

# **Urbun Call Options: A Proposal for an Islamic Risk Management Tool**

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## **Abstract**

An option is a derivative which is not allowed by Islamic Fiqh Academy of OIC (Organization of Islamic Countries) due to its speculative nature and the premium fee charged. However, the idea of options as a hedging instrument in the financial industry to cater the sales and purchase of goods of the Islamic countries should not be entirely neglected especially when the financial system is not one hundred percent free from the element of *riba*, *maysir*, and *gharar*. In order to safeguard the *maslahah* of the ummah, a proposed call options using the application of Urboun is put forward in this paper. This suggestion is made based on the Islamic Fiqh Academy's approval of urbun sale. With the application of urbun sale contract on call option, it is hoped that the disapproved aspect of conventional call option would be eliminated.

Keyword: *Islamic Financial Instruments, Options, Urbun.*

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## **A. Introduction**

Currency or money is an important aspect in our life because it facilitates trade activities, payments of debts and zakah, and measures of values or units of account and as storage of values. The purpose of currency trading is for three reasons which namely sale and purchases of currency, a) to settle international payments, b) to hedge against market volatility and c) to make profits (Saiful Azhar, 2005, pg 565).

The evolution of the economic system from barter trading to the uses of bimetallic and fiat money (paper money) as a medium of exchange shows that the process of civilization, modernization and the fallen of a society do have strong connections with monetary stability.

The Origins of Money as stressed by Glyn Davies (2002) are:-

- Money did not have a single origin but developed independently in many different parts of the world.
- Many factors contributed to its development and if evidence of what anthropologists have learned about primitive money is anything to go by economic factors were not the most important.
- Money performs a variety of functions and the functions performed by the earliest types were probably fairly restricted initially and would NOT necessarily have been the same in all societies.
- Money is fungible: there is a tendency for older forms to take on new roles and for new forms to be developed which take on old roles.

It is clear about the permissibility of the usage of fiat money in the current economics system but Umar Vadillo to name one, issued a controversial decree stating that the existing fiat money is not in accordance to Shariah principles since it promotes injustice and riba and needs to be reconsidered. He suggested that the Muslims to use the gold dinar and silver dirham, as the bimetallic currencies, which have intrinsic value as these currencies were accepted during Prophet Muhammad saw time.

Nevertheless, the OIC Fiqh of Academy has issued a decree on the permissibility of using paper money as currencies as long as it adheres to the strict rules and regulation regarding to the sale and purchase of sarf. Mohamed Sharif (2006) mentioned that the currency is not a shariah matter because it is based on nuqud. The OIC view is used throughout the discussion in this paper to avoid any misunderstanding and misconception on the derivatives.

Derivatives such as Forwards, Futures and Options are instruments that are widely used for hedging and speculating. The currently practices of futures and options derivatives

are not in accordance to the shariah laws. Futures and Options are derivatives, which values derive from other financial products. On the other hand, options are yet too speculative, which involve gharar and maisir, which are not in accordance to the shariah laws (Nuradli R.S and Sanep Ahmad 2006). However, there are two forward products which have been developed - the Tawarruq Murabahah Forward Delivery and Tawarruq Salam Forward Delivery. Nevertheless, the development of the Islamic contract for option is still debatable. In the light of future financial instruments, the contract of sulh and jaa'lah could be used as an alternative to conventional future. However in this paper, the discussion on option will be discussed as for the futures will be discussed in a subsequent forthcoming paper.

## **B. Literature Review**

Derivatives as a whole from Islamic perspective are an issue which many ulama' have different opinions on its permissibility. They have their own different reasons for approving and prohibiting such contracts except for Salam contract (Nuradli R.S & Sanep Ahmad 2006). Obiyatullah Ismath Bacha, (1999) reviewed the evolution of modern financial derivatives and its needs, urged the Islamic scholars to do some rethinking and evaluation (Obiyatullah, 1999). He explained the instruments in details by laying out critical issues on why the Islamic communities need these instruments in the market place as well as highlighting several consequences that would affect the Islamic business if these instruments were ignored (Obiyatullah, 1999).

Mohammed Obaidullah (1999) has laid out that futures and options are prohibited with emphasis on the definition of sarf from two different points of views. The first view stated that only gold and silver would be governed in the rules of bai as-sarf while the fiat or paper currencies did not fall into bai-sarf category. He cited Ibnu Taymiyah definition of sarf, as gold and silver could perform as a medium of exchange and the fiat money was not considered as sarf or currency. Therefore selling and buying fiat money with other fiat money with deferred delivery if the currencies are not made of gold and silver is acceptable because fiat money is not categorized as sarf (Mohammed Obaidullah 1999). However in this current economic system, if this view is apprehended, lending fiat money with interest is acceptable which will have a major implication on the Islamic banking system especially and Islamic jurisprudence generally.

The contemporary view states that fiat or paper currencies fall into *bai al-sarf* category therefore deferring delivery is *riba* (Obaidullah, 1999). This is also supported by the decree issued by the OIC Fiqh academy regarding bay' al-sarf. Another prominent Islamic scholar, Monzer Kahf also prohibits the sale of currency with deferred delivery. This view is more practical in the current system and in the light of the economic development of the ummah. However, it is undeniable that the use of gold and silver as medium of exchanges could promote economic stability. Therefore research on its impact on the economic social order and comeback should not be ignored.

## Options

Options are a more complex financial derivative instruments compared to forward and futures. The instruments give the buyer and seller the rights or option to withdraw from the agreement of sale and purchase. In other word, option is the right to buy or sell a certain amount of an underlying financial asset at a specified price for a given period of time. Basically there are two basic types of options, which are called option and put option. A call option is the buyer's right to buy or not to buy an underlying asset from a seller. In contrast, put option is the seller's right to sell or not to sell an underlying asset to a buyer. A certain premium fee is charged to the buyer or seller in order to have the right whether to buy or not to buy for call option or to sell or not to sell for put option. The major indicator that influences on the behaviors of the options players is the price movement of the underlying assets.

As the resolution of the Islamic Fiqh Academy, Jeddah asserts "Option contracts as currently applied in the world financial markets are a new type of contracts which do not come under any one of the Shariah nominate contracts. Since the subject of the contract is neither a sum of money nor a utility or a financial right which may be waived, the contract is not permissible in Shariah." (Obaidullah, n.d.).

For a call option, the buyer will exercise the rights if the underlying asset price increase and in the put option it work in reverse. Mufti Taqi Usmani prohibits options on the basis of the fee charge for the promise and not because of the promise (International Journal of Islamic Financial Service, 1999). The promise is permissible according to shariah perspective for call and put options.

It is a promise from a party to another party to buy or sell his/her property in a future date. The problem in options is the premium fee that is imposed on the promise, which makes the contract invalid.

### ***‘Urbūn*<sup>1</sup> Sale in Islamic Jurisprudence**

Urbun is a sale where the buyer pays a deposit (earnest money) to the seller; if the sale proceeds, the deposit is considered as a part of the price, but if the sale recedes, the deposit is for the seller (as gift). This type of sale is controversial and the Islamic jurists are of different opinions with regard to its validity. The discussion can be summarized in the following points:

1. *al-Hanafiiyyah, al-Malikiyyah, al-Shafi’iyyah*, Abu al-Khattab from *al-Hanabilah*, Abdullah Ibn Abbas and al-Hasan consider the urbun sale as void as it is narrated by Amru’ Ibn Syu’aib that “The Prophet (Peace Be upon Him) forbade (us) from the sale of *urban*”<sup>2</sup>. The sale also constitutes elements

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<sup>1</sup> It is also called as *‘arabūn* and *‘urbān*.

<sup>2</sup> This hadith was narrated by Abi Dawud dan Ibn Abi Khaythamah with a good chain of narrators (*sanad hasan*). There are other 9 narrations from the hadith books with a weak chain of narrators (*sanad dhaif*).

*gharar, maysir*, two invalid conditions, one unfair stipulation, illegal taking of other's property and unspecific *khiyar*.

2. *al-Hanabilah*<sup>3</sup>, Muhammad Ibn Sirin and Ibnu Umar approve the sale of urbun based on the practice of Umar al-Khattab. He once appointed Nafi' Ibn al-Harith to buy a house from Safwan Ibn Umayyah in Mecca to be converted into a prison for 4,000 dirhams. Safwan asked Umar for a deposit of 10% (400 dirhams) and laid down a condition that the deposit would be his if Umar terminated the contract. Umar agreed to the condition.<sup>4</sup> The proponents also insist on the weakness of hadith prohibiting urbun sale. Furthermore, this type of sale consists of mutual benefit and interest (*maslahah*) for the contracting parties and it is very much similar to option of condition (*khiyar al-sharh*).

Going through the discussions of the jurists on the status of urbun sale, al-Shawkani asserts on its invalidity due to the various narrations of prophet's prohibition by hadith scholars. Even there are claims that these chains of narrations are weak, yet it becomes strong as the chains are supporting each other. In the other hand, Adnan al-Ahmadi has concluded that the supporting arguments are stronger and thus, urbun sale is permissible. Contemporary scholars such as Yusuf Qardawi, Mustafa al-Zarqa and Hashim Kamali also have authenticated and approved urbun sale. Wahbah in his opinion states that Urboun is permissible on the basis that it has been a customary and the hadiths from both oppositions are weak (Wahbah al-Zuhaili,(a) pg. 462, 1995). Additionally, in the Malaysian context, the Syariah Advisory Council of Securities Commission has passed a resolution permitting the sale of urbun to be applied in the Malaysian Islamic financial markets.

Islamic Fiqh Academy of OIC has approved Urbun sale with the following conditions:

1. The time frame of the contract should be predetermined.
2. The urbun deposit is considered as part of the selling price if the purchase is carried through.
3. It is not applicable in the sales which stipulate the reception of either of the two elements of exchange in the contract setting i.e. the salam sale; or the reception of the two elements of exchange in the contract setting i.e. money and currencies exchange.

Urboun or earnest deposit is suggested as a Shariah compliance alternative to the premium fee call options. The buyer will pay an earnest deposit for the call option and in the case of withdrawal; the deposit will be forfeited as a gift to the seller. If the buyer continues on the purchase then the deposit will be treated as the purchase price. For the seller, there will be no option for not to sell.

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<sup>3</sup> Imam Ahmad Ibn Hanbal approved the sale of Urboun based on the hadith narrated by Zaid Ibnu Aslam. Ibnu Qudamah, a hanbali scholar, states that Urboun must have time period in the contract to prevent *gharar*, conflict and uncertainty but Ahmad himself approved Urboun without any time period stipulating that both parties agreed to it in the contract.

<sup>4</sup> This athar was narrated by Abd al-Razzaq (Musannaf), al-Bayhaqi (Sunan Kubra), al-Azraqi (Akhbar Makkah) and al-Fakihi (Akhbar Makkah).

In a discussion forum published in the International Journal of Islamic Financial Service, Muhammed Shahid Ebrahim and Tariqullah Khan approve the usage of option while Mahmoud El-Gamal has an opposite view on its permissibility (International Journal of Islamic Financial Service, 1999). Muhammad Ayub states that modern options could not be found in any Islamic fiqh law since the modern financial transactions did not exist during the classical theory of fiqh. Furthermore khiyar could only take place for exchange transactions, which has taken place not as options, where payment and delivery will take place in the future (Muhammad Ayub, 2003).

With all the opinions from the distinguished scholars the views that approved the usage of Urboun will be used in developing call option only. Put option could not be integrated with Urboun since Urboun is a deposit to purchase whereas in put option the promise is to sell. The paper will discuss two parts, which are the domestic call option and currency call option.

### **C. Objective of the Study**

The objective of this study is to propose a call option using Urboun deposit for reconsideration and rethinking.

### **D. The Limitation of the Study**

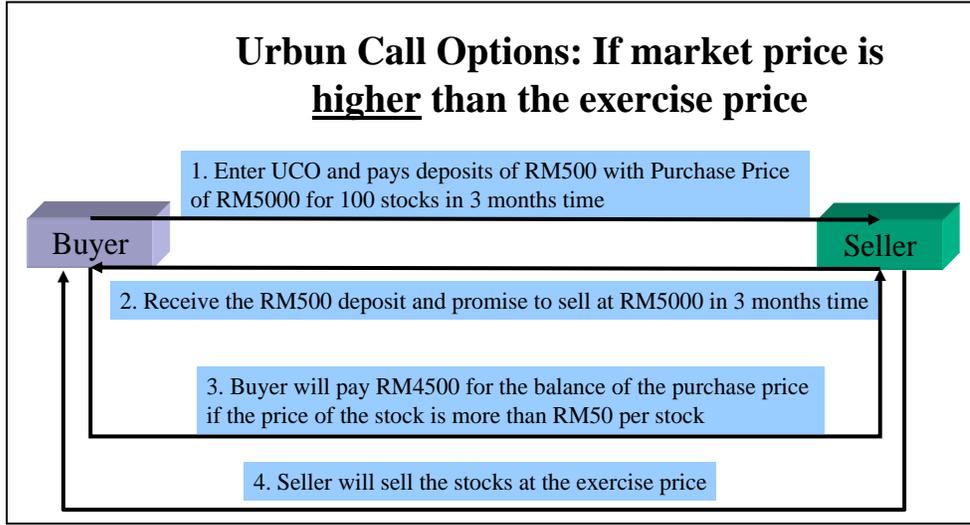
The research is only a proposal on the development of call option using Urboun deposits and it will need for authoritative Shariah scholars to evaluate on its permissibility. Therefore these theoretical frameworks would be useable if the Shariah scholars approved the usage.

### **E. Justification of the Study**

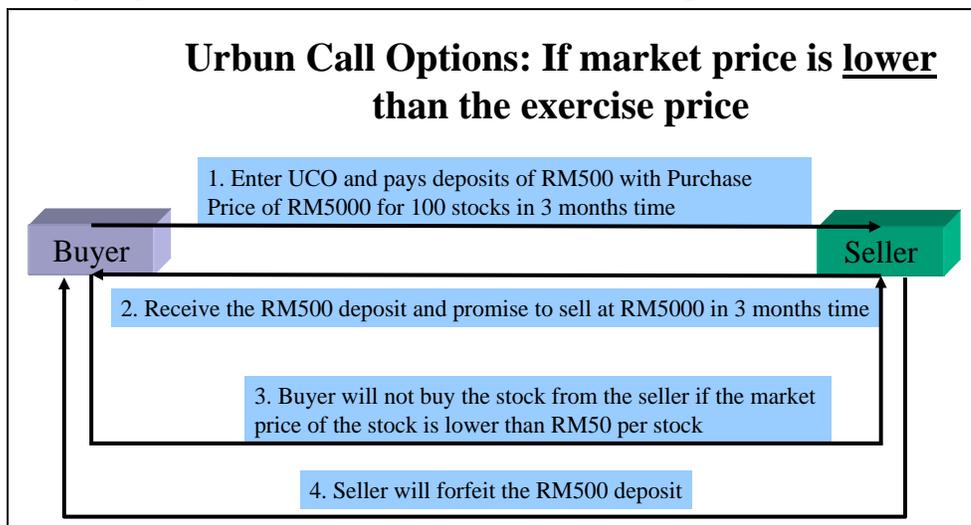
The product development would enrich the development of Islamic financial derivatives instruments literature for the development of the Islamic economy and the *maslahah* of the ummah.

### **F. Urboun Call Option (UCO)**

UCO would treat the premium paid by the buyer as Urboun or deposit. Since Urboun is a deposit, it will be treated as part of the purchase price when the UCO is exercised. This is different from the conventional options that treat the premium as a fee and it will not be included as part of the purchase price if the call options is exercised. The following diagram will be useful to illustrate the overall process of UCO if the market price is higher than the exercise price at the exercise date.

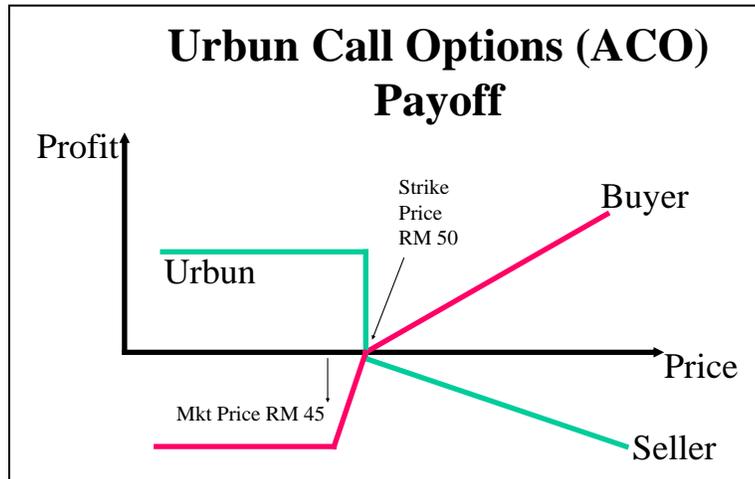


The buyer and seller will enter into an agreement or a promise to buy and sell. The buyer will pay the Urboun deposits of RM500 with the purchase price of RM5000 for 100 stocks. The exercise period is in 3 months time. The seller will receive the RM500 Urboun deposit and promise to sell to the buyer at RM5000 in 3 months time. At the exercise date the buyer will pay RM4500 for the balance of the purchase price if the market price of the stock is more than RM50 per stock. In this case he will buy at RM50 per stock and can sell the stocks at the market price. The profit that the buyer will make is the differences between the market price and the strike price. The seller will sell the stocks at the exercise price even though at the exercise date the market price is higher than the strike price. In the event of the market price is lower than the strike price, the following diagram would be best to illustrate the overall processes;



In the case if the market price is lower than the strike price, the buyer will not buy the stocks from the seller because it would be profitable for the buyer to buy from the market. However, the buyer might not be buying from the buyer only after the price of

the stock is at RM45 because the buyer will try to honor his promise to buy from the seller. But if the price is lower than RM45 the buyer will dishonor his promise and the seller will forfeit the RM500 deposit. The overall payoff diagram for the UCO is as follows:



The payoff diagram shows that if the price is higher than the strike price, the buyer will gain profit by buying from the seller and sell the stocks at the market price whereas if the market price is lower than the strike price the buyer will be loosing a gradually of its deposit by buying from the seller and selling the stocks at the market price or losing the amount of deposit if the price is lower than RM45.

### Currency Call Option

In the case of currency call option, the process is the same except that the buyer will have to convert his currency to the seller currency at spot and if his country's currency depreciates, he will be loosing the amount of deposit and if his country's currency appreciates against the seller currency then he will make profit.

From the fiqh point of view, it is impermissible to implement the urbun sale on the currency call option. This is due to the reason that the sale or exchange of currencies stipulates reception and delivery of the two elements of exchange in the contract setting (majlis). However, in an urbun sale, both of subject matter and price balance are deferred to a predetermined date. If urbun sale is implemented on the currency call option, the contract will be void due to the occurrence of *riba al-nasiah* (riba due to deferment). Creating underlying asset to validate currency call option may render to bay al-‘inah which is controversial.

## **G. Selected Shariah Issues Related to the Application of Urbun Call Option**

### **i. Selling of Urbun Call Option in the Secondary Market**

One of the controversial issues regarding the application of Urbun Call Option is its tradability in the secondary market from the *fiqh* perspective. This matter constitutes of three issues i.e. the nature of Urbun, pricing of UCO and selling of UCO to the third party.

#### **The Nature of Urbun**

The view of some Shariah scholars is that an option is a promise to sell or purchase a thing at a specific price within a stipulated time and such a promise in itself is permissible. The promise is also binding on the promisor. However, this promise cannot be the subject matter of a sale or purchase (Obaidullah, n.d.)

In other hand, a few studies consider right of selling (in options) is similar to *khiyar*. Since options involve a benefit (a right without obligation) for the purchaser, trading of such benefit (*manfa'ah*) is observed to be permissible. The Islamic Investment Study Group of the Securities Commission, Malaysia in its report finds call warrants to be acceptable because it "has the characteristics of an asset which satisfies the concept of "*haqq mali*" and "*haqq tamalluk*" which is transferable based on the view of majority *fugaha'* other than *Hanafiyyah*. Therefore this right can be classified as an asset and can therefore be traded (Obaidullah, n.d.).

#### **Pricing of Urbun Call Option**

In the application of conventional option, the fee is not considered as a portion of the purchase (exercise) price. Its price does not relate to the price of the underlying asset from the contractual point of view. However, in the proposed UCO, the urbun deposit will be treated as a portion of the purchase price for the underlying asset. It is stated previously that Islamic Fiqh Academy approves urbun sale with the condition that the urbun deposit is considered as part of the selling price if the purchase is carried through.

#### **Selling of UCO to the third party**

An Urbun sale is a sale contract between two particular buyer and seller. The seller is bonded to sell the specified subject matter to the specific seller. However, if the buyer sells his right to proceed (or recede) the contract to the third party, it can only be done with the consent of the seller.

From the authors' viewpoint, this practice could be approved based on the following arguments. Firstly, the first buyer sells his right which he has already

owned to the third party. As previously discussed, the buyer has the right to proceed or recede from the sale. However, this right is not for free, it is obtained with the advance of earnest money to the seller. Hence, it is not considered as a sale of non-possessed or non-existent asset. Considering the right as a non-physical asset such as goodwill and copyright, the sale of the *urbun* right to the third party could be approved under the light of the same arguments. Moreover, the sale of several *khiyarat* is permissible according to several jurists (Obaidullah, n.d.)<sup>5</sup>. If, as stated above, analogy can be made between options and *khiyar*, then, the majority of *fuqaha'* (Malikiyyah, Shafi'iyyah and Hanabilah) state that *khiyar* can be inherited. This proves that the ownership of *khiyar* is transferrable. Hence, it could be traded.

With respect to the consent of seller to proceed with the *urbun* sale with the third party, it could be stipulated upfront in the *urbun* sale contract that the buyer is entitled to sell his right to the third party and the contracting parties are bonded with any conditions laid down in the contract. This condition is permissible based on a Hadith narrated from the Prophet PBUH which stated that "Muslims are bonded with their stipulations except stipulations that permit unlawful matters or prohibit lawful matters".

## **ii. Speculative or gambling element of *urbun* call option**

There is no clear cut prohibition of speculation in Islamic jurisprudence unless if it refers to the meaning of *maysir* or *qimar* (gambling or game of chance). A situation whereby a trader makes bountiful gains as a result of a price increase following an increased demand is acceptable in Islam. What are clearly forbidden in Islam are fraud and manipulation (Securities Commission, 2002). From the authors' viewpoint, speculation is haram if it involves element of *gharar*, *ihthikar* and *al-najsh* from the speculators. However, if the speculation is based on adequate information and natural causes where the price is determined by market forces and free from any manipulation, it should be permissible. The most important matter is to ensure that trading activities in UCO is free from those prohibited elements.

With regard to the gambling issue, the authors insist that UCO is not an instrument for gambling as it is not a zero sum-game where the parties involved are in the situation of either win or loss. In a conventional option, the gains of the buyer are equal to the losses of the seller and vice versa. In UCO, the buyer of UCO could rescind the contract and purchase (sell) in the market, thereby not losing the profit potential. Thus, the *khiyar al-shart* could provide a benefit for the party holding the option at the cost of the counterparty. However, the shortcoming caused to the counterparty can be compensated in the form of higher contractual price and need not be paid separately upfront to the counterparty. While this is true, the fact remains that an overwhelming majority of

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<sup>5</sup> The authors do not come across the discussion on sale of *khiyarat* in the classical fiqh books.

transactions are speculative –with gambling element- and not for hedging (Obaidullah, n.d.).

## **H. Conclusion**

Although Urboun is debatable in Islamic jurisprudence but its application in developing options should be taken into consideration by the Islamic scholars as it would provide an alternative for the Muslim to hedge against the price movement of an assets or a currency. However, the development of UCO would be beneficial if the speculative element, which is similar to *maysir*, could be avoided in order to provide a win-win situation for both parties: the buyer and the seller. More studies on the Islamic contracts and their risk management features should be carried out to develop more Islamic risk management tools in an Islamic framework.

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