CAPITAL MARKET PRODUCTS ACCORDING TO ISLAMIC JURISPRUDENCE
CALL WARRANTS

RESOLUTION

At its 4th meeting on 26 July 1995, the Islamic Instrument Study Group (IISG) passed a resolution permitting the use of call warrants on the condition that the underlying shares of the warrants in question are Shariah compliant. This instrument fulfils the features of *mal* (asset) according to Islamic jurisprudence as outlined in the *haq maliy* and *haq tamalluk* principles. *Haq maliy* can be traded if it complies with Islamic principles and conditions of buying and selling.

INTRODUCTION

A call warrant is a right, but not an obligation, to buy a fixed quantity of an asset (such as shares) for a specified price within a limited period of time.\(^{155}\)

The following are three defining features of call warrants:\(^{156}\)

**Underlying Asset**

Call warrants are issued based on the underlying assets, for example, the shares of a company. They give warrant holders the right, but not the obligation, to buy a certain number of shares of the underlying company at a price agreed upon before or on a future date.

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\(^{156}\) Securities Commission, *Understanding Call Warrants*, p. 3.
Exercise Price

This is the price at which a warrant holder can choose to exercise his right to buy the underlying shares. The exercise price is fixed at the time the warrants are issued.

Exercise Period

The validity of the exercise period of a call warrant is limited, after which it has no value.

ARGUMENTS THAT SUPPORT THE PERMISSIBILITY OF CALL WARRANTS

In determining the status of call warrants, athar and Islamic jurisprudence are used as a reference. Although there are no such instruments in the practices of Islamic muamalat, the studies are nevertheless made from the perspective of general Shariah principles that are relevant to the instruments. These principles are as follows:

Athar\(^{157}\) as a Basis

There is evidence of practices similar to paying for a right by the companions of the Prophet s.a.w. The evidences were in the form of sales and purchases, and rentals.

Holding Rights in Sales and Purchases

According to Imam Ahmad, as narrated by Ibn Qadah in his book al-Mughni, Nafi’ bin al-Harith was reported to have bought a house from Safwan bin Umayyah for Caliph Omar which was to be converted into a prison. He laid down a condition to Safwan that if the Caliph agreed, then he would buy the house, otherwise, Safwan would still be paid a certain sum. In the book, Ilam al-Muwaqiqin, Ibn Qayyim said that the cost of the house was 4,000 dirham, and Safwan would be paid 400 dirham if the Caliph did not agree to the purchase. In al-Mughni, the reason for the 400

\(^{157}\) Athar refers to a practice based on the companions of the Prophet s.a.w.
dirham was given so that the house would not be sold to someone else.\textsuperscript{158} This narration showed that payment was permissible to give holding right to a property.

### Holding Rights in Rentals

There was also a narration on holding rights in rentals. Such activities were reported in \textit{Sahih Bukhari}. Ibn \'Aun narrated, a man asked the owner of a mount-for-hire, “Prepare your mount, if I do not rent it on the promised date, I will give you 100 dirham”. The tenant did not rent on the promised date and Qadhi Shuraih said the condition previously agreed upon had bound the tenant and considered it an obligation.\textsuperscript{159}

This narration shows that holding rights payment in the form of rental is permissible and the payment ensured that the mount was not rented out to someone else.

### The \textit{Haq Maliy} Principle

Under Islamic jurisprudence, there are two types of rights:\textsuperscript{160}

(a) \textit{Haq maliy} are rights on assets with financial values. Examples of such rights are \textit{haq dayn} (debt rights) and \textit{haq tamalluk} (ownership rights); and

(b) \textit{Haq ghair maliy} are rights not related to assets with financial values. Examples of such rights are \textit{haq hadhanah} (child custody rights) and \textit{haq wali} (right to be a \textit{wali}).

### The \textit{Mal} Principle

The majority of Islamic jurists were of the opinion that something could be regarded as \textit{mal} if it could be controlled and benefited from.\textsuperscript{161}

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Capital Market Products According to Islamic Jurisprudence

كل ما يمكن حيازته والانتفاع به على وجه معتد

*Meaning: “Something that can be controlled and benefited from according to customs.”*

The Shafi‘i Mazhab also provided general guidelines on what can be considered as a property. This principle strengthens the awarding of the status of *mal* on call warrants according to Islamic jurisprudence as outlined by Imam al-Suyuti.\(^{162}\)

لا يقع اسم المال إلا على ما له قيمة يباع بها ويلزم متعلقه

*Meaning: “Something is categorised as mal if it has value. That is why it can be traded, and compensation shall be paid by anyone who causes it to be damaged.”*

Opinions of Past Islamic Jurists

There were two opposing opinions of past Islamic jurists on rights and benefits; some regarded rights as not *mal* while the rest thought that rights could be divided into two types; rights that could be categorised as *mal* and otherwise.\(^{163}\)

According to the Hanafi Mazhab, rights and benefits could not be categorised as *mal*.

The Maliki, Shafi‘i and Hanbali Mazhab and some jurists of the Hanafi Mazhab of the later generation regarded rights and benefits as *mal*, if they are related to *mal*, or ‘urf, if they are regarded as something of value.

The differences in opinions have a great influence on the decisions on rulings by contemporary Islamic jurists depending on how they strengthened their arguments based on the views of the Hanafi Mazhab or the majority of the Islamic jurists.

\(^{162}\) Al-Suyuti, *Al-Asybah wa al-Naza’ir*, p. 409.

TRANSFERABLE SUBSCRIPTION RIGHTS (TSR)

RESOLUTION

At its 6th meeting on 5 October 1995, the IISG resolved that transferable subscription rights (TSR) is an instrument permissible from the Shariah perspective. The characteristics of this instrument fulfil the principle of *mal* according to Islamic jurisprudence as outlined in the *haq maliy* and *haq tamalluk*.

The meeting resolved that what is called *bai` ma`dum* (buying and selling something that does not exist) does not occur in TSR trading but such trading is, instead, *bai` maujud* (buying and selling something that exists).

INTRODUCTION

TSR is a contract that gives its shareholders a right but not an obligation, to subscribe to new ordinary shares at an authorised price that has already been preagreed within a stipulated period. It loses its value after the stipulated period. In other countries, TSR is commonly known as a warrant.

ARGUMENTS THAT SUPPORT THE PERMISSIBILITY OF TRANSFERABLE SUBSCRIPTION RIGHTS

Several issues of Islamic jurisprudence have been studied in evaluating TSR which include holding rights and *bai` ma`dum*. The question of rights and the views of the Islamic jurisprudence will not be discussed as it has been discussed in the previous chapter on call warrants.
Bai` Ma`dum

The main focus is on the purchase of something that does not exist (bai` ma`dum) as it involves a quantity of shares yet to be subscribed by TSR holders. Many Islamic jurists do not allow bai` ma`dum in general.\(^\text{164}\) However, Ibnu Qayyim studied this issue from two dimensions which show the permissibility of bai` ma`dum based on certain conditions:

**First:** It is not true that bai` ma`dum is not permissible. This is because there is no evidence in the Quran, Sunnah and opinions of the companions of the Prophet s.a.w. which state that bai` ma`dum is not permissible. The only thing is a hadith prohibiting certain types of buying and selling, and certain non-existing products. This is similar to the prohibition of the sale and purchase of existing products that come with certain features.

Therefore, the prohibition on the buying and selling of such products is not whether they exist or otherwise, but rather because of the element of gharar which is uncertainty and deceit in a transaction. Gharar occurs when there is an element or incapability of delivering a product that has been sold whether it really exists or not. A classic example would be the selling of runaway slaves and stray animals. Although the product existed, the seller was incapable of handing it over to the buyer. It was an obligation for the seller to hand over the product immediately after the `aqd had been completed. The failure of the seller to fulfill his obligation meant the occurrence of gharar, the element of uncertainty which was prohibited.

**Second:** Certain conditions of Syara` allow bai` ma`dum and consider it legal. As an example, Syara` allows the buying and selling of fruits and grains that have a high chance of becoming food produce. The Prophet s.a.w. permitted this type of transaction. It is bai` ma`dum because even though the `aqd has been concluded, the buyer is still not able to claim the produce but has to wait until a certain period when the fruits and grains are ready to be harvested and delivered.\(^\text{165}\)

Al-Kasani stated that among the conditions of a legal transaction is the capability of the seller to hand over the goods sold. The important point is the capability to hand over the goods with absolute certainty even though it is some time in the future.\(^\text{166}\)

\(^\text{165}\) Ibnu Qayyim, I`lam al-Muwaqqi`in, vol. 2, pp. 8–10.
\(^\text{166}\) Al-Kasani, Bada`i` Sana`7, vol. 5, pp. 147–148.
Ibnu Qudamah also addressed the same question by bringing up the issue of selling fish that are still in the water. According to him, most Islamic jurists are of the same opinion that such a transaction is illegal. The ‘illah is due to the presence of gharar. However, in certain conditions, it is permissible to sell fish in the water, provided that:

(a) The pond belongs to the seller;

(b) The water in the pond is shallow and the fish in it can be identified; and

(c) There is a possibility of catching the fish.\textsuperscript{167}

All these conditions must be fulfilled before it becomes permissible to sell the fish. Otherwise, gharar will be present, as the seller is incapable of surrendering the goods.

Based on the texts of Islamic jurisprudence, it can be concluded that ‘illah bai’ ma’dum is gharar. Gharar occurs when the seller is not able to hand over the goods sold. This means that when bai’ ma’dum occurs without gharar – a sale will be made; its features, rate and price can also be determined; and the seller is able to hand over the goods within a specific time – then, such a transaction is legal.

In conclusion, the prohibition of bai’ ma’dum is not that the goods do not exist during the `aqd but because of gharar. Therefore, what is prohibited is the element of gharar and not the non-existence of the goods.

On the question of subscribing to shares that have yet to be issued, it is not bai’ ma’dum because the quantity, nature, rate, type and price of the shares have been determined, and the company will create the new shares within a specific period.

It can be concluded here that TSR instruments do not contradict the Shariah. In this context, a TSR is approved by Shariah when the shares to be created are also shares that comply with the Shariah principles.

\textsuperscript{167} Ibnu Qudamah, Al-Mughni, vol. 4, p. 294.
ASSET SECURITISATION

RESOLUTION\textsuperscript{168}

At its 7th meeting on 1 December 1995, the IISG resolved that asset securitisation is permissible if the underlying asset of the instrument is Shariah compliant.

INTRODUCTION

In general, asset securitisation is a process of issuing securities by selling financial assets identified as the underlying asset to a third party. Its purpose is to liquidate financial assets for cash or as an instrument to obtain new funds at a more attractive cost, compared to obtaining funds through direct borrowing from financial institutions.

Specifically, financial assets which have a future cash flow will be sold by a company that needs liquidity or as new funds to a third party known as a special purpose vehicle (SPV) for cash. To enable the payment for the purchase of the assets, the SPV will issue asset-backed debt securities to investors, based on the pledged future cash flow of the assets. Investors will then gain returns through future cash flows managed by the SPV.

Among the assets with future cash flows that has the potential to be securitised for the issuance of asset-backed debt securities issues are house financing receivable account, credit card account, vehicle financing receivable account.

\textsuperscript{168} A resolution made was regarding asset securitisation in general. However, several matters related to this concept specifically are still under study.
account, highway toll collection, etc. In the Islamic context, assets must be securitised in accordance with the Shariah.

**ARGUMENTS THAT SUPPORT THE PERMISSIBILITY OF ASSET SECURITISATION**

The basis for the concept of asset securitisation is already present in Islam and has been discussed at length by past Islamic jurists, especially on the securitisation of cash flow. The basis can be examined through the following principles:

**The Mal Principle**

The use of assets as collateral in asset securitisation to facilitate the issuance of an instrument of value is part of the mal principle in Islam. Mal refers to something that has value and can be gainfully used according to the Shariah. A clear difference between the concept of mal and an asset lies in the features prohibited by the Shariah. In Islam, prohibited items such as liquor and pork are not included in the mal category for Muslims. However, if they are owned by non-Muslims, these items are mal for them.

Cash flow is also included in the category of mal if its origin is halal (lawful) according to the Shariah. This is because, cash flow is considered a dayn (debt) and according to Islamic jurisprudence, a debt with no ambiguity is haq maliy which is included in mal.\(^{169}\)

**Bai` Dayn**

Asset securitisation is related to the sale of debts, (bai` dayn) which is debated in Islamic jurisprudence. The IISG, at its 8th meeting on 25 January 1996, and the SAC at its 2nd meeting on 21 August 1996, discussed this issue. The SAC, at its 2nd meeting, agreed to accept bai` dayn in the structuring of Islamic capital market products.\(^{170}\)

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169 See SAC resolution on call warrants for further elaboration on the mal concept.  
170 See SAC resolution on bai` dayn for further details.
The Rahn Principle

In asset securitisation, a fixed cash flow is the main criterion of the asset. The cash flow of the asset is packaged and made the collateral for issuing securities. This form of securitisation conforms to the rahn principle in Islamic jurisprudence. Rahn is a valuable underlying asset (collateral) used to obtain funding on credit. A collateral must have the mal feature to enhance the confidence of creditors to provide the funds. The mal can be used as a collateral to redeem a debt in the event there is a failure to settle the debt.\(^{171}\)

Opinions of Past Islamic Jurists

There is evidence in Islamic jurisprudence that allows the use of cash flow as a collateral to obtain new funding which enables the creditor to achieve liquidity. With this available liquidity the creditor can participate in economic activities or seize business opportunities without having to wait for a long time to recover the debt. According to a statement from the Maliki Mazhab, a debt can be used as a collateral for funding. This means that the Maliki Mazhab established a concept that packaged cash flow as an underlying asset for obtaining funds.\(^{172}\)

The example quoted from the Maliki Mazhab was wages earned by a mudabbar\(^{173}\) (slave) from services rendered to his master. This meant that throughout his master’s life, the mudabbar worked and earned an income for his master. The Maliki Mazhab stated that an income that was going to be earned by the mudabbar could be packaged by his master as a collateral of value for raising funds. This proves that a cash flow can be packaged and accepted as a collateral of value.\(^{174}\) In short, say a mudabbar works to earn a monthly wage of RM1,000. In a year he is able to earn RM12,000. The master can turn the cash flow into a collateral of value for raising funds, e.g. RM6,000, for a period of less than a year.

Cash flows currently in the form of income from toll collection, electricity bills, water bills, telephone bills, Islamic house financing and Islamic vehicle financing can also be packaged as underlying assets. This is because such cash flows are fixed cash flows for the company.

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173 Al-Mudabbar refers to types of slaves who will be free when the master dies.
\section*{Wathiqah Dayn}

To enable the public be more actively involved in economic activities through investments, assets with regular streams of cash flow can be packaged and used as underlying assets for issuing securities.

The Maliki \textit{Mazhab} put forward this idea in a term known as \textit{wathiqah dayn}.\textsuperscript{175} A paper of value symbolises the total share of ownership of an ongoing project. It is also known as \textit{sukuk} (or \textit{shahadah}).\textsuperscript{176} \textit{Sukuk} only acts as a financial instrument. It is similar to a company share certificate that facilitates easy transfer of ownership.

Liquidity can be obtained with \textit{sukuk}, enabling the entrepreneur to inject capital into the economic cycle. The \textit{sukuk} issued is based on the system of \textit{mudharabah}, \textit{musyarakah mutanaqisah}, \textit{ijarah}, etc. It all depends on the form of business activity that is used as collateral and how the profits will be distributed.


REGULATED SHORT SELLING AND SECURITIES BORROWING AND LENDING

RESOLUTION

At its 13th meeting on 19 March 1998, the SAC resolved to accept the existing securities borrowing and lending (SBL) principles in the securities industry. To comply with Shariah principles, SBL will be aligned to *ijarah* (leasing contract) principles. Nevertheless, the *istihsan* methodology is used as an exception to the general *ijarah* principle. This means the *ijarah* relationship between the lessee and the shareholder is not severed even though in SBL, the lessee has to surrender the share leased.

In addition, the SAC at its 69th meeting on 18 April 2006 resolved that regulated short selling (RSS) is in line with the Shariah as the inclusion of SBL principles in RSS eliminates the element of *gharar*.

INTRODUCTION

Regulated Short Selling

In general, short selling is the act of an individual selling securities which he does not own at the point of transaction.177

RSS is the selling of approved securities,178 where the seller does not have an exercisable and unconditional right to vest such securities in the purchaser at the time of the execution of the sale. However, prior to the execution of the sale...

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177  http://www.bursamalaysia.com/website/education/glossary.htm#S
178  Please refer to Rule 704 of the *Rules of Bursa Malaysia Securities Berhad* regarding definitions of approved securities for regulated short selling.
sale, the seller has executed an agreement to borrow the approved securities to enable delivery of the same to the purchaser under the sale, in accordance with the rules relating to delivery and settlement.\textsuperscript{179}

From the above definition of RSS, it can be surmised that RSS is a form of short selling that is combined with SBL and executed according to the rules set by Bursa Malaysia.

**Securities Borrowing and Lending**

The principle of SBL on regulated short selling was first introduced to the local capital market at the end of 1995. However, it was suspended at the end of 1997 following the economic crisis which threatened the stability of the share market activities in the Kuala Lumpur Stock Exchange (now Bursa Malaysia). However, before SBL was suspended, the SAC had already conducted studies on this principle from the Shariah perspective and resolved that it was permissible.

SBL is a securities borrowing and lending activity which involves the borrower and lender who need to fulfil their temporary needs, and such transactions must be completed according to specified regulations and guidelines. As an example, a lender who owns long-term securities (shares) agrees to lend securities to a borrower for a stipulated period. When the period expires, the borrower must return the securities either in the original form or another form of securities of the same type and amount. Meanwhile, the lender will impose a deposit and service charge on the borrower, as one of the securities borrowing conditions.

**ARGUMENTS PERMITTING REGULATED SHORT SELLING**

In general, short selling involves the selling of shares not owned by the seller. As a result, such transactions fall under the category of *bai` ma`dum*. Islam prohibits such transactions involving *bai` ma`dum* since the delivery of the subject matter cannot be effected and this brings about the prohibited element of *gharar*.

However, the issue of *gharar* can be overcome in RSS – the inclusion of SBL principles in RSS eliminates the element of *gharar*. In other words, the

\textsuperscript{179} Rule 704.1(1) of the *Rules of Bursa Malaysia Securities Berhad*. 

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introduction of SBL can increase the probability that the shares sold will be delivered. When the probability of delivery is high, then the element of gharar will no longer be significant. Consequently, when an obstacle that hinders the recognition of a certain activity as Shariah compliant is overcome, then that activity can be classified as Shariah compliant. This fulfils a fiqh methodology: “When an issue that impedes (the permissibility) is removed, then the activity which was initially forbidden becomes permissible”.180

ARGUMENTS PERMITTING SECURITIES BORROWING AND LENDING

Because SBL was something new to the capital market, the SAC undertook research to determine Shariah principles that could be used as arguments in evaluating the status of SBL. Based on the research, the following principles were used as a basis for the permissibility of SBL.

_Istihsan Principle_

The SAC in several of its meetings attempted to identify a Shariah principle that can be used as a basis for the implementation of SBL. As a result of the studies and discussions, the SAC decided that the _istihsan_ principle should be instilled in the _ijarah_ methodology to form the basis for SBL after evaluating that other methods such as _i`arah_ (asset borrowing), _hawalah_ (debt assignment contract) and _bai` wafa’_ (selling and buying back) were found to be unsuitable for the concept and implementation of SBL.

_Istihsan_ is an exemption of a ruling that is juz’ie (branch) in nature compared with a general principle decision.181 Al-Syatibi defined _istihsan_ based on the Maliki Mazhab as accepting _maslahah_ (public interests) that has juz’ie as compared with accepting _dalil kulliy_ (general).182 In summary, it means the use of a specific method as an exemption from the general one.

_Istihsan_ that was popularised by the Hanafi jurists and accepted by the Maliki jurists had become a serious topic of discussion among Islamic

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jurists from other schools of thought especially the Syafi’i jurists. The Syafi’i jurists rejected _istihsan_ if it had no basis. Despite that, _istihsan_ is still widely referred to by those who have accepted it. In truth, many contemporary problems can be overcome by accepting _istihsan_. This need is strongly felt, especially in handling issues that have arisen in a _muamalat_ system which is always developing and changing from time to time.

**Istihsan with Maslahah**

The decision taken by the SAC that the selling of borrowed/leased shares to a third party does not nullify the _ijarah_ `aqd, because the decision is based on _istihsan_ with _maslahah_. This gives a clear advantage to the original shareholder and can provide liquidity to the share market.

**Istihsan with `Urf Khas**

`Urf _iqtisadi khas_\(^{183}\) (a customary practice accepted in economic activities) which occurs in SBL activities is `urf _sahih_ (customary practices accepted by _Syara_’). Therefore, the argument employing _istihsan_ with `urf also strengthens the evidence.

**Accepting the Ijarah Concept with Consent to Sell**

_Istihsan_ allows the _ijarah_ concept, with the consent of the owner to sell the leased shares, to be acceptable as a basis for SBL. According to the original _ijarah_ concept, the relationship between the owner and lessee will be severed when a transaction involving the sale and purchase of an asset occurs. This is because the _ijarah_ contract as defined by the _ulama_’ is the contract for using the asset and paying for its use.\(^{184}\)

With the sale of the assets, the _ijarah_ contract will automatically be terminated. Nevertheless, as the SBL contract is similar to the terms in the _ijarah_ contract in many situations, such as the authority of the owner recalling the assets, evaluating the assets according to current market value and so forth. The SAC members resolved that the _ijarah_ concept, with the consent of the owner to sell the leased shares can be applied to the Islamic capital market.

\(^{183}\) See SAC resolution on `urf for further details.

RESOLUTION

At its 11th meeting on 26 November 1997, the SAC resolved that the futures contract on crude palm oil is permissible as it is in accordance with Shariah principles.

INTRODUCTION

In general, there are two types of futures contracts: commodity futures contract and financial futures contract. However, this resolution only takes into consideration the views of Islamic jurisprudence regarding commodity futures contract. This contract can be defined as an exchange-traded agreement to buy and sell a commodity in an actual market (cash market) in a standard quantity, at a future date and at a determined place of delivery. In Malaysia, there is only one type of commodity futures contract – the crude palm oil futures contract. It is a financial product innovation for those involved in crude palm oil trading to manage risks more efficiently and effectively, especially the risk of price fluctuation.

ARGUMENTS THAT SUPPORT THE PERMISSIBILITY OF CRUDE PALM OIL FUTURES CONTRACT

The SAC, assisted by the Islamic Capital Market Department (ICMD) conducted an in-depth study on this instrument and related Shariah issues. Among the issues were as follows:
Resolutions of the Securities Commission Shariah Advisory Council

Gambling

There were doubts about this instrument based on the requirement imposed on a market player to place a deposit as a margin of payment before he begins trading. This action is regarded as a prohibited bet.

The SAC resolved that such a trading activity does not constitute gambling because the fluctuation of the value occurs due to the change in demand in the crude palm oil futures market. It is also a common phenomenon in the trading world. It is not appropriate to judge a contract whose value fluctuates due to the changing demands for crude palm oil futures market as a gambling activity. This is because gambling activities depend solely on luck and are not related to demand and offer.

Gharar

Gharar is defined as something that is not certain. This instrument relates to the uncertainty in obtaining goods that have been bought and in receiving potential profits. The SAC is of the opinion that profit and loss in business is a common factor, although traders aspire to earn profits. This is stated by Allah s.w.t. in several verses, such as Surah al-Fatir verse 29 which describes the aspiration of traders of not incurring losses. Allah s.w.t. states:

Meaning: “For them, they secretly and openly hope for a commerce that will never fail.”

(Surah Fatir: 29)

Similarly, in Surah al-Taubah verse 24 which describes the worry over a losing concern. Allah s.w.t. states:

Meaning: “… the commerce in which you fear a decline.”

(Surah Al-Taubah: 24)

185 See SAC resolution on gharar for further details.
This shows that profit and loss is a characteristic of trading and a trader should take steps to minimise loss.

The main question in a crude palm oil futures contract is whether *gharar* really exists. An important element in trading raised by Islamic jurists is the element of *ghalat*.\textsuperscript{187} This must be clarified as there is a misunderstanding that it is similar to the principle of *gharar*. The Islamic jurists see *ghalat* from the view point of *maslahah istiqrar ta’amul* which means that market players are given the freedom to trade, accept and trust each other in their transactions to ensure that the market runs smoothly. Factors that can disturb the market operations are cheating and manipulation. *Ghalat* that involves a wrong assessment of an individual (*ghalat ‘aqid*) cannot be used as a basis to terminate a contract. The factor that can terminate a contract is *ghalat wadhih*, which is a mistake caused by apparent cheating.\textsuperscript{188}

When a crude palm oil futures contract is offered, specifications such as quantity, type, price and delivery date are made known to the market players. Therefore there is no element of *gharar* in the contract. All specifications are made clear in the contract, and surveillance and regulation are provided to ensure there is no cheating.\textsuperscript{189}

### Buying Something That Does Not Exist (*Bai` Ma`dum*)

Ibn Qayyim had studied the issue of *bai` ma`dum*\textsuperscript{190} and clarified that the prohibition of *bai` ma`dum* was actually due to presence of the element of uncertainty to hand over the goods sold. Such transactions can take place regardless of whether the goods exist or not. Nevertheless, *bai` ma`dum* that involves something that exists and the seller can obtain it or in the form that can be made tangible, is approved and valid. This often occurs in Shariah, such as *salam* (forward sale) and *istikna* (contract of manufacture). Therefore, *bai` ma`dum* is prohibited because of the element of *gharar* rather than the element of *ma`dum*.\textsuperscript{191}

The above situation does not occur in the crude palm oil futures market. The contract can be settled in cash before the due date or settlement by delivery

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\textsuperscript{187} It means mistake. See SAC resolution on *ghalat* for further details.

\textsuperscript{188} Al-Zarqa’, *Al-Madkhal al-Fiqhi*, vol. 1, pp. 390–405.

\textsuperscript{189} See *Futures Industry Act 1993*, Business Rules (Exchange and Clearing House).

\textsuperscript{190} See SAC resolution on *bai` ma`dum* for further details.

on the due date. In addition, the clearing house ensures the delivery and settlement of a transaction. Therefore, the element of gharar does not exist or is insignificant.

Speculation

Speculation is also one of the issues that cast doubts on the permissibility of crude palm oil futures contracts according to the Shariah.\textsuperscript{192}

Speculation\textsuperscript{193} refers to making profits out of the price movements of goods. In fact, speculation exists in all forms of businesses and is not limited to futures transactions. The concern is whether it is excessive or conducted under normal circumstances.

No Exchange of Goods (‘\textsuperscript{1wadh})

Present Islamic scholars\textsuperscript{194} put forward the issue that ‘\textsuperscript{1wadh} does not occur in crude palm oil futures transactions. ‘\textsuperscript{1wadh} means the exchange in buying and selling, but in this context no purchase of goods in the actual sense has occurred. Therefore, there is no increase in the value of economic activities. Crude palm oil futures contract trading, in actual fact, gives an increase in value to market players. For example, when producers of crude palm oil hedge,\textsuperscript{195} they endeavour to cut costs. This will indirectly improve company profits and make their products more competitive.

Based on the studies, claims such as gharar, bai\textsuperscript{‘} ma\textsuperscript{‘} dum, non-existence of ‘\textsuperscript{1wadh}, etc. do not occur. The SAC thus resolved that crude palm oil futures contracts are in accordance with the Shariah, for as long as they are free from the element of riba and gambling. So, investors who are concerned with Shariah practices can benefit from these facilities used as instruments for risk management.

\textsuperscript{192} Al-Uthmani, "‘Uqud al-Mustaqbaliyyat", vol. 1, pp. 353–354.
\textsuperscript{193} See SAC resolution on speculation for further details.
\textsuperscript{195} Price risk management using a concept known as hedging.
COMPOSITE INDEX FUTURES CONTRACT

RESOLUTION
At its 13th meeting on 19 March 1998, the SAC resolved that the mechanism for stock index futures contracts does not contradict Shariah principles. Therefore, stock index trading is allowed as long as it is Shariah compliant, and this is done by ensuring that the index component is made up of Shariah-compliant securities.

INTRODUCTION
A composite index futures contract is one of the instruments categorised as a financial futures contract. A crude palm oil contract is categorised as a commodity futures contract. There are two types of financial futures contracts in the futures industry in Malaysia. These are the Kuala Lumpur Composite Index (KLCI) futures contracts and KLIBOR futures contracts which are traded on Bursa Malaysia Derivative Bhd. The SAC decided that both of these contracts are not permissible by Shariah. This is because the KLCI futures contract is based on the underlying index where most of its components are securities of companies that have not been approved by the SAC. On the other hand, the KLIBOR futures contract is based on interest rates and hence, contains the element of *riba*.

Nevertheless, it is important to discuss the extent to which the stock index mechanism is permissible according to Shariah in the context of risk management. Added to this was the launch of the Shariah Index by Bursa Malaysia. It functions as a benchmark for the performance of Shariah-compliant securities. The increase in the Shariah Index depicts an increase in the share prices in this sector and vice-versa.
A composite index futures contract is created when a total number of shares which form the index components are made the underlying asset to the instrument. The share index is a benchmark which indicates the performance of the share/equity market. The contract is an agreement between a buyer and seller to receive and hand over a certain number of shares comprising the selected share components at an agreed price and at a determined future date. However, the agreed price is not paid in full, merely a margin value until a full settlement is made.

In the Malaysian context, the KLCI is a combination of 100 companies listed on the Main Board that represent various sectors and are most frequently traded on Bursa Malaysia. This index is calculated every minute during a trading day. The Shariah Index is made up of all Shariah-compliant securities approved by the SAC and are listed on the Bursa Malaysia Main Board.

As the composite index varies based on market performance, the price of a composite index futures contract will also change according to the movement of the share index value on the stock exchange. The underlying asset exists in the physical form and is the total number of shares which are components of a stock index. As the total is rather large, delivery in its physical form cannot take place in an index futures contract. The buyer will receive only its value in lieu of the physical delivery. That is why the contract is settled in cash before or on the due date.

ARGUMENTS THAT SUPPORT THE PERMISSIBILITY OF COMPOSITE INDEX FUTURES CONTRACTS

A composite index futures contract is a new instrument for managing risks in securities trading. It is not fully compatible with the concepts of salam, istisna’, musyarakah, etc. Therefore, it would be inaccurate to categorise it as the same with existing named contracts, in accordance with Islamic jurisprudence. The SAC, assisted by the ICMD carried out studies on this new contract and resolved that it does not contradict the Shariah principles, provided the index components comprise Shariah-compliant securities.

Features of a Contract Are Not Similar to Muqamarah, Jahalah and Gharar

The issues of muqamarah (gambling), jahalah, gharar and bai’ ma’dum are
Capital Market Products According to Islamic Jurisprudence

among the main issues emphasised by contemporary ulama` who do not permit composite index futures contracts.

Buying and selling of index is not synonymous with gambling because there is no similarity to losing a bet. In gambling, the player loses all his money if his guess is wrong. This does not happen in index trading as the total index point has its own inherent value. What happens is, the investor will experience a decrease or increase in the value depending on the demand for the total number of shares that comprise the index component. Index trading does not involve any element of betting.\(^{196}\)

This contract also does not contain elements of jahalah and gharar as it is traded in clear quantities and pricing. There is no vagueness in price and quantity. The price is determined by the market based on demand and supply.

**The Issue of Bai` Ma`dum\(^{197}\)**

In an index futures contract, there is actually no physical delivery on the due date. This is in contrast to crude palm oil futures trading where physical delivery can occur. As a solution, physical delivery can be substituted for cash value.

In general, Islamic jurisprudence can accept this. Al-Baghdadi in his book Majma` al-Dhamanat discussed the relevant issues. Such settlements are carried out when physical delivery cannot be done.

Solutions using cash value means pricing something according to current market value without increasing or decreasing it.\(^{198}\) Other than the case of trading, the ulama` also discussed at length the same problem on issues concerning ghasb\(^{199}\) and its compensations.\(^{200}\) This shows that replacing physical delivery with cash value is not something new in Islam.

\(^{196}\) See SAC resolution on gambling for further details.

\(^{197}\) See SAC resolution on bai` ma`dum for further details.


\(^{199}\) Ghasb refers to taking something by force. It is different from sariqah (theft) in the sense that a thief takes something inconspicuously while in ghasb it is done blatantly.

**Ta’wil Based on Hikmat Tasyri`iyyah**

*Ta’wil* (interpretation) based on *hikmat tasyri`iyyah* (secrets and reasons for a ruling) is very important. Prof Dr Fathi al-Duraini stressed that *ta’wil* based on *hikmat tasyri`iyyah* is stronger and more correct because a *mujtahid* uses his understanding to apply the secrets and intentions to be achieved by a *nas* in implementing a ruling. Therefore, it does not mean that we have digressed from a certain *dalil* but that we understand the actual intentions of the *nas* more comprehensively.\(^{201}\)

In the context of a market, if viewed from the angle of *hikmat tasyri`iyyah*, the stock index futures will create *maslahah* to the trader (investor) in particular and to the economic system in general as it acts as a hedging instrument.

**‘Urf Iqtisadi Khas**

‘*Urf* are common practices recognised by the local people in their daily lives be they in action or words. The composite index futures contract is an instrument that can be used by fund managers, underwriters and market players to transfer market price risks. In principle, it is a valid *‘urf iqtisadi khas* (common practices specifically occurring in economic activities) that does not contradict the Shariah principles. What needs to be corrected is that the index component must consist of securities that are Shariah compliant. This is overcome by the establishment of the Shariah Index.

**The Mal Concept**

The recognition of *mal* is important to determine whether something can be traded. Imam Al-Suyuti outlined the *mal* concept as something that has a value that can be bought and sold, and can be compensated for its damage.\(^{202}\)

Based on this guideline, the status of a futures contract as *mal* is confirmed. This is because it has a value within a specific period and is traded in its own market. It also fulfils *haq maliy* in Islam. In the instance of *‘urbun* (deposit),\(^{203}\) for example, *haq maliy* is limited until the maturity date where, if it is not

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\(^{201}\) Al-Duraini, Al-Manahij al-Usuliyyah, p. 208.


\(^{203}\) ‘Urbun refers to deposit. See Nazih Hammad, Mu`jam al-Mustalahat, p. 196.
utilised before that date, the right no longer has value. Likewise in a composite index futures contract, it is of value until the maturity date, after which the contract cannot be traded. However, the holder of the contract still benefits from the difference in the buying and selling price upon maturity.

204 Ibn Qudamah, Al-Mughni, vol. 4, pp. 312–313.
ISLAMIC BENCHMARK BOND

RESOLUTION

The SAC discussed this in a series of meetings and, at its 8th meeting on 9 June 1997, agreed to the structuring of the Islamic benchmark bond, also known as the Khazanah Bond. This bond is structured based on murabahah principles.

INTRODUCTION

The main function of the Khazanah Bond is not to raise capital or to finance a certain project but is created specifically as a benchmark for corporate bonds to be issued.

The murabahah principle is used in structuring the Islamic benchmark bond. This principle can be applied as it fulfils the features of a benchmark bond. Several main features are essential for an Islamic benchmark bond to be issued:

(a) The bond is liquid, that is, it can be traded actively in a secondary market;
(b) The bond will be issued in series and frequently;
(c) The returns from the bond must be made known; and

205 It is not a Shariah criteria.
(d) The returns from the bond are determined by the market.

In this context, the Khazanah Nasional Bhd (KNB) was found to be a suitable corporate institution for issuing the bonds. It is a government corporation that manages the assets of the Malaysian government.

Under this concept, KNB will sell its Shariah-compliant assets to investors for cash, and buy them back at a higher price on a deferred basis.

What is interesting about the Islamic benchmark bond is that the asset buy-back price through the *murabahah* way is predetermined by KNB but the cash price or selling price (cost to the investor) will only be known through a tender process by bidding using the *bai` muzayadah* principle (bidding or bargaining). After the bidding is carried out, the cash selling price and buy-back price through *murabahah* for trading the KNB assets are agreed upon by both parties. This agreement is called *ittifaq dhimni*. The cash selling price is lower than the buying-back price as the latter has already included profits to the investor. For example, if the cash selling price for the investor is RM90 million and the buy-back price from the investor five years later is RM100 million, this means that the investor receives a profit of RM10 million. This trading is then structured into securities to enable it to be a capital market instrument.

**ARGUMENTS THAT SUPPORT THE PERMISSIBILITY OF AN ISLAMIC BENCHMARK BOND**

An Islamic benchmark bond is regarded permissible based on the following arguments:

*Siyasah Iqtisadiyyah Principle*

The SAC resolved that a benchmark used as a guide in price determination does not contradict Shariah based on *siyasah iqtisadiyyah* which is an economic ruling. It acts as a reference for determining the price level in a more systematic way and consistent with prevailing market conditions. An appropriate price level is an important feature of an Islamic market as underlined by the principle of *istiqrar ta`amul*. In general, this principle emphasises the importance of a market that operates smoothly based on the mutual agreement of buyers and sellers, resulting from a system that is
transparent, fair and efficient, and with market integrity. Hence, participating individuals will not be ignorant of the market and will be able to facilitate trading activities to fulfil their needs.\(^{206}\) To achieve this, Islam defined the principle of *ghalat*\(^ {207}\) and prevented the occurrence of *gharar*. With the establishment of benchmark, the uncertainty of pricing is minimised and the market is made more transparent and efficient.

**The Murabahah Principle**

The principle involves an *`aqd* for buying and selling assets whereby the price which includes a profit margin is agreed upon by both parties (the buyer and seller). This concept is appropriate in structuring an Islamic benchmark bond as the profit in selling the asset has been predetermined. The price of the issued bond and yield to be earned will be determined based on the total assets transacted and the *murabahah* profit.

**The Bai` Dayn Principle**

After the buying and selling of assets have been concluded according to *murabahah*, the Islamic debt securities can be structured and sold in a secondary market according to the principle of *bai` dayn*. The SAC, at its 2nd meeting on 21 August 1996, agreed to accept the principle of *bai` dayn* as an instrument for the Islamic capital market.\(^ {208}\)

In the context of the Islamic benchmark bond, the KNB will sell its assets in cash to a principle dealer (PD)\(^ {209}\) and buys them back on *murabahah*. The *murabahah* price which is paid in instalments is a right to the debt for the PD. This right is *haq maliy* or the right on an asset that can be traded.\(^ {210}\) The right to the debt which is in the form of *syahadah dayn* (debt certificate) can be used to obtain cash by redeeming it from the debtor upon maturity. This *syahadah dayn* complies with *mal* according to a majority of Islamic jurists\(^ {211}\) and can be traded.

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\(^{207}\) *Ghalat* outlines the mistakes that should not happen to parties that have performed *`aqd* to build confidence in the market.

\(^{208}\) See resolution on *bai` dayn* for further details.

\(^{209}\) Principal dealer is a financial institution authorised by the central bank to deal in debt securities, such as government and private debt securities.


According to the Syaf`i’i Mazhab, a debt that is to be sold to a third party must comply with several basic regulations as follows:

(a) The debt must be the result of trading activities permissible in Islam and the ‘aqd must be legal according to Shariah; and

(b) The debt to be sold must be a debt of quality, i.e. guaranteed to be safe and has a low risk of default. This is in the interests of the investor.\(^\text{212}\)

In this context, the Islamic benchmark bond that is issued through the KNB, fulfils both criteria above. This is because the KNB has a sound credit rating supported and guaranteed by the Malaysian government.

**The Bai` Muzayadah Principle**

The Islamic benchmark bond is also intended to be a benchmark for the current value of an asset and also the profit level. In this context, the principle of *bai` muzayadah* can be applied. It refers to the action of the seller offering his products in the market followed by the demand of several buyers competing to offer a higher price, which results in the seller selling the product to the highest bidder. The SAC resolved that *bai` muzayadah* is permissible (please refer to the resolution regarding *bai` muzayadah*). This is based on a practice of the Prophet s.a.w. himself. Imam Bukhari has dedicated a specific topic that explains the permissibility of such trading.

This principle allows the market player to obtain the true market value of the assets sold. As many financial institutions are willing to buy the assets in cash, KNB will open tenders for the purchase of the assets. KNB will choose the best price offered at the lowest cost and with high liquidity.

**The Ittifaq Dhimniy Principle**

*Ittifaq dhimniy* refers to a tacit understanding that exists before a contract is sealed. The seller and buyer have made a prior agreement to sell the asset at a certain price and to buy it back at a certain price. In this context, the PD who has succeeded in securing the tender will buy the assets that have been

\(^{212}\) Al-Syirazi, *Al-Muhazzab*, vol. 1, pp. 262–263.
bidden on. This refers to the tacit understanding in a sale and purchase transaction, in accordance with *muzayadah* trading. It is likely that in the context of forming an Islamic benchmark bond, there is more than one PD successfully buying the assets. Therefore, several PDs will be partners in buying the assets according to their allotment.
FINANCE LEASE AND OPERATING LEASE

RESOLUTION

The SAC, at its 14th meeting on 7 May 1998 resolved that rental payments from finance leases and operating leases are Shariah-compliant products if they are free of any element of penalty.

INTRODUCTION

Finance lease facilities are usually given by finance companies registered with Bank Negara Malaysia. Most of these companies are subsidiaries of financial institutions. There are also other non-finance lease companies which offer leasing facilities commonly known as operating lease. Operating lease services can be slightly different from that of finance lease services in that an operating lease does not offer an option to customers to buy the leased assets at the end of the period.

In calculating the lease rental, the approach adopted by the finance leasing and operating leasing companies is similar, that is based on the value of asset being financed, rate of charge or returns and the period of financing.

In general, the penalty rate on late payment is high. This payment charge is imposed to discourage late payment by customers as well as to prevent leasing companies from being exposed to losses due to opportunity loss.
THE IJARAH PRINCIPLE: COMPARISON OF FINANCE LEASE TO OPERATING LEASE

From research carried out, the SAC resolved that finance lease and operating leases are permissible. This is based on the following:

The Ijarah Principle

The mechanisms that are almost similar to finance leases and operating leases in daily practices are *ijarah* and *ijarah thumma bai*. Other terms used are *ijarah wa iqtina* and *ijarah muntahiyah bi tamlik*.

The concept for finance and operating leases without the late payment clause is no different from *ijarah* and *ijarah thumma bai*. In an operating lease, the lessee has the right of utilising the assets within a specific period as agreed to in the contract. As a consumer of the assets, he is required to pay for the consumption within a certain period, whereas ownership of the assets is still under the jurisdiction of the lessor.

The principle is similar to *ijarah* as the assets can benefit the lessee (*musta’jir*) within a certain period for a certain sum agreed on. Meanwhile, the assets still belong to the original owner (*mua’jjir*). The *musta’jir* only has the right to benefit from the assets. However, the Islamic jurists still include *ijarah* in the category of buying and selling (*bai*). The item traded is a benefit which is the right to use the asset.\(^{213}\) It is to be understood that Islamic jurisprudence recognises the right as *mal*.

The basis of finance lease is similar to *ijarah thumma bai*. This mechanism is a development of the principle of *ijarah* which is in the nominee contract as it is more of a financing feature. Unlike the first instrument, it gives a choice to the *musta’jir* at the end of the *ijarah* period whether to buy the asset or to dispose of it. If the *musta’jir* chooses to buy the asset, a new contract will be drawn up.

The SAC then resolved that finance and operating lease activities without the penalty clause do not contradict the Shariah as they are similar to our daily practices of *ijarah* and *ijarah thumma bai*.

Penalty

Regarding the penalty on late payment for finance and operating leases, the SAC at its 20th meeting on 14 July 1999 agreed to accept the resolution of the SAC of Bank Negara Malaysia. The resolution allowed only one per cent penalty rate to be imposed on late payment and the calculation of the penalty is not based on compounded value. Based on the resolution, the SAC resolved to take into account the difference between penalty rates imposed by a company that provides finance and operating lease facilities with a permitted penalty rate of one per cent.\(^{214}\)

\(^{214}\) See SAC resolution on penalties for further details.
PREFERENCE SHARES

RESOLUTION

At its 20th meeting on 14 July 1999, the SAC resolved that the basic preference share (non-cumulative) is permissible based on tanazul.\textsuperscript{215}

INTRODUCTION

A preference share is among hybrid instruments that combine equity and debt in a capital market. It is in the form of hybrid equity which allows its holders to receive a fixed dividend not enjoyed by ordinary shareholders. Usually, this fixed dividend is described as a percentage of the nominal share value.

The \textit{Companies Act 1965} defines preference share as a share that does not give a right to the shareholders to vote at its general meeting or any right to participate in any distribution of the company that is above the stated amount, whether through dividends or redemption, dissolution or otherwise.\textsuperscript{216}

There are many forms of preference share in the market, among which are:

- Redeemable preference shares;
- Participating preference shares;
- Cumulative preference shares;

\textsuperscript{215} Tanazul means to drop claims to right.
\textsuperscript{216} Companies Act 1965, section 4.
(d) Convertible preference shares;

(e) Increasing rate preference shares; and

(f) Perpetual/irredeemable preference shares and non-cumulative preference shares.

The SAC carried out studies on non-cumulative preference shares. It refers to preference shares whose period of holding by the investor is permanent and similar to ordinary shares except that dividends are fixed and non-cumulative. It has features similar to those of an ordinary share – no maturity date and non-cumulative dividend payment. Non-cumulative preference shares are included in the classification of equity with fixed dividends.

**ARGUMENTS THAT SUPPORT THE PERMISSIBILITY OF PREFERENCE SHARES**

The SAC ruled that non-cumulative preference shares are permissible based on *tanazul* where the right to profit of the ordinary shareholder is willingly given to a preference shareholder. *Tanazul* is agreed upon at an annual general meeting of a company which decides to issue preference shares in an effort to raise new capital. As it is agreed at the meeting to issue preference shares, this means that ordinary shareholders have also agreed to give priority to preference shareholders in dividing the profits, in accordance with *tanazul*.

In the context of preference shares, *tanazul* means surrendering the rights to a share of the profits based on partnership, by giving priority to preference shareholders. It is also known as *isqat haq*\(^\text{217}\) in Islamic jurisprudence.

\(^{217}\) *Al-Mausu’ah al-Fiqhiyyah*, vol. 4, pp. 226–256.