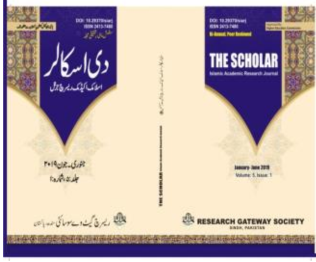


THE SCHOLAR
Islamic Academic Research Journal
ISSN: 2413-7480(Print) 2617-4308 (Online)
DOI:10.29370/siarj

Journal home page: http://siarj.com

THE APPLICABILITY OF SHARI'AH COMPLIANT COMMODITY FUTURES IN AGRICULTURE SECTOR

1. **Abidullah Khan**
Assistant Professor-Islamic Finance, Department of Business Administration, Sukkur IBA University, Airport Road, Sukkur, Pakistan
Email: abidullah@iba-suk.edu.pk
ORCID ID:
https://orcid.org/0000-0001-5072-5948

2. **Abdul Rahman Nizamani**
Assistant Professor, Department of Economics, University of Sindh, Jamshoro, Pakistan.
Email: a.nizamani@usindh.edu.pk
ORCID ID:
https://orcid.org/0000-0002-1904-2265

3. **Irfan Ahmed Shaikh**
Assistant Professor, Department of General History, University of Sindh, Jamshoro, Pakistan.
Email: irfan.shaikh@usindh.edu.pk
ORCID ID:
https://orcid.org/0000-0003-4662-7864

To cite this article:
Khan, Abidullah, Abdul Rahman Nizamani, and Irfan Ahmed Shaikh. "ENGLISH: THE APPLICABILITY OF SHARI'AH COMPLIANT COMMODITY FUTURES IN AGRICULTURE SECTOR." *The Scholar-Islamic Academic Research Journal* 5, no. 1 (May 6, 2019): 95–111.
To link to this article: https://doi.org/10.29370/siarj/issue8ar13

Journal	The Scholar Islamic Academic Research Journal Vol. 5, No. 1 || January -June 2019 || P. 113-128
Publisher	Research Gateway Society
DOI:	10.29370/siarj/issue8ar13
URL:	https://doi.org/10.29370/siarj/issue8ar13
License:	Copyright c 2017 NC-SA 4.0
Journal homepage	www.siarj.com
Published online:	2019-05-24

THE APPLICABILITY OF SHARI'AH COMPLIANT COMMODITY FUTURES IN AGRICULTURE SECTOR

Abidullah Khan, Abdul Rahman Nizamani, Irfan Ahmed Shaikh

ABSTRACT:

The presence of the commodity future contracts in the financial markets gave rise to the idea of introducing Shari'ah compliant commodity futures in order to channel the investments from the oil rich Muslim countries. Bay al-Istisnais considered an ideal contract for the commodity future contract as the nature of this mode of financing is similar to the conventional commodity future contracts. The main objective of this paper is to sort out the applicability of Shari'ah compliant commodity futures in the agricultural market and to highlight the issues that can arise from the application of the commodity futures. A content analysis on the current literature has been performed to achieve the objective. It is found that due to speculation activities in the current market, a separate market for Islamic future contracts is necessary. It is suggested that Istisna based future contracts can be traded in this market. This will help the buyer and seller of the agriculture based commodities to hedge against the price uncertainties.

Keywords: Future Contract; *Bay al-Istisna*; Speculation, Agriculture Sector

1. INTRODUCTION

It is believed that future contracts are evolved during the mid of nineteenth century in Chicago, United States of America. The farmers used to incur losses due to the limited availability of storage for huge supply of crops and absence of buyers of the same crop in short-term. Because of this problem, the farmers, in the upcoming years, became unable to buy raw materials for the crop for the next season. To overcome such problems, the farmers sold their crops in advance to the dealers on specified terms. At first, this agreement appeared to be merely an exchange of documents of contract mentioning the nature and quantity of crop, the price of crop at the future date of delivery along-with a nominal fee representing a guarantee. Such contract was known as a forward contract.

Gradually the application of future contracts started to apply in metals, tropical and forest products and petroleum industry too. In Islamic juristic view, the commodities that are subject to the futures market must be physically tangible, measureable, as well as suitable for standardization and grading, deliverable,and are generally storable either for short time or indefinite[1].

The commodity future contract is defined as an obligation, commitment or a legal agreement to purchase or sell a commodity in which the terms are standardized by type, quantity, quality, delivery, time place and at the price agreed upon when the contract is made[2].

Generally speaking, a commodity futures contract crafts an obligation or commitment to deliver or to take the delivery of the underlying commodity given the terms of contract are satisfied. The contracting parties involved in the transaction have no legal right to amend or alter any term of the contract[3]. As this contract is standardized and uniform hence,

[1]Uzaimah Ibrahim, "Commodity Futures Contract; An Analysis in Islamic Commercial Law" (The University of Wales, Lampeter, 2000).
[2]Kimberly Amadeo, "Commodity Futures Definition and How It Works," USEconomy, 2013, ttp://useconomy.about.com/od/commoditiesmarketfaq/f/Futures.htm.
[3]Amadeo.

the contract becomes interchangeable providing an opportunity to the buyer of the contract to offset their commitments in the contract by entering into the equal but opposite contract before the expiry of the contract. In other words, a purchaser is allowed or has the opportunity to offset his position by entering into a same contract to sell the same underlying commodity and can buy the exact amount of the same commodity to offset his obligations.

It can be observed that future contracts comprise the basic fundamental elements of forward contracts. Four elements are involved in this contract, i.e. the buyer of the contract, the seller, the underlying commodity that will be delivered in future and the price that should be paid at the delivery time[4]. If we compare this mechanism under Islamic commercial law, it resembles with the contracts of *bay al-Salam* and *bay al-Istisna.* However, a further examination is required to look at the other aspects of the commodity futures contracts that are still questionable and still the main subject of discussion among modern Islamic Scholars.

Hence the main objective of this paper is to sort out the applicability of Shari'ah compliant commodity futures in the agricultural market. The paper will also focus on the aspects other than Shari'ah that can benefit or harm both parties financially. For this purpose content analysis has been performed on the existing literature by utilizing a deductive approach. A secondary source of date including journal articles, books and reports are the subjects of the content analysis from which the content has been analyzed in order to achieve the objective.

[4]AbdulRahim Al-Saati, "Sharia Compatible Futures," *Journal of King Abdulaziz University: Islamic Economics* 15, no. 1 (2002).

2. LITERATURE REVIEW

The main reason behind the emergence of commodity futures is the agriculture sector. The seasonal phenomenon of demand and supply in this sector made the farmers to incur the losses. The price of the agricultural products at the time of making decisions is high because of the off-season for such products. Hence, due to offseason the supply of the product is less while the demand is more. At the time of harvesting the crop, the price becomes lower because of the excess supply in the market, for which reason the farmers bear losses. If the weather is better, the supply in the market will be more and he may end up not even making the break-even[5]. In such case the farmer has the option not to sell the commodity at the time of harvest and keep it till the off-season comes. In such scenario the farmer will incur cost related to transportation and storage and ultimately these costs have to be transferred to the consumers[6]. Hence the future markets have provided them with the opportunity to enter the market and fix the price of the commodity that will be delivered in the future.

2.1 COMMODITY FUTURES AND ITS MECHANISM

Commodity futures that is traded at any future market must have its own contract specification that includes all terms of the specific commodity futures, the quantity, grade, time and place of delivery, price limitation and other required information[7]. With this contract specification, a trader dealing in futures, either buying or selling, has no reason or opportunity to

[5]Fahim Ali Khan, "Islamic Futures and Their Markets," *Journal of Islamic Development Bank* (Jeddah, 2013).
[6]Mohammad Hashim Kamali, "Commodity Futures: An Islamic Legal Analysis," *Thunderbird International Business Review* 49, no. 3 (2007): 309–39.
[7]Al-Saati, "Sharia Compatible Futures."

negotiate on the price of the commodity which he normally does in the process of auction[8].

Initially the future contracts were used by the real traders who had an underlying commodity or the dealers or manufacturers who wanted to secure a consistent supply of raw material for their products[9]. For example, a farmer came to know that the grain price would fall in the upcoming few months or during harvest time, would execute a future contract to secure the current price for the future sales and the delivery of the product. Similarly, a manufacturer who felt that the price of grains would rise in the forthcoming months or feared of not having the raw material for his final product would like to lock-in the current price or guarantee the availability of supplies for his future operations by buying the specified futures contracts of specific amount of grain and specific time of delivery.

As we discussed earlier that the terms of the contract are uniform and because of this uniformity the contract becomes fungible. As a result, not only the futures traders can enjoy the benefits from trading in futures markets but also the public investors and professional speculators can take

[8]Obiyathulla I Bacha, "Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration," 1999.

[9]Sherin Kunhibava, *Derivatives in Islamic Finance* (International Shari'ah Research Academy for Islamic Finance (ISRA), 2010).

the opportunity of making a profit from the rise and fall of the commodity futures prices[10]. The interchangeable nature of contract makes the investors to come and leave the market at any time. But this mechanism becomes more complex with the introduction of clearing house in the market. The clearing housesintervenes itself between the seller and the buyer of the commodity futures and then assumes the role of counter party for both of them[11]. In this case, the futures trader has to pay certain percentage of the total amount of the contract before making any initiative of making an order of selling or buying the commodity[12]. The fee is called as margin fee. This margin is paid to the clearing house via broker who basically works as agent for trader in buying the commodity futures contract. The margin is paid as a performance bond or financial guarantee to ensure that they will fulfill the obligation of the futures contract[13]. When the broker receives an order from the dealer which is actually a management company working on the behalf oftrader, it then transmits the order to the other broker who basically holds that contract from the trader who is interested to sell. When they reached an agreement after negotiation (bid and offer of price), the transaction report is forward to the clearing house to clear. At this moment the clearing houseintervene itself between the two parties and guarantee the performance of the contract. The report is forwarded to the dealer who forwards it back to the client/trader[14].

---

[10]Ali Salehabadi and Mohammad Aram, "Islamic Justification of Derivative Instruments," *International Journal of Islamic Financial Services* 4, no. 3 (2002): 11–17.
[11]Ibrahim, "Commodity Futures Contract; An Analysis in Islamic Commercial Law."
[12]Kamali, "Commodity Futures: An Islamic Legal Analysis."
[13]Ibrahim, "Commodity Futures Contract; An Analysis in Islamic Commercial Law."
[14]Ibrahim.

After taking possession of the commodity futures contract, the trader has to maintain a minimum margin (also known as maintenance or variation margin) set by the exchange whereas the actual price of the underlying commodity has to be paid upon delivery. This variation margin should be observed throughout the time or as long as the trader keeps the futures position open until the expiration of the contract. When the trader offset his position before the maturity by taking the position of the opposite commodity but equal to initial one, his obligations are terminated under initial contract (El-Din 2004).

As the basic purpose behind this trading is earningprofit, hence apart from profit a trader may incur a loss. Since the market prices of the commodities varies or fluctuate between the time at which the order was made and the time of offsetting the position, the trader may either make loss or gain between the initial agreed buying and selling price and the cost of offsetting the transaction[15]. To illustrate more, suppose a trader anticipates a rise in corn prices, so he instructs his broker to buy 5000 bushels of corn in an exchange to be delivered in July for $2.00 per bushel. Now the trader has two options, either to remain in this position till maturity or to offset his position by selling the same. If the market price moves to $2.20 at the time of selling the contract, then he would be able to earn $1000 but if the price drops to $1.90 then he would incur a loss of $500.

[15]Reza Abbaspour, "Futures Contracts In Trading From the Perspectives of Juridical Issues," in *International Conference on Economics, Business and Management*, 2011.

2.2 THE POSITION OF COMMODITY FUTURES IN ISLAMIC COMMERCIAL LAW

It has been argued that the sale of non-existing commodity is not permissible in Islamic legal view. Most of the past and present scholars have argued that this prohibition of non-existing commodity is related to the risk of producing upon the maturity date and not at the time of the contract[16]. The contract of *bay al-Salam* is also based on the sale of non-existing object but it is allowed by Prophet PBUH with the guarantee that the commodity of sale will be delivered by the full specification and date of delivery decided at the time of contract[17].

If the mechanism of commodity futures is observed as discussed earlier, the concept of *bay al-Salam* and *bay al-Istisna* are the same since the underlying commodity in a commodity futures contract has been specified in standard terms. It means that the future delivery of the commodity must be made according to what is specified in the contract and delivered it at pre-determined time and place.

However, *bay al-Salam* contract cannot be applicable to the commodity futures because in case of *Salam* contract, the full price of the commodity should be paid in advance. Only one of the Maliki schools has allowed the deferment of the payment for only three days after the contract[18]. The basic purpose of the advance payment is to provide ease to the manufacturer in buying the raw material for manufacturing or producing the commodity. Hence, in this case *bay al-Salam* contract is not applicable

[16]Kamali, "Commodity Futures: An Islamic Legal Analysis."

[17]Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing, 2013).

[18]Muhammad Ayub, *Understanding Islamic Finance* (Gramedia Pustaka Utama, 2013).

to commodity contracts as in such contracts only the initial margin is paid in advance which is a small portion of the total cost of the commodity.

As *bay al-Salam* cannot fulfill the requirements of commodity futures, *bay al-Istisna* could be an alternative. In *bay al-Istisna*, either the buyer of the commodity can pay the full price in advance or a small portion as the advance for the commodity that would be delivered in future[19]. Although, the time and date of delivery is not obligatory to mention in *bay al-Istisna* but it is preferable in order to have more efficient and convincing transaction[20][21]. Hence is such case, the initial margin issue can be met.

In commodity futures, if the purchaser is defaulted then the initial margin is forfeited which seems unjust to the one who pays margins. However, the modern scholars are in the favor of forfeiting the margin in case of default as it will decrease the risk of losses that could be borne by the manufacturer in case of denial by the purchaser to buy[22]. Thus in the latter view, there is no need of modification to the current commodity futures contract to be legalized under Islamic law.

It is argued that although the Islamic law does not provide any tool or risk mitigation but the tools that are used in the conventional market to mitigate the risk can also be used for Shari'ah complaint commodity futures[23]. Since protection of the property is one of the objectives of *maqasid al-Shari'ah*, it is compulsory to protect one's property. It is the requirement for buyer and seller to take protective measure against the

---

[19]Ayub.
[20]Razali Hj. Nawawi, *Islamic Law on Commercial Transactions* (Kuala Lumpur: CERT Publication Sdn. Bhd, 2009).
[21]Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, vol. 687 (John Wiley & Sons, 2011).
[22]Ibrahim, "Commodity Futures Contract; An Analysis in Islamic Commercial Law."
[23]Kamali, "Commodity Futures: An Islamic Legal Analysis."

actual and potential harms. Although, the risk cannot be eliminated thoroughly but at least it can be decreased with effective risk management strategies that are practiced in the market nowadays[24].

The clearing house works as guarantor between the both parties i.e. buyer and seller in order to avoid the risk of default. The clearing house is monitoring the size of each trading position to make it sure that traders do not overextend themselves by building a large amount of contracts which may lead them to default. The exchange is responsible to compensate the party who incurred losses from the breach of contract and to take necessary actions against the violator[25].

2.3 THE POSITION OF ISLAMIC COMMERCIAL LAW ON SPECULATION AND UNCERTAINTY IN FUTURE MARKET

In the future market a trader who wants to enter in a future contract can either be a hedger who wants to buy or sell futures in order to protect himself against drastic fluctuations, or a speculator who wants to earn profit from the price movements in the market (Kamali 2007). It is often difficult to decide between hedger and speculator because the hedger may become speculator if the price movement is in his favor. He may sell the futures contract that he is holding to buy the cheaper one[26]. This hedging and speculation is the part of the market without which the market cannot function.

[24]Bacha, "Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration."
[25]Ibrahim, "Commodity Futures Contract; An Analysis in Islamic Commercial Law."
[26]Amadeo, "Commodity Futures Definition and How It Works."

The Scholar Islamic Academic Research Journal
Vol. 5, No. 1 || January -June 2019 || P. 113-128
https://doi.org/10.29370/siarj/issue8ar13

There are two types of speculation, the pure speculation that is observed in the market and related to any real activity for gaining profits from the movement of prices in the market which is not allowed in Islam. The other type of speculation is a real activity which helps in shifting the risks from vulnerable producer to those who can afford to take risk. This type of speculation is allowed in Islam[27]. But in futuremarket the only speculation that can be seen is the pure speculation from which only the speculator can benefit rather than farmers. Due to lack of experience and knowledge the farmer may not be able to take benefit of such markets. Secondly, when the time of delivery is near, the selling out of that future contract will be at its peak while no one to buy which may damage the portfolio of the investor who is holding it[28].

No matter how much the commodity future is Islamized but this contract has to be traded in the same future market hence the pure speculation cannot be stopped. If the Shari'ah advisors are able to develop some tools by which the pure speculation can be avoided then there will be no demand of Shari'ah compliant futures due to the reason that investors enter into such market for the purpose of speculation rather than buy the commodity in future.

In most countries the weather is unpredictable and most of the time the crops are damaged by rain and storm. According to *bay al-Salam* and *bay al-istisna* if the manufacturer is not able to produce the commodity upon the date of delivery or the commodity is different than what is specified in

[27]Khan, "Islamic Futures and Their Markets."

[28]Bacha, "Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration."

Vol. 5, No. 1 || January -June 2019 || P. 113-128
https://doi.org/10.29370/siarj/issue8ar13

the contract, then the contract will be considered as void and the manufacturer has to return the advance payment that he is taken at the time of contract. As the nature of agricultural product is more volatile, there is probability that the farmer may incur severe losses.

There is a need to match the applicability of commodity futures in agriculture market with legal maxims or *qawaidfiqhiyyah*. These are the basic principles that are derived from Quran and Sunnah[29]. According to the first maxim 'the status of everything is determined by its purpose'. It means that consideration should be given to the purpose and meaning of the contracts and not to the words and forms. As the purpose of the futures market is to help the speculators to take benefit of it hence, it is very difficult for Shari'ah compliant commodity futures to remain halal in such market.

Second maxim says that 'there shall be no damage and no mutual infliction of damage'. To elaborate, Islam discourage those actions which causes harm. Such kind of actions must be avoided whenever possible. However, if it is impossible to avoid, the lesser of the two evils should be perpetrated to avoid the greater. In case of future contracts, the farmer or the manufacturer tries to avoid the greater losses which can be caused by the fluctuation of the prices. Hence, we can conclude from this maxim that it is allowed for the farmer or manufacturer to enter in such type of contracts.

2.4 PROPOSAL FOR ISLAMIC FUTURE MARKET

As it is discussed that with the existence of pure speculation in the conventional future market, it would not be possible for the Islamic future

[29]Ibrahim, "Commodity Futures Contract; An Analysis in Islamic Commercial Law."

The Scholar Islamic Academic Research Journal
Vol. 5, No. 1 || January -June 2019 || P. 113-128
https://doi.org/10.29370/siarj/issue8ar13

contracts to be traded. Hence, a separate future market only for Islamic future contracts is proposed. However, the question arises, that who will buy Islamic future contracts when the activity of future market is to promote speculation so that investors can make money. It is because those speculators have no intention to purchase the commodity at the expiry of the contract which violates the first legal maxim i.e. ‘the status of everything is determined by the purpose’. In our proposal, there is no place for those speculators but this market will only be workable for those manufacturers who think that there is uncertainty of prices of raw material in future. They can enter the market to buy the future contracts to hedge against the future price. On the other hand, the seller of the future contract will enter with the same intention. However, it is not necessary the each of the party will hedge with the same price they decided but the negotiations between the parties will set the prices which may result in win-win situation for both parties.

This type of market will help in boosting the businesses and help the farmers to get financial boost. In order to elaborate, let’s imagine that a farmer of sugarcane would sell its sugarcane to a sugar mill after few months. However, he wants to hedge against the future price hence, he may enter into Islamic future market where he can have a number of buyers for this future contracts. The price can be settled after negotiations with those parties and the party which gives favorable price to the farmer may buy the contract. The same goes for the buyer of the future contract as he would also find a number of farmers and in this way he can settle the future price of the raw material. Such type of market will help both the parties to minimize the costs in finding the right buyer or seller.

It is proposed that the future contract will be based on *bay al-Istisna*. It is because in such contract, the advance amount is paid upfront. In case the

The Scholar Islamic Academic Research Journal
Vol. 5, No. 1 || January -June 2019 || P. 113-128
https://doi.org/10.29370/siarj/issue8ar13

farmer is unable to supply to commodities on time or the quality or quantity of the commodity is different than what it proposed in the contract, then the upfront payment will be forfeited.

Since, we are proposing *Isitisna* based future contracts therefore, the following conditions must be fulfilled[30].

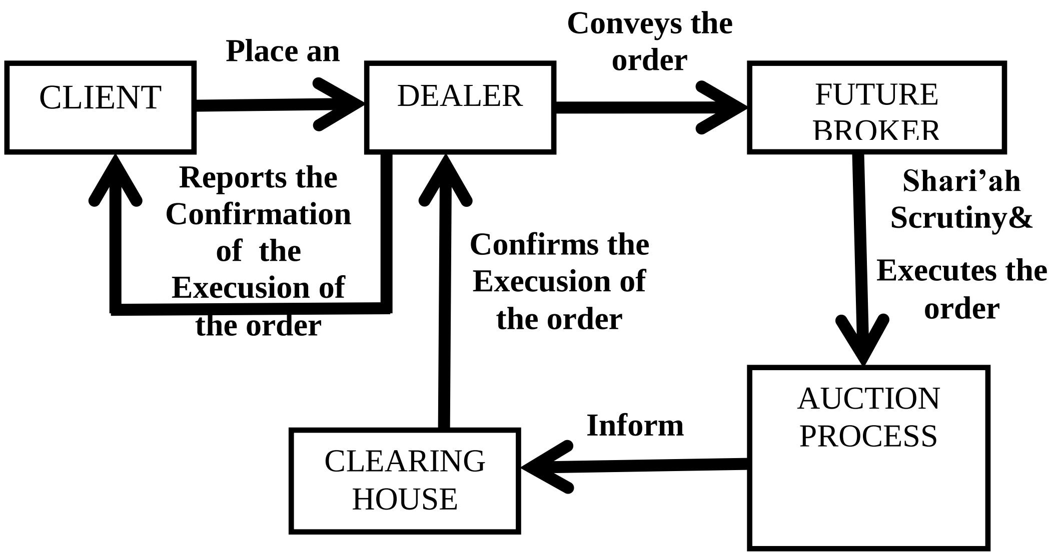
i. It is the main condition to mention about the type, dimension and all the specification of the future goods in clearest terms. Therefore, in future contract related to agriculture commodity, all the specifications related to the crops must be mentioned.
ii. The material should be supplied by the maker. Hence, once both parties enter into future contract, the farmer will provide all the inputs and do the monitoring tasks so to achieve the same product as mentioned in the contract.
iii. The contract is binding on both parties so none of the party in the future contract will be allowed to retract the contract. However, the buyer has the authority to retract the contract if the goods supplied are not as per contract specification.
iv. The delivery time must be specified by both parties in order to avoid any conflict.
v. Once, the contract is completed, it is the liability on the farmer to supply the commodity and the buyer to pay the remaining price.
vi. The place of delivery must be stated in the contract because loading and transportation charges are attached to this type of future contract. In such case, both parties would try to minimize the costs which will lead to conflict. Therefore, mentioning the place of delivery in contract specification will avoid such issue.

[30]Ahcene Lahsasna, *Shari'ah Issues and Resolutions in Contemporary Islamic Banking and Finance* (Kuala Lumpur: IBFIM, 2014).

The Scholar Islamic Academic Research Journal
Vol. 5, No. 1 || January -June 2019 || P. 113-128
https://doi.org/10.29370/siarj/issue8ar13

In Figure 1, the working mechanism of proposed Shari'ah compliant future contract in Islamic future market is portrayed. First, the client who is actually a trader (who needs to buy future contract) will place an order to the dealer and the dealer will forward the order to the broker. The broker who holds the contracts from the seller will execute the contract. However, before the execution it is proposed to have a Shari'ah scholar who should endorse the legality of the contract. It will then go for auction process and once the price is settled then the clearing house will guarantee the execution of the contract. The report will be then sent to the dealer who will sent it to his client.

Figure 1: The proposed Mechanism of Islamic Future Market



2.5 CONCLUSION

Future contracts came to existence due to its need in the agriculture market. Farmers, who were concerned about the price fluctuation that they could observe at the time of sowing and cultivation, mostly preferred future contracts. Initially this contract was introduced as forward contract in which the farmer fixes the price of the commodity that is subjected to be deliver in future. But the after the emergence of future markets, it is no more considered as a hedging tool only but also a speculative tool that is used in speculation.

Due to the speculation, most of the Muslims countries are looking for Shari'ah compliant contracts invest in commodity futures. Therefore, this study aims to understand the nature of future contracts and the applicability of Shair'ah compliant future contract. According to the modern scholars, the nature of the conventional commodity futures resembles with the contract of *bay al-Istisna*. Hence there is no need to make any changes to the present commodity futures contracts to make it is Shari'ah compliant.

In this paper apart from the Shari'ah issues, we have examined and the applicability of the commodity futures (*Istisna* based) in agricultural market and it is found that due to the speculation activities in the futures market it is very hard for the Shari'ah compliant commodity futures in the same conventional market . Therefore, it is proposed that there should be a separate market where such type of future contracts can be traded. As, there will be no speculation in the market hence, only real traders will buy and sell the contract.

Such market will help the farmers who are unable to find buyer for their commodities and also the buyers of those commodity will be able to hedge the price to avoid any loss due to price fluctuation in the future.