⁹⁴

Munawar & Tariqullah discuss the argument between two different opinions of the scholars about the extent of the relationship between *khiyar al-shart* and conventional options. Some scholars have concluded that conventional options could be accommodated in *khiyar al-shart*, while other scholars have concluded that there are no grounds for legalising options by making an analogy with *khiyar al-shart*.⁹⁵

According to Angelo Venardos, *khiyar al-tayeen* implies the option to choose an object of sale out of multiple varieties of a given article, which can be different in quality, design, material etc., and these varieties must not be more than three.⁹⁶ For example, a buyer may wish to purchase one of three vehicles owned by the same seller, with the option to specify which one within a period of three days;⁹⁷

⁹³ Mohammed Obaidullah, 'Financial Engineering with Islamic Options', *Islamic Economic Studies*, Vol. 6, issue 1, 1998, p. 92.

⁹⁴ *Ibid.*, p. 77.

⁹⁵ Munawar Iqbal & Tariqullah Khan, *Financial Engineering and Islamic Contracts*, Palgrave Macmillan, New York, 2005, pp. 71-72.

⁹⁶ Angelo Venardos, *Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System*, World Scientific, Singapore, 2010, p. 264.

⁹⁷ *Ibid.*

whereas *khiyar al-shart* is a stipulation that any of the parties has the option to rescind the sale within a predefined period.⁹⁸ The similarity relates to stipulating the option in the contract and continuing for a specified time period.⁹⁹ Under this kind of Islamic option, the parties to the contract have more flexibility in their decision and, further, can compare whether the object or value to be exchanged matches their expectations.¹⁰⁰ According to Younes and Mohd, however, in *khiyar al-tayeen* the buyer faces the challenge of a choice out of no more than three articles, and for optimal benefit he must choose the best of the three.¹⁰¹

There is significant disagreement among classical jurists about the legality of *khiyar al-tayeen*. According to the *Hanafi* school, *khiyar al-tayeen* is valid based on *istihsan* (juristic preference) as it meets a legitimate need of the contracting parties. The *Shafii* and *Hanbali* jurists, on the contrary, consider that *khiyar al-tayeen* is invalid in view of the state of ignorance (*jahalah*), and *jahalah* is considered *gharar*,¹⁰² which is forbidden in trading by the prophet Muhammed.¹⁰³ Therefore, the contract of sale that contains *khiyar al-tayeen* is considered null and void because it includes uncertainty according to the opinion of the *Shafii* and *Hanbali* jurists.¹⁰⁴

The researcher supports the *Hanafi* opinion because modern jurists permit some *gharar* transactions based on *maslahah* (public interest). In this regard, the researcher recommends that contemporary scholars, whether in Saudi Arabia or elsewhere, stipulate numerous conditions to contemporary financial transactions such as forward, futures, options and swaps to reduce *gharar*.¹⁰⁵

⁹⁸ Ibid.

⁹⁹ Adnan Siddiqi & Peter Hrubí, *Islamic Investments Funds Versus Hedge Funds*, Unpublished Diploma Thesis, University of Vienna, Austria, 2008, p. 125.

¹⁰⁰ Ibid.

¹⁰¹ Younes Elahi & Mohd Ismail Abd Aziz, 'Islamic options (al-Khiyarat); Challenges and opportunities' in *Proceedings of the 2011 International Conference on Information and Finance*, IPEDR vol.21, IACSIT Press, Singapore, 2011, pp. 101-104.

¹⁰² Mohammed Obaidullah, 'Financial Engineering with Islamic Options', *Islamic Economic Studies*, Vol. 6, issue 1, 1998, p. 101.

¹⁰³ Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim: Hadith number: 1513*, International Ideas Home for publication and distribution, Saudi Arabia, 1998, p. 614-615.

¹⁰⁴ Abdul-Rahim Al-Saati, 'The Permissible Gharar (Risk) in Classical Islamic Jurisprudence', *J.KAU: Islamic Econ*, Vol. 16, issue 2, 2003, p. 7.

¹⁰⁵ Abdul-Rahim Al-Saati, 'The Permissible Gharar (Risk) in Classical Islamic Jurisprudence', *J.KAU: Islamic Econ*, Vol. 16, issue 2, 2003, p. 15.

According to Younes and Mohd, there are numerous challenges in Islamic options (*Khiyarat*). One of these is time of contract and time of delivery; as mentioned in the previous example in *khiyar al-shart*, the contract of sale can be cancelled, based on *khiyar al-shart*. Another challenge is the conditions of contract which are stipulated by the holder of the option. If these conditions have not been satisfied, then the contract can be cancelled. Both these challenges face the risk of cancellation that may occur by parties trading with an agreement on how to exercise it.¹⁰⁶ Younes and Mohd recommend scholars who are considered *Shariah* compliant to create an opportunity for beneficial activity that it is *Shariah* compliant, and they conclude that the development of Islamic options is the key for growth of trading in the Islamic financial market and becoming an important international power.¹⁰⁷

According to Nouredine Krichene, promise (*waad*) refers to a unilateral promise by one party to complete a transaction (sale or purchase) at some specified date and in compliance with specified conditions.¹⁰⁸ *Waad* has been used as a cornerstone for a variety of structured products and in the evolution of Islamic derivatives. For instance, *waad* can be used as a *Shariah*-compliant concept to replicate short-selling and hedging contracts such as profit-rate swap. *Waad* can also be used to structure a foreign exchange (forex) option.¹⁰⁹

There are different opinions among Islamic scholars on the legality of this concept. Under Resolution No: 40 - 41 (2/5 and 3/5) [1], the OIC Fiqh Academy has ruled that *waad* is binding not only in the eyes of God but also in a court of law when it is made in commercial transactions; it is a unilateral promise; and it causes the promisee to incur liabilities.¹¹⁰

¹⁰⁶ Younes Elahi & Mohd Ismail Abd Aziz, 'Islamic options (al-Khiyarat): Challenges and opportunities' in Proceedings of the 2011 International Conference on Information and Finance, IPEDR vol.21, IACSIT Press, Singapore, 2011, pp. 101-102.

¹⁰⁷ Ibid., pp. 101-104.

¹⁰⁸ Nouredine Krichene, *Islamic Capital Markets: Theory and Practice*, John Wiley & Sons, Singapore, 2013, p. 637.

¹⁰⁹ Nouredine Krichene, *Islamic Capital Markets: Theory and Practice*, John Wiley & Sons, Singapore, 2013, p. 637.

¹¹⁰ See the official website of the International Islamic Fiqh Academy, available at: <http://www.fiqhacademy.org.sa/qrarat/5-2.htm>, [Accessed 19 September 2013].

The second view of Accounting and Auditing Organization for Islamic Financial Institutions is that a bilateral promise to purchase and sell currencies is forbidden if the promise is binding, even for the purpose of hedging against the risk of currency devaluation, because binding bilateral promises from two parties are equivalent to a contract. In contrast, according to classical Fiqh rules, *waad* is not legally binding and the promising party may rescind his promise, therefore cannot be compelled by the process of law. The third view (of some Maliki jurists) is that *waad* is not binding in normal conditions, but if the promisor has caused the promisee to incur some expenses or undertake some labour or liability on the basis of a promise, it is mandatory on him to fulfil his promise for which he may be compelled by the courts. Shaikh Muhammad Taqi Usmani contends that the question whether or not a promise is enforceable in courts depends on the nature of the promise. But in commercial dealings, where a party has given an absolute promise to sell or purchase something and the other party has incurred liabilities on that basis, there is no reason why such a promise should not be enforced.¹¹¹

According to Hassan and Lewis, there are some conditions where *waad* is binding. These conditions are that the promise should be unilateral; it must have caused the promisee to incur some costs/liabilities; if the promise is to purchase something, the actual sale must take place at the appointed time by the exchange of offer and acceptance. Mere promise itself should not be taken as a concluded sale; if the promisor reneges on their promise, the court may force them either to purchase the commodity or to pay actual damages to the seller. The actual damages will include the actual monetary loss suffered by the promisee, and must not include the opportunity cost.¹¹²

There are a number of *Shariah*-compliant swap structures introduced by IFIs for the purposes of hedging such as foreign currency risk and interest rate fluctuations. The common types of these structures are the Islamic Cross Currency Swap (ICCS), and the Islamic Profit Rate Swap (IPRS).¹¹³ These types of Islamic swaps will be discussed below.

¹¹¹ Muhammad Ayub, *Understanding Islamic Finance*, John Wiley & Sons, Ltd, UK, 2007, p. 224.

¹¹² M. Kabir Hassan, *Handbook of Islamic Banking*, Edward Elgar Publishing Limited, UK, 2007, p. 88.

¹¹³ Andreas Jobst & Juan Sole, 'The governance of derivatives in Islamic finance', *Journal of International Banking Law and Regulation*, Vol. 24, issue 11, 2009, pp. 559-560.

According to the Asian Finance Bank, the Islamic Cross Currency Swap (ICCS) is an agreement between two parties to exchange a series of profit and currency payments denominated in one currency for another series of profit and currency payments denominated in another currency, based on an actual principal amount over an agreed period. ICCS is used to protect assets against unfavourable benchmark rates and exchange rates by a series of profit payments in one currency by another currency, as well as providing fully *Shariah*-compliant instruments to customers to manage multi-currency swaps.¹¹⁴ In addition, they have other useful functions besides serving as a tool of risk management, such as reducing the cost of raising resources, better asset-liability management, and identifying appropriate investment opportunities.¹¹⁵

Although these benefits also apply to conventional swaps, Islamic swaps are different in that they do not involve interest-related cash flows. Therefore, according to *Shariah* principles, conventional swaps are prohibited because they clearly involve interest payments.¹¹⁶

According to one prominent view, Islamic swaps are not free from controversy and there is no consensus regarding their acceptability.¹¹⁷ Contemporary juristic opinion seems to reject Islamic swaps on different grounds.

Obaidullah states that it is one of the principles of *Shariah* that two financial transactions cannot be tied together in the sense that entering into one transaction is made a precondition to entering into the second. Keeping this principle in view, the swap transaction is not permissible because, for instance, a loan of US \$50 is made a precondition for accepting a loan of Rs1100.¹¹⁸

¹¹⁴ See the official website of the Asian Finance Bank, available at: [http://www.asianfinancebank.com/product_services/Treasury-PDS/PDS%20\(ICCS\).pdf](http://www.asianfinancebank.com/product_services/Treasury-PDS/PDS%20(ICCS).pdf), [Accessed 25 September 2013].

¹¹⁵ Mohammed Obaidullah, *Islamic Financial Services*, Scientific Publishing Centre, King Abdulaziz University, Jeddah, Saudi Arabia, 2005, pp. 198-199.

¹¹⁶ Mohammed Obaidullah, 'Financial Options in Islamic Contracts: Potential Tools for Risk Management', J.KAU: Islamic Econ, Vol. 11, issue 4, 1999, p. 18. See too 8th International Conference on Islamic Economics and Finance: Use of *W'ad* and *Tawarruq* for Swaps in the framework of Islamic Finance, available at: <http://conference.qfis.edu.qa/app/media/317>, [Accessed 26 August 2013].

¹¹⁷ Mohammed Obaidullah, *Islamic Financial Services*, Scientific Publishing Centre, King Abdulaziz University, Jeddah, Saudi Arabia, 2005, pp. 198-199.

¹¹⁸ Mohammed Obaidullah, *Islamic Financial Services*, Scientific Publishing Centre, King Abdulaziz University, Jeddah, Saudi Arabia, 2005, p. 199.

ICCS debuted recently when Standard Chartered executed the first ever swap transaction of this kind for Bank Muamalat Malaysia in July 2006.¹¹⁹ The basic structures of ICCS used by the banks in Islamic swaps are two-commodity *murabaha* sale contracts that generate offsetting cash flows in opposite currencies with maturities desired by the contracting parties, *tawarruq* and *waad*.¹²⁰ An example of a two-commodity *murabaha* sale contract is where A makes a payment of Rs1000 to and receives US\$50 from B today at the given rate 1:20. Both A and B use and invest the money so received at their own risk. At the end of a stipulated time period, say six months, the transaction is reversed. A repays US\$50 to and receives Rs1000 from B. Simultaneously, Al Rajhi bank in Saudi Arabia buys an amount of commodity B, also under a *murabaha* agreement, but denominated in US dollars and sells it forward against payment in Malaysian Ringgit. By combining the two *murabaha* contracts, each denominated in a different currency, each party will be able to receive cash flows in the desired currency. Finally, both banks sell their respective commodities in order to recoup their initial expense, where the fair value of each commodity (A and B) should wash out at the prevailing exchange rate.¹²¹

This form of contracting can also be viewed as an exchange of or swapping of interest-free loans between A and B.

This is in contrast to conventional swaps, which are generally interest-based and involve the swapping of principal and interest payments. Conventional swaps clearly have no place in the Islamic system as they involve interest payments.¹²²

¹¹⁹ In October 2006, Citigroup designed a currency swap for the Dubai Investment Group (DIB) to hedge the currency risk on DIB's RM 828 million (approximately £119 million) investment in Bank Islam Malaysia. Standard Chartered Saadiq, Al Hilal Bank and Calyon also market products based on Shariah-compliant cross-currency swaps. See to Islamic Derivatives: Theory and Practice, Global Islamic Finance Report 2010, BMB Islamic UK Limited, 2010, p. 137.

¹²⁰ Andreas Jobst & Juan Sole, 'The governance of derivatives in Islamic finance', *Journal of International Banking Law and Regulation*, Vol. 24, issue 11, 2009, p. 559; Mondher Bellalah, *Islamic Banking and Finance*, Cambridge Scholars Publishing, UK, 2013, p. 58.

¹²¹ Andreas Jobst & Juan Sole, 'The governance of derivatives in Islamic finance', *Journal of International Banking Law and Regulation*, Vol. 24, issue 11, 2009, p. 559; Mohammed Obaidullah, *Islamic Financial Services*, Scientific Publishing Centre, King Abdulaziz University, Jeddah, Saudi Arabia, 2005, p. 196.

¹²² Mohammed Obaidullah, *Islamic Financial Services*, Scientific Publishing Centre, King Abdulaziz University, Jeddah, Saudi Arabia, 2005, p. 196.

According to Bank Negara Malaysia (BNM), the Islamic Profit Rate Swap (IPRS)¹²³ is an agreement between two parties to mutually exchange profit rates between a fixed rate party and a floating rate party (or vice versa) through the execution of a series of *Shariah*-compliant sales contracts to trade certain assets. Therefore, IPRS is considered the *Shariah*-compliant version of the conventional Interest Rate Swap (IRS). The objective of IPRS is to enable the bank to manage the mismatch between cash inflow generated from the asset and cash outflow arising from payment of expenditure or cost of funding associated with the liability side of the balance sheet.¹²⁴

Under Resolution No. 85, IPRS was approved by the *Shariah* Advisory Council of Bank Negara Malaysia (SAC),¹²⁵ in its 44th meeting dated 24 June 2004. The resolution stipulates that SAC “has resolved that the proposed offset practice in the IPRS structure is permissible and is not tantamount to the sale of debt with debt, which is prohibited by the *Shariah*”.¹²⁶ However, some scholars argue that the floating rate payer paying a variable amount would not be *Shariah*-compliant due to the uncertainty of the amount to be paid.¹²⁷

According to Bellalah, IPRS can be structured based on *murabaha* and *waad* contracts. Under IPRS, the parties enter into a series of separate contracts to sell *Shariah*-compliant assets (often London Metal Exchange traded metals). *Murabaha* contracts are structured in two stages.

¹²³ IPRS was created by Commerce International Merchant Bank (CIMB) of Malaysia in June 2005, as an Islamic replication of conventional interest-rate swap (IRS) through an Islamic Swap Master Agreement that mirrored the ISDA Master Agreement for IRS in a fully *Shariah*-compliant way. See to Ravindran Ramasamy and others, ‘Basic Pricing Methodology for Islamic Profit Rate Swap’, *Global Journal of Management and Business Research*, Vol. 11, issue 5, 2011, pp. 38-39; Angelo Venardos, *Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System*, World Scientific, Singapore, 2010, p. 257.

¹²⁴ See the official website of Bank Negara Malaysia (BNM), ‘*Shariah Resolutions in Islamic Finance*’, available at: <http://www.bnm.gov.my/index.php?ch=7&pg=1038&ac=345&bb=file1>, [Accessed 30 September 2013].

¹²⁵ SAC was established in 1997 as the highest authoritative body in ascertainment of *Shariah* matters relating to Islamic finance in Malaysia. See to http://www.bnm.gov.my/microsites/financial/pdf/resolutions/04_sac.pdf.

¹²⁶ See the official website of Bank Negara Malaysia (BNM), ‘*Shariah Resolutions in Islamic Finance*’, available at: <http://www.bnm.gov.my/index.php?ch=7&pg=1038&ac=345&bb=file1>, [Accessed 30 September 2013].

¹²⁷ Sidney Yankson, ‘Derivatives in Islamic Finance: A Case for Profit rate Swaps’, *Journal of Islamic Economics, Banking and Finance*, Vol. 7, issue 1, 2011, p. 47.

The first stage has generated a fixed profit rate and is structured around a sole *murabaha* contract at a fixed profit rate. At this stage, the fixed-rate payer sells commodities to the floating-rate payer under a *murabaha* contract, and the profit element represents the fixed-profit rate. The second stage involves a series of sequential secondary *murabaha* contracts. In this stage, the floating-rate payer sells commodities to the fixed-rate payer under a *murabaha* contract. The delivery is realised at the date of the contract and the payment coincides with the next primary *murabaha* instalment. The cost price of these commodities equals the cost price element paid by the fixed-rate payer for each instalment. The mark up rate is determined by a floating rate, the determination of each fixed rate depends on a floating interest rate such as the LIBOR. IPRS might also be structured as a series of *waad* whereby each of the two parties issues an undertaking *waad* to swap relevant fixed and floating rate payments at some point of time.¹²⁸ In addition, there are several other structures of IPRS such as *tawarruq*,¹²⁹ and *bai-el-Inah*.¹³⁰

3. Regulatory Framework for Islamic Banking and Finance, Including Islamic Financial Derivatives, in Saudi Arabia

In Saudi Arabia, there is no specific law governing Islamic banking and finance including Islamic financial derivatives in spite of the importance of regulating and supervising Islamic financial activities. There are two acts for regulating banking business and securities in Saudi Arabia. The first one is the Banking Control Law (BCL), issued under Royal Decree No. M/5, dated 11/6/1966, which is considered the main legislation to regulate all banking business in Saudi Arabia.¹³¹

Under this law, the Saudi Arabian Monetary Agency (SAMA) is responsible for the regulation of Saudi banks. For example, Article 3 of the BCL stipulates that all applications to carry on a banking business in Saudi Arabia shall be addressed to SAMA.¹³²

¹²⁸ Mondher Bellalah, *Islamic Banking and Finance*, Cambridge Scholars Publishing, UK, 2013, pp. 58-59.

¹²⁹ Karen Hunt-Ahmed, *Contemporary Islamic Finance: Innovations, Applications and Best Practices*, John Wiley & Sons, New Jersey, 2013, p. 347.

¹³⁰ It refers to a contract which involves sale and buy back transactions of an asset by the seller. (<http://www.bnm.gov.my/index.php?ch=7&pg=1038&ac=345&bb=file1>).

¹³¹ See the official website of the Saudi Arabia Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx>, [Accessed 18 October 2013].

¹³² *Ibid.*

The second act is the Capital Market Law, issued by Royal Decree No. (M/30) dated 31/07/2003. Under this act, the Capital Market Authority (CMA) is responsible for regulating the Saudi Arabian Capital Market and creating an appropriate investment environment, boosting confidence, reinforcing transparency and disclosure standards in all listed companies, and protecting investors and dealers from illegal acts in the market.¹³³

Neither act mentions Islamic banking, nor have SAMA and CMA issued a single document pertaining to Islamic banking and financial business, in contrast to the central bank of Malaysia (Bank Negara Malaysia (BNM)), and the Securities Commission Malaysia (SC), or even the Financial Services Authority (FSA) in the UK, which have issued numerous documents and guidelines pertaining to Islamic banking and finance. For example, in March 1993, BNM introduced a scheme known as an interest-free Banking Scheme which allows existing banking institutions to offer Islamic banking products through their existing infrastructure and branch network.¹³⁴ In 2005, BNM issued its Guidelines on the Governance of *Shariah* Committees known as BNM/GPS 1, which regulates the governance of the *Shariah* Committee of IFIs in Malaysia.¹³⁵ BNM has also issued Guidelines on the Disclosure of Reports and Financial Statements of Islamic Banks known as BNM/GPS8-i.¹³⁶ The *Shariah* framework is set by the SAC of BNM, and this SAC approved several financing techniques and capital market instruments.¹³⁷

In addition, some Gulf Cooperation Council (GCC) countries have mentioned Islamic banking in their legislation. For example, in Kuwait, the Central Bank of Law was amended to bring the Islamic banks formally under the jurisdiction of the Central Bank of Kuwait (CBK).¹³⁸

¹³³ See the official website of the Capital Market Authority (CMA), available at: <http://www.cma.org.sa/En/AboutCMA/Pages/default.aspx>, [Accessed 18 October 2013].

¹³⁴ Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', *Pacific-Basin Finance Journal*, Vol. 17, issue 1, 2009, p. 130.

¹³⁵ Hjh Siti Faridah Abd Jabbar, 'The governance of Shari'a advisers of Islamic financial institutions: the practice in Malaysia', *Company Lawyer*, Vol. 30, issue 10, 2009, p. 312.

¹³⁶ Zulkifli Hasan & Zulkifli bin Hasan, *Shariah Governance in Islamic Banks*, Edinburgh University Press, UK, 2012, p. 109.

¹³⁷ Kabir Hassan & Mervyn Lewis, *Handbook of Islamic Banking*, Edward Elgar Publishing Limited, UK, 2007, p. 135.

¹³⁸ Kabir Hassan & Mervyn Lewis, *Handbook of Islamic Banking*, Edward Elgar Publishing Limited, UK, 2007, p. 122.

In Bahrain, the Central Bank of Bahrain (CBB) issued a rulebook for Islamic Banks.¹³⁹ In the United Arab Emirates (UAE), Federal Law No. 6 of 1985 mentions ten articles regarding Islamic banking, financial institutions and investment companies.¹⁴⁰

4. How Do Islamic Financial Derivatives Work in Saudi Arabia?

While many countries such as Malaysia and Singapore struggle to be the best example of Islamic financial derivatives. Yet despite the increasing demand, Saudi Arabia is still not involved, even though it has the capabilities, experience, Islamic scholars, and financiers as well as the Islamic status in Muslims' hearts, to be in this position. One example of this absence is the lack of regulation of the financial derivatives market, whether conventional or Islamic derivatives.¹⁴¹

Specialists in Islamic finance believe that the SAMA, and the Ministry of Finance for the Kingdom of Saudi Arabia are accountable for not taking the lead in Islamic finance, because there is no independent Capital Market Authority with common criteria for all Islamic finance products. They are also suspicious about the concordance of Islamic finance procedures with present laws, whereby the regulations of Islamic finance institutions are not compatible with the law, and the Banking Control Law (BCL) of 1966 is a traditional one and not suitable for developing new products according to Islamic *Shariah*.¹⁴²

According to Hasan, despite the legal system of Saudi Arabia being based on Islamic *Shariah*, derived from the *Quran* and the *Sunnah*, the IFIs in Saudi Arabia operate under a strange legal framework, since the existing law of the BCL 1966 is still applicable and has not been repealed or amended to regulate the establishment and existence of the IFIs.¹⁴³ Hasan adds that despite 15 *sukuk* issuances between 2000 and 2008 and huge Islamic mutual funds in Saudi Arabia, there is no single piece of legislation specifically regulating the implementation of Islamic finance.¹⁴⁴

¹³⁹ See the official website of the Central Bank of Bahrain (CBB), available at: http://www.cbb.gov.bh/page-p-cbb_rule_book.htm, [Accessed 20 October 2013].

¹⁴⁰ Federal Law No. 6 of 1985.

¹⁴¹ See, Al-Eqtisadiyah Newspaper, January 24, 2013, Issue 7045.

¹⁴² See, Al-Eqtisadiyah Newspaper, January 24, 2013, Issue 7045.

¹⁴³ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', Kyoto Bulletin of Islamic Area Studies, Vol. 3, issue 2, 2010, p. 97.

¹⁴⁴ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', Kyoto Bulletin of Islamic Area Studies, Vol. 3, issue 2, 2010, p. 97.

According to Meshal, General Manager of the Raqaba Company for Consultations in the UK, Saudi Arabia is theoretically at the top of the list of those countries able to lead Islamic finance, because all sovereign laws and jurisdiction in Saudi Arabia are based on Islamic *Shariah*. One of these laws is Royal Decree No. 23, dated 15 February 1958, to establish the SAMA, where Article 2 prohibits the paying and receiving of interest,¹⁴⁵ besides the Islamic identity of Saudi society and the view of Muslims around the world that Saudi Arabia is the centre for executing *Shariah* in every aspect of life.¹⁴⁶

Meshal adds that although Saudi Arabia has the capabilities to take the lead in the field of Islamic finance instead of Malaysia and Bahrain, it is notably late in doing so. He attributes this absence to the lack of initiative of the supervisory authorities to improve, protect and enhance this field and its credibility in front of the whole world. Meshal believes that the absence of supervisory authorities has created a trend for Islamic banks towards making frequent use of *tawarruq* contracts (monetisation of commodities), which is similar to interest-based financing, instead of using other Islamic financial contracting forms.¹⁴⁷

As a result, the reputation of Islamic finance in Saudi Arabia has been distorted, in the eyes of its customers, even though *tawarruq* is permitted by the *Shariah* board.¹⁴⁸

He continues by pointing out that in banks that adopt Islamic finance, the same people sit on several different committees or boards, and this has raised questions about the validity of such committees or boards and their decisions. For example, why not have one legal committee or *Shariah* board at the level of the banking sector in Saudi Arabian Monetary Agency?

¹⁴⁵ See the official website of the Saudi Arabia Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD01.aspx>, [Accessed 07 October 2013].

¹⁴⁶ See the *Al-Eqtisadiyah* Newspaper, January 24, 2013, Issue 7045.

¹⁴⁷ Murabaha (trade with mark up or plus sale), Musharaka (partnership or joint venture), Mudaraba (profit and loss sharing), Ijara (leasing contract), Bai bithaman ajil (Deferred payment sale, credit sale), Bai salam (forward selling), Istisna (order to manufacture) and Qardh-al-hasan (benevolent loans or interest free loan).

¹⁴⁸ See the *Al-Eqtisadiyah* Newspaper, January 24, 2013, Issue 7045.

Or why has the Agency not issued common legal criteria for all Islamic financial products? Meshal believes that the establishment of an independent central Shariah board in Saudi Arabia, and the adoption of uniform standards of legitimacy, would reduce the emergence of products that do not add value to Islamic banking as *tawarruq*.¹⁴⁹

Alnuwayser agrees with Meshal that Saudi Arabia is qualified to become the capital of Islamic banking more than any other country. He considers that SAMA and the Ministry of Finance are responsible for the country's absence in this field which is likely to become the highest economic income, after oil, in the future. Alnuwayser adds that, after the financial crisis in 2007, many of the big banks were impressed by Islamic banking and finance, where the banks were more willing to confront the repercussions of the financial crisis than conventional banks, and especially as they looked more profitable and less exposed to risks than the conventional banks.¹⁵⁰

However, SAMA gave no importance to this, and did not even establish a legislative committee for Islamic finance based on clear regulations. Alnuwayser explains that Saudi banks that have Islamic windows do not have a legislative committee to ensure that all the financial products offered to customers comply with Islamic finance principles. He considers that the Ministry of Finance should develop Islamic banks in Saudi Arabia so that they work according to a clear approach under the supervision of an agency specialised in Islamic finance.¹⁵¹

Although SAMA regulates and supervises the IFIs under the BCL, there is no standard guideline on *Shariah* governance for Islamic financial institutions. According to Hasan, the practices of the existing Islamic financial institutions in Saudi Arabia show that the *Shariah* governance system is based on a self-regulated approach. He adds that the notion of having a *Shariah* governance system within the IFIs is not based on any legal and supervisory requirements but would be a voluntary initiative.¹⁵² Therefore, the IFIs in Saudi Arabia are free to adopt their own *Shariah* governance without adhering either locally to SAMA or CMA standards or internationally to Accounting and Auditing Organization for Islamic Financial Institutions standards.

¹⁴⁹ See the Al-Eqtisadiyah Newspaper, January 24, 2013, Issue 7045.

¹⁵⁰ Ibid.

¹⁵¹ Ibid.

¹⁵² Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', Kyoto Bulletin of Islamic Area Studies, Vol. 3, issue 2, 2010, pp. 97-98.

For example, the Al-Rajhi bank has established its own *Shariah* guidelines and procedures, known as the *Shariah* Monitoring Guide and *Shariah* Control Guidelines, in order to ensure the proper monitoring and implementation of *Shariah* rulings.¹⁵³

According to Ibn Mani, a member of the council of senior scholars in Saudi Arabia, one of the main reasons for the absence of Islamic financial derivatives in Saudi markets is the lack of a system (law) for the *Shariah* Supervisory Board (SSB) of Islamic banks, where the Saudi banks unilaterally choose the members of the SSBs of the bank. Using the National Commercial Bank of Saudi Arabia (NCB) as a model, the SSB was formed based on a request by the Islamic Banking Development Group in NCB to scientists who meet the Secretariat and science to join the *Shariah Fatwa* for National Commercial Bank products.¹⁵⁴ This practice comes in the light of the absence of laws to regulate the work of the SSBs.

Ibn Mani recommends finding a common denominator between Islamic banks in Saudi Arabia through the establishment of united SSBs, with SAMA overseeing the coordination between the SSBs. He added that in the case of a difference of opinion or a dispute amongst *Shariah* Boards (SBs), the difference of opinion should be presented to the International Islamic Fiqh Academy.¹⁵⁵

According to Hammad, it is possible to find one person being a member of a number of Islamic banks and financial institutions, because of the lack of laws regulating the SSBs.

¹⁵³ See the Official Website of Al Rajhi Bank, available at: <http://www.alrajhibank.com.sa/en/about-us/pages/sharia-group.aspx>, [Accessed 28 October 2013].

¹⁵⁴ Adli Hammad, *The provisions of Islamic investment funds: comparative legal doctrinal study*, Arabic edition, Fouad Baido Press, Lebanon, 2010, pp. 172-173.

¹⁵⁵ Adli Hammad, *The provisions of Islamic investment funds: comparative legal doctrinal study*, Arabic edition, Fouad Baido Press, Lebanon, 2010, pp. 173-174.

For example, Shaykh Abdullah ibn Mani is a member of many *Shariah* supervisory committees of banks such as the *Shariah* Board at Gulf Finance House (GFH),¹⁵⁶ the NCB *Shariah* Board,¹⁵⁷ the *Shariah* Board at Saudi Hollandi Bank,¹⁵⁸ the *Shariah* Standards Board at Accounting and Auditing Organization for Islamic Financial Institutions,¹⁵⁹ the Islamic Fiqh Academy of the Organisation of Islamic Conference (OIC),¹⁶⁰ and other *Shariah* supervisory committees.

The researcher believes that Saudi Arabia is not ready to apply Islamic financial derivatives along with its compliance with Islamic laws (*Shariah*) for several reasons. One of the main reasons is the lack of a stand-alone Islamic banking law to regulate those Islamic institutions that conduct banking and financial activities. Currently, in Saudi Arabia, the Islamic banks are regulated by the Banking Control Law (BCL) of 1966.¹⁶¹ In contrast, Malaysia's Islamic banks are governed by a separate Act (the Islamic Banking Act 1983 (IBA)).¹⁶²

The absence of a legislative and regulatory framework for Islamic banking and finance in Saudi Arabia has resulted in a questioning of the legal status of *Shariah* rulings and also a conflict of *Shariah* opinion (*fatwa*) by the *Shariah* boards of different IFIs on the same issue.

In other words, the IFIs have founded a self-regulatory process within each institution. In addition, they are free to adopt their own *Shariah* governance without adhering either locally to SAMA or CMA standards or internationally to Accounting and Auditing Organization for Islamic Financial Institutions standards.

¹⁵⁶ See the official website of Gulf Finance House (GFH), available at: <http://www.gfh.com/en/about-us/shariaa-board-eng.html>, [Accessed 17 October 2013].

¹⁵⁷ See the official website of the National Commercial Bank (NCB), available at: <http://www.alahli.com/en-US/About%20Us/ibdg/Pages/TheNCBShariahBoard.aspx>, [Accessed 17 October 2013].

¹⁵⁸ See the official website of the Saudi Hollandi Bank, available at: <http://shb.com.sa/en/about/AboutSHB/ShariahBoardmembers.aspx>, [Accessed 17 October 2013].

¹⁵⁹ See the official website of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), available at: <http://www.aaofi.com/en/about-aaofi/sharia-standards-board/ssb-committees/>, [Accessed 17 October 2013].

¹⁶⁰ See the official website of the International Islamic Fiqh Academy, available at: <http://www.fiqhacademy.org.sa/>, [Accessed 17 October 2013].

¹⁶¹ This Act has issued by the Royal Decree No. M/5 Dated 12th June 1966. See the Official Website of Saudi Arabia Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx>, [Accessed 09 October 2013].

¹⁶² See the official website of Bank Negara Malaysia (BNM), available at: <http://www.bnm.gov.my/index.php?ch=7&pg=715&ac=802>, [Accessed 09 October 2013].

This has caused a lack of the homogeneity that Islamic jurists need in order to be able to issue uniform *fatwas* for some financial products. This problem is due, on the one hand, to the multiplicity of *Shariah* boards and different opinions of Islamic scholars for each bank, and, on the other, to the uncertainty on the part of clients as to whether a product developed in one jurisdiction is *Shariah*-compliant in a neighbouring jurisdiction.¹⁶³

Another main issue is the absence of a national centralised *Shariah* supervisory board. In Saudi Arabia, there is no independent central *Shariah* board to regulate and supervise Islamic banking activities. Currently, SAMA supervises and regulates Islamic institutions that conduct banking and financial activities side-by-side with conventional commercial banking businesses under Royal Decree No. M/5, dated 12 June 1966.¹⁶⁴ However, in Malaysia, the *Shariah* Advisory Council (SAC) regulates and supervises Islamic banking activities. SAC is the highest *Shariah* authority in Islamic finance, responsible for validating all Islamic financial products to ensure their compatibility with *Shariah* principles.¹⁶⁵

This absence of a central *Shariah* supervisory board raises the probability of conflict in opinions (*fatwas*) between Islamic scholars in Saudi Arabia. These differing opinions may result in significant damage to the IFIs in addition to breach of confidence among investors.¹⁶⁶ An example of this conflict is the initial public offering of the Yanbu National Petrochemical Company (YANSAB), where the opinions of Islamic scholars are divided into two groups with different points of view. These differences of opinion arose because the company borrowed money from a conventional bank with an interest rate.

¹⁶³ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability*, John Wiley & Sons, UK, 2011, p. 184.

¹⁶⁴ See the official website of the Saudi Arabia Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx>, [Accessed 09 October 2013].

¹⁶⁵ See the official website of Bank Negara Malaysia (BNM), available at: <http://www.bnm.gov.my/index.php?ch=7&pg=715&ac=802>, [Accessed 09 October 2013].

¹⁶⁶ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review*, Vol. 5, issue 3, 2011, p. 194.

The first opinion is represented by the opinion of Dr Yusuf Alshubaili, who stated that the main activities of the company were *Shariah* compliant and that contributing to YANSAB's initial public offering (IPO) was permitted even if the company was involved in non-*Shariah*-compliant activities such as borrowing small amounts of money from conventional banks. The other opinion is represented by Dr Yusuf Alahmad, who adopted the view that contributing to the IPO of the company was not permitted, due to the involvement of the company in a non-*Shariah*-compliant activity.¹⁶⁷

The researcher recommends the establishment of a stand-alone Islamic banking law, drafted by experts in the fields of law and Islamic finance, whose qualifications include a PhD in Islamic finance. This stand-alone Islamic banking law must be consistent with the provisions and principles of Islamic law in order to fill the legislative and regulatory gap for Islamic banking and finance in Saudi Arabia. Article 1 of the Basic Law of Governance in Saudi Arabia stipulates that the constitution of the Kingdom of Saudi Arabia is the Holy *Quran* and the *Sunnah*.¹⁶⁸ Therefore, any Bill must take into account the principles of Islamic law (the Holy *Quran* and the *Sunnah*).

The researcher also recommends the establishment of an independent body called the Saudi *Shariah* Advisory Council (SSAC) to regulate and supervise all Islamic banking and finance activities including Islamic financial derivatives, instead of SAMA. Members of the SSAC should be qualified in banking, finance, law and the application of *Shariah*, particularly in the areas of Islamic banking and finance. The number of members must be at least 25. The researcher further recommends that the SSAC should look into issues related to Islamic banks and their customers under the name "the Committee for Settlement of Banking Disputes" instead of the Committee for Settlement of Banking Disputes in SAMA which was issued, formed of three competent members from SAMA under a Royal Order on 1/3/1987.¹⁶⁹ The Committee for Settlement of Banking Disputes in SAMA would continue to look into issues related to conventional banks and their customers, while the SSAC would look into issues related to Islamic banks and their customers.

¹⁶⁷ Ibid.

¹⁶⁸ See the official website of the Bureau of Experts at the Council of Ministers, available at: <http://boe.gov.sa/ViewStaticPage.aspx?lang=en&PageID=25>, [Accessed 12 October 2013].

¹⁶⁹ See the official website of the Saudi Arabia Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAHistory.aspx>, [Accessed 10 October 2013].

The lack of commercial courts in Saudi Arabia and the need for three competent members from SAMA to consider the banking disputes support the researcher's view. The researcher's view is that the banking disputes need a specialised body such as the SSAC and experts in Islamic finance to look into banking issues. The SSAC would not be a court and its decision would not be final and binding, but it would give an opinion. It would just be a settlement committee, and the binding resolution would be by specialised commercial courts.

The researcher believes that the establishment of the proposed SSAC is not difficult in Saudi Arabia, because the system of governance in the Kingdom of Saudi Arabia is monarchical. Under Royal Order No: A/90 dated 1 March 1992 of the Basic Law of Governance, Article 5/A stipulates that "the system of governance in the Kingdom of Saudi Arabia shall be monarchical".¹⁷⁰ Therefore, under Articles 5/A, 57, 58 and 62 of the Basic Law of Governance, the establishment of an independent body called the Saudi Shariah Advisory Council (SSAC) to regulate and supervise all Islamic banking and finance activities in Saudi Arabia is the king's prerogative. For example, Saudi Arabia's King Abdullah bin Abdulaziz issued a Royal Decree establishing an Anti-Corruption Commission (ACC) to monitor and observe government departments.¹⁷¹ The ACC is directly connected to the King of Saudi Arabia under Royal Decree No. A/65 dated 18 March 2011.¹⁷²

However, the proposed SSAC may face the challenge of restriction of *Shariah fatwa* where that Saudi Arabia's King Abdullah issued Royal Order No: B/13876 dated 12 August 2010 to restrict *Shariah fatwa* on the Council of Senior Scholars in Saudi Arabia (also known as the Senior Council of *Ulema*). This royal order prevents any body or person from practising the *fatwa* except the Council of Senior Scholars. To address this issue, this royal order needs to be amended so as to appoint the Saudi *Shariah* Advisory Council with the Council of Senior Scholars as the body that is responsible for issuing *Shariah fatwa* regarding Islamic financial business, Islamic banking business, Islamic bonds (*sukuk*), *takaful* business, Islamic financial derivatives, Islamic development financial business, or any other Islamic financial business.

¹⁷⁰ See the official website of the Bureau of Experts at the Council of Ministers, available at: <http://boe.gov.sa/ViewStaticPage.aspx?lang=en&PageID=25>, [Accessed 12 October 2013].

¹⁷¹ See the official website of the National Anti-Corruption Commission, available at:

<http://www.nazaha.gov.sa/en/About/Pages/Establishment.aspx>, [Accessed 10 October 2013].

¹⁷² *Ibid*.

The researcher recommends adopting Accounting and Auditing Organization for Islamic Financial Institutions' standards and guidelines and the IFSB guidelines in IFIs such as accounting standards, auditing standards and governance standards until the establishment of the proposed SSAC. The SSAC would provide guidelines for *Shariah* governance framework for the Islamic financial institutions to ensure the proper monitoring and implementation system of *Shariah* rulings on the IFIs. The researcher believes that it is also important to amend the Banking Control Law (BCL) issued under Royal Decree No. M/5 dated 11 June 1966, and the Capital Market Law, issued by Royal Decree No. (M/30) dated 31 July 2003 in order make them accommodate standards issued from international bodies specialised in the field of Islamic finance.

The researcher also recommends that the Saudi government should set up specialised commercial courts to look into commercial issues including Islamic banking issues. Such courts should take the opinion of SSAC in the Islamic banking and finance issues. Both the specialized commercial courts and SSAC should consider standards and recommendations that have been issued and developed by the Accounting and Auditing Organization for Islamic Financial Institutions; such as governance standards, *Shariah* standards, accounting standards, auditing standards, and ethics standards.¹⁷³ They should also consider decisions and recommendations that have been issued by the Islamic Fiqh Council (IFC) regarding Islamic banking and finance, such as Resolution No: 85 (2/9) [1] Salam contract and its contemporary applications.¹⁷⁴

5. Summary

This article has provided a comprehensive and critical review of Islamic financial derivatives in Saudi Arabia, their concept, mechanism, principles, practices and models as an Islamic alternative to conventional derivatives. This article also has examined whether the current uses of accepted risk transfer mechanisms in Islamic structured finance are compatible with the principles of Islamic law.

¹⁷³ See the official website of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), available at: <http://www.aaofi.com/aaofi/Publications/KeyPublications/tabid/88/language/en-US/Default.aspx>, [Accessed 12 October 2013].

¹⁷⁴ See the official website of the Islamic Fiqh Council (IFC, available at: <http://www.fiqhacademy.org.sa/qrarat/9-2.htm>, [Accessed 12 October 2013].

The research question of this article has discussed how Islamic financial derivatives work in Saudi Arabia.

The researcher found that there is no a special law to regulate and supervise Islamic banking and financial services in Saudi Arabia. The Saudi Arabian Monetary Agency (SAMA) regulates and supervises Islamic institutions that conduct banking and financial activities side-by-side with conventional commercial banking businesses under the Banking Control Law (BCL) of 1966. Unlike Malaysia, there is no an independent central *Shariah* board to regulate and supervise Islamic banking and financial activities in Saudi Arabia. The researcher also found that there are no specialized commercial courts in Saudi Arabia to look into commercial issues including Islamic banking issues.

The researcher recommended the enactment of a special law for Islamic banking and finance by experts in the field of law and Islamic finance in Saudi Arabia. The researcher also recommended establishing an independent body called the Saudi *Shariah* Advisory Council (SSAC) to regulate and supervise all Islamic banking and finance activities including Islamic financial derivatives instead of SAMA. The researcher recommended adopting Accounting and Auditing Organization for Islamic Financial Institutions' standards and guidelines and the IFSB guidelines in IFIs such as accounting standards, auditing standards, and governance standards until the establishment of the proposed SSAC. The researcher also recommended the establishment of specialized commercial courts to look into commercial issues including Islamic banking issues in Saudi Arabia. The researcher recommended transferring the Malaysian experience in the field of Islamic banking and finance to Saudi Arabia with some modifications that are commensurate with the nature of the Saudi regime.