BOOK REVIEWS

Derivatives in Islamic Finance: Examining the Market Risk Management Framework

Sherif Ayoub
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1. INTRODUCTION

According to the economic doctrine of the *Sharia'ah,* Islamic finance is a normative and mainly prohibition-driven discipline based on three main pillars: prohibition of *Riba* (usury),[1] *Gharar* (excessive uncertainty), and *Maysir* (gambling). A majority of conventional derivative instruments are dismissed by Islamic finance scholars, standard setting institutions, and Islamic finance boards by resorting to these three general prohibitions. This book provides a revisionist approach to Islamic finance by defending and providing evidence for the permissibility of the use of derivative instruments within the market risk management framework in Islamic finance. It is an attempt to reconcile the risk management demands of the modern business world with the rigid prohibition-driven stance of the majority of *Shari'ah* scholars on derivative instruments. This is undertaken by sketching out the main arguments made by prominent Islamic scholars in rejecting the use of derivative instruments in Islamic finance, by patiently replying to those objections, and by proposing adjustments to conventional economic theory, so that it can make inroads into Islamic finance.

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1 Although throughout the book the concept of *Riba* is assumed to be the equivalent of usury, the two concepts are not necessarily the same. *Riba,* which is also not the same as interest, is defined as "trading two goods of the same kind in different quantities, where the increase is not a proper compensation". See Abd al-Rahman Al-Jaziri, *Al-Fiqh 'Ala Al-Madhahib Al-Arba'a* (Cairo: Dar Ihya' Al-Turath Al-'Arabi, 1986).

2. SUMMARY OF THE BOOK

The book consists of eight chapters, including introductory and concluding chapters. The first four chapters lay the groundwork for putting the main arguments of the book in context. Indeed, the author exhibits a deep knowledge of modern conventional theories of economics, finance, and Islamic finance. These chapters discuss the theoretical underpinnings of market risk management techniques and strategies in conventional finance with a particular focus on the role of derivative instruments. Though helpful for the uninitiated, reading the first four chapters of the book may not be overly helpful for those who already have a basic understanding of (Islamic) finance.

The second chapter entitled "Truth Formation in *Mua'amalat* [dealings between individuals, or transactions]", which is mainly focused on philosophical issues that are hardly relevant to those discussed in the rest of the book, appears superfluous. Neither is the content of this chapter referenced later in the book, nor does the chapter discuss *Mua'amalat* as the title suggests. Unless the reader is interested in philosophy or hermeneutics, s/he is advised to skip the second chapter.

The fifth chapter provides evidence for the permissibility of derivative instruments by introducing them as powerful tools for hedging market risks in a manner that does not involve *Riba* and *Gharar*. The sixth chapter argues, and provides evidence, for the permissibility of the financial instruments with monetary benchmarks as underlying variables. The seventh chapter, which is the final conceptual chapter, argues that not only do derivative instruments not give rise to *Maysir*, but also that, since they are tools for hedging market risks, they play an important role in reducing uncertainty.

3. CONVENTIONAL ECONOMIC THEORY AND ISLAMIC FINANCE

The book's main contention is that risk management is generally encouraged in Islamic finance. Indeed, large sections of the book are dedicated to demonstrating that the prevailing views in Islamic finance in favor of prohibiting derivative instruments are not well supported in Islamic thought and jurisprudence. Hence, swimming against the tide, the book takes the stance that *market risk management with derivative instruments* should be encouraged in Islamic finance. In justifying its position, it sheds light on many controversial aspects of Islamic finance by applying conventional economics and finance reasoning to the realm of derivatives transactions in Islamic finance.

The book provides an intriguing discussion about the blanket prohibition of derivative products in Islamic finance. The prevailing traditional view in Islamic finance holds that most derivative instruments should be prohibited because of the Islamic prohibitions on *Riba*, *Gharar*, and *Maysir*. One of the greatest success stories of the book is that it clearly shows why none of those three concerns should be an impediment to using derivatives employed in the market risk management context.

Regarding *Gharar*, the book shows that not only does the use of derivatives not give rise to *Gharar*, but also, with increased standardization, technological advances, and better market infrastructure (existence of central counterparties), using derivatives substantially reduces uncertainty. With regard to *Riba*, it shows that conventional derivative instruments should not be viewed as debt instruments, and hence the concern about *Riba* is largely unfounded. With respect to *Maysir*, the book illustrates that, although some derivative instruments can be used for gambling, and despite the difficulties in distinguishing the use of derivative instruments in gambling versus hedging, prohibiting all derivative instruments to prevent gambling is akin to firing a cannon to kill a mosquito. Besides, the book rightfully argues that those who wish to engage in transactions involving *Riba*, *Gharar*, and *Maysir* would find ways to do so despite the prohibitions on derivative instruments, not because of the existence of such financial instruments.

Arguments used in favour of the permissibility of derivative instruments have immensely benefited from the application of conventional theories of economics and finance to Islamic finance. This can be a virtue as well as a vice. It is almost a forgone conclusion that, on purely secular grounds, the underpinnings of Islamic finance would not stand the excruciating scrutiny of the scientific methodology adopted in conventional finance theories. However, within the ideological framework of Islamic finance, in which derivative products are almost indiscriminately prohibited, the application of finance theory to Islamic finance should not overlook the challenge in Islamic finance and jurisprudence that lies in the tradeoff between efficiency and legitimacy. Although efficiency is all that matters in conventional finance theory, there are other normative considerations in Islam that might support forgoing efficiency gains for the sake of legitimacy. The book argues for an efficiency-centered reading of Islamic finance, but at least theoretically, it fails to provide sufficient evidence to demonstrate that the foundations of Islamic finance are laid on the concept of economic efficiency, be it a Pareto or a Kaldor-Hicks improvement.

By venturing into offering a new perspective on Islamic finance with the concept of efficiency at its heart, the book reduces the concept of legitimacy to efficiency and ultimately metamorphosizes Islamic finance from an ideological discipline into a purely rational discipline dominated by the concept of economic efficiency. Needless to say, such a revisionist approach would require a fundamental deontological, and perhaps ontological, shift in Islam and its approach to transactions, contracts, and finance.

4. ISLAMIC FINANCE FROM FORM TO SUBSTANCE

An additional commendable contribution of the book lies in its attempt to highlight the importance and primacy of substance over form. The move away from the form to the substance of transactions makes Islamic finance adhere to the spirit of the Islamic law rather than to the legalistic and juristic constructs that present the prohibited products of conventional finance in Islamic finance's

clothing. Such an approach is essential to salvaging Islamic finance, which is hamstrung by the transaction costs imposed by *Shari'ah* arbitrage modes of contracting and financing.

In putting substance over form, the book offers a reading of the primary sources of Islamic jurisprudence to pave the way for the supremacy of substance over form. It further questions the underpinnings of the tendency in Islamic finance scholarship to find nominate contracts in the classic Islamic legal texts for each conventional finance product. It delicately illustrates that the search for nominate contracts has its roots in the fact that modern Islamic finance is built on the Islamic theory of *Qiyas* (analogical reasoning) focused on finding analogues to modern financial instruments in the commercial practices of the early Muslim community. To help support such a shift from form to substance, the book advocates a paradigm shift in Islamic finance from its supreme emphasis on the legal constructs in the interpretation of scripture to giving more weight to economic theories.

Indeed, this might be the only way forward for Islamic finance to rid itself of the shackles of strict adherence to form rather than substance. However, this revisionist approach to Islamic finance requires a paradigm shift. The springboard for such a great leap is set by "the possibility of adopting . . . a pragmatic utilitarian approach to *Shari'ah* rulings within the realm of *Mua'malat* (i.e., not *Ibadah*, or worship) in a manner that promotes social welfare through the maximisation of societal benefits and the reduction of harm".[2]

By advocating such a paradigm shift, the book walks a tight rope in reconciling the implications of a pragmatic utilitarian approach with those of the ideological Islamic approach, even in the realm of financial transactions as opposed to that of worship. Reconciling these often conflicting implications of utilitarianism with so-called Islamic economics or Islamic jurisprudence could be an impossible mission, and it is not surprising that, despite taking bold steps in introducing pragmatic utilitarianism in Islamic finance, the book leaves the reader with many unanswered questions. For example, if pragmatic utilitarianism, by which the author seems to mean the new classical economics framework, is used to justify all financial products that are at large, why should the reader be convinced that there should be something called 'Islamic finance'? In other words, in an attempt to justify the derivatives contracts in a detailed fashion, the book fails to see the forest for the trees; because it delves deeply into the details of derivatives contracts, it loses sight of the big picture and overlooks the broader implications of its analysis for the very existence of Islamic finance. Indeed, holding such a stance of Islamic finance will subsume Islamic finance in conventional economics and finance.

Applying a pragmatic utilitarian approach to the realm of transactions (*Mua'malat*) is likely to debunk the entire edifice of Islamic finance, mainly because, by its nature, Islamic 'finance' is all about 'transactions' and has no

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2 Sherif Ayoub, *Derivatives in Islamic Finance: Examining the Market Risk Management Framework* (Edinburgh: Edinburgh University Press, 2014) at 197.

bearing on 'worship'. Although the reader may comfortably follow the author throughout the book in applying the concepts of conventional finance theory to Islamic finance, at the end of the book, the reader may find himself in a moment of anagnorisis by suddenly discovering that Islamic finance, like Wile E. Coyote, has already run off the cliff and there is nothing 'Islamic' to which it can cling. Hence, one of the failings of the book is that it does not explain what remains of the adjective 'Islamic' in the term 'Islamic finance' after the application of a pragmatic utilitarian approach.

In the end, in its quest to apply conventional finance theory to Islamic finance and its unequivocal support of conventional economics and finance literature, the book has little, if anything, to offer as to why Islamic finance should exist in the first place. Ultimately, adopting the approach advocated by the author will make Islamic finance a discipline devoid of any substantial differences between Islamic financial products and those of the conventional finance, rendering all the detailed hair-splitting between Islamic finance and conventional finance mere distinctions without differences.

5. CONCLUSION

The book is an ambitious attempt to reconcile traditional Islamic finance with conventional finance theory, to emancipate Islamic finance from puritanical readings and the strict juristic shackles of Islamic jurisprudence, and to revive it by benefiting from the insights of conventional finance theory. In other words, the book is an extended version of Luther's proverbial response to a Christian shoemaker suggesting that a Muslim risk manager serves God best by making 'good' rather than 'Islamic' financial instruments for risk management purposes.

Overall, the book has taken up a brave undertaking in analyzing derivatives contracts and is a passionate and reasoned defense of the use of derivatives contracts in Islamic finance. Indeed, the insights of the book could immensely benefit lawyers, policy makers, Islamic jurists, scholars of Islamic finance, as well as Islamic finance practitioners. The book might not be very warmly received in the Islamic finance forums, but that should not be viewed as a shortcoming. Rather, Islamic finance needs a self-reevaluation, especially in the methodology to which it adheres, to bring itself into line with the needs and requirements of modern day businesses. The suggestions made in the book are indispensable to this self-reevaluation and the long-term sustainability of Islamic finance, but, having applied those suggestions, an impartial spectator would rightfully wonder whether Islamic finance has any clothes.