

**EXPLORING FINANCIAL DERIVATIVES THROUGH SHARIAH PRINCIPLES:  
IDENTIFYING PARALLELS IN ISLAMIC JURISPRUDENCE AND MODERN FINANCE**

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<b>Abstract</b>	<p><i>This paper analyzes the key features of financial derivatives and explores their compatibility with Shariah principles by comparing them with contracts in Islamic jurisprudence, such as salam, istisnā', and wa'd. The study highlights how these Islamic contracts align with the underlying functions of conventional derivatives, while avoiding prohibited elements such as gharar, ribā, and qimār/maysir. It employs a qualitative, document-based analysis, using a doctrinal approach to assess the feasibility of adapting conventional derivative instruments within a Shariah-compliant framework. The findings indicate that while Islamic alternatives fulfill similar economic objectives, structural limitations remain in addressing the complexities of modern derivatives. This research contributes to the ongoing discourse on Islamic finance by assessing the potential for ethical financial instruments to meet global market demands. However, it notes that further innovation is necessary to address the flexibility required in contemporary financial transactions.</i></p> <p><b>Keywords:</b> <i>Derivative, Risk Management, Salam, Istisnā', Wa'd</i></p>
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## INTRODUCTION

The conceptualization of asset pricing traces back to Bernoulli's 1738 paper (Bernoulli, 1954), although more formalized models did not emerge until the 1960s and 1970s. This period was pivotal for the development of the Capital Asset Pricing Model (CAPM), Arbitrage Pricing Theory (APT), and derivative valuation techniques, which profoundly impacted economic science and transformed financial markets (Dimson & Mussavian, 1999). These innovations catalyzed the growth of derivatives, expanding the scope and depth of financial markets and playing a crucial role in modern finance.

However, the 2007–2008 financial crisis, the most severe since the Great Depression, underscored the potential dangers of derivative instruments and hedge funds (Duignan, 2019). This crisis, which led to significant economic turmoil, highlighted the risks associated with highly leveraged derivative markets. In this context, the Islamic finance sector faces increasing pressure to address the inherent volatility and liquidity risks of derivatives while adhering to Shariah principles. Derivative instruments, often

based on underlying financial assets, commodities, indices, or interest rates, present a challenging intersection between modern financial practices and Islamic jurisprudence.

In conventional finance, derivatives serve multiple purposes, including financial risk management, operational advantages, information discovery, and enhancing market efficiency. They are generally categorized into two basic functions: hedging and speculation. Hedgers use derivatives to manage uncertainty or reduce financial risk, while speculators use them to take risks, aiming to profit from market fluctuations rather than mitigate risk. Other market participants, such as market makers and arbitrageurs, also play important roles, but their activities largely relate to the primary functions of hedging and speculation (Durbin, 2011). Integrating derivatives into Islamic finance poses unique challenges. Elements such as *qimār/maysir* (gambling), *gharar* (uncertainty), and *ribā* (usury/interest), prohibited in Islamic law, complicate the adoption of these instruments. This creates a complex environment where Shariah-compliant derivatives must navigate these prohibitions while fulfilling similar financial roles.

To address these challenges, Islamic derivatives have been developed as Shariah-compliant alternatives to conventional derivatives, replicating their functions while adhering to Islamic principles. Instruments like the Islamic Profit Rate Swap (IPRS) and Cross-Currency Swap (ICCS) have gained traction, particularly within Islamic banking and the *ṣukūk* market, as tools to hedge against fluctuations in market rates. Significant milestones in this area include the Islamic Derivatives Master Agreement (IDMA), introduced by Bank Negara Malaysia (BNM) to facilitate Islamic hedging products, and the Taḥawwuṭ Master Agreement (TMA), a standardized framework developed by the International Swaps and Derivatives Association (ISDA) and International Islamic Financial Market (IIFM) to align hedging transactions with Shariah principles.

The introduction of these derivatives has sparked ongoing debate about their role and function within Islamic finance. There is contention over whether derivative instruments primarily serve as risk mitigation tools or involve speculative elements. Scholarly opinions generally permit hedging but prohibit speculation (ISDA-IIFM, 2010), though these distinctions remain somewhat abstract and lack definitive juristic evidence. Despite advancements, challenges persist, including inefficient pricing mechanisms and improper contract structuring that can compromise Shariah compliance, potentially exacerbating systemic risks.

In light of these discussions, this paper seeks to analyze the key features of financial derivatives in conventional markets and explore their compatibility with Shariah principles. The objective of comparing these instruments with their counterparts in Islamic jurisprudence is to assess their potential for adaptation and compliance within the Islamic financial framework. Rather than dismissing derivatives entirely, this study aims to provide a nuanced understanding by identifying specific aspects of these instruments that align with Shariah, while also highlighting elements that raise concerns and require scrutiny to ensure compliance.

## **LITERATURE REVIEW**

A derivative is a financial instrument whose value is derived from an underlying asset, including financial assets, commodities, indices, or interest rates. Unlike mutual funds and exchange-traded funds (ETFs), which pass through the returns of their underlying assets, derivatives transform the performance of these assets before paying it out. This transformation distinguishes derivatives from other instruments that do not alter the underlying asset's performance but only deduct expenses (Pirie, 2019).

Derivatives are broadly categorized into four basic types, each offering unique financial functionalities (Durbin, 2011):

- i. Forward: A contract in which a buyer agrees to purchase the underlying asset from the seller at a specified price on a future date.

- ii. Futures: Standardized forward contracts traded on exchanges, such as the CME Group or Bursa Malaysia Derivatives Berhad (BMD), where the exchange guarantees that both parties will fulfill their obligations.
- iii. Swap: An agreement to exchange future cash flows, typically one based on a variable or floating price and the other on a fixed one.
- iv. Option: An arrangement granting the holder the right, but not the obligation, to buy or sell an asset at a specified price on or before a specified future date.

Derivatives are traded in two primary markets: the Exchange-Traded Derivative Market and the Over-the-Counter (OTC) Derivative Market (Pirie, 2019). Exchange-traded derivatives are standardized and regulated, while OTC derivatives are customized bilateral contracts between parties. Additionally, financial instruments such as mortgages with early repayment options or convertible bonds, contain embedded derivative elements. Although these instruments are not formalized as traditional derivatives, they embody rights or obligations that resemble derivative contracts (Durbin, 2011).

Based on the rights and obligations of the contracting parties, derivatives can be classified into Forward Commitments and Contingent Claims. Forward Commitments obligate both parties to execute a transaction at a future date under predetermined terms, while Contingent Claims grant one party the right, but not the obligation, to enter a future transaction under agreed terms (Pirie, 2019). This classification is crucial for understanding how derivatives operate within different financial contexts, including their adaptation to Shariah principles.

In the context of Islamic finance, several papers have discussed the adaptation of conventional derivatives to comply with Shariah principles. Yankson (2011) analyzed synthetic interest rate swaps and concluded that despite their compliance with Shariah law in form, their substance often mirrors conventional swaps, especially concerning *ribā* and *gharar*. Similarly, Nadhirah et al. (2014) suggested employing *wa'd* and *murābahah* as foundational concepts for Islamic swaps to mitigate these issues. However, this approach, while effective, has been previously implemented, and their proposal did not significantly advance existing discourse.

Other research focused on the technical aspects of Islamic derivatives, particularly pricing mechanisms. Kok et al. (2014) explored the mathematical frameworks for Islamic profit rate swaps, suggesting risk-sharing models involving combinations of *wa'd* and *murābahah*. Al-Jallad (2018) further elaborated on the challenges of using conventional benchmarks such as the London Interbank Offered Rate (LIBOR), stressing the need for a universally accepted Islamic profit rate to avoid pricing inconsistencies that could compromise Shariah compliance. These studies highlight the ongoing need for innovation in developing robust pricing methodologies that align with Islamic principles.

Muhammad Ayub (2011) raised concerns about the proliferation of complex structures, such as *tawarruq* and *wa'd*-based products, cautioning that their widespread use could shift the focus of Islamic finance away from real-sector activities towards a derivative-driven system. Zaharuddin (2016) echoed similar concerns, noting that certain profit rate swap structures might contain gambling elements, undermining their Shariah validity. He emphasized the necessity of further research to refine these instruments and address potential pitfalls in their current configurations.

Despite these efforts, the adaptation of derivatives in Islamic finance remains a challenging task. Issues related to *ribā*, *gharar*, and *qimār/maysir* continue to pose significant hurdles. Furthermore, the development of standardized benchmarks and effective pricing models is critical for enhancing the acceptance and functionality of Islamic derivatives. Noor Suhaida and Siti Syafira (2015) addressed the issue of early termination in Islamic profit rate swaps, highlighting the need for a more structured approach to manage compensation and compliance.

Overall, the literature reveals a concerted effort to develop Islamic derivatives that replicate the financial functions of their conventional counterparts while adhering to

Shariah principles. However, significant gaps remain, particularly in addressing structural and pricing challenges. These discussions align with the paper's objective to explore the compatibility of conventional derivatives with Islamic finance, aiming to identify potential areas for further adaptation and development to ensure these instruments can serve their intended roles within a Shariah-compliant framework.

## METHODOLOGY

This study employs a qualitative, document-based analysis, focusing on a doctrinal method to evaluate the compatibility of financial derivatives with Shariah principles. The term 'doctrine' essentially covers everything under the legal umbrella in terms of rules, precedents, and statutes, and where it can be abstractly binding or non-binding (Malhotra, 2021). This method, the so-called 'black letter' methodology, necessitates the researcher to compose a descriptive and detailed analysis of the legal rules found in legal sources, such as cases, statutes, or regulations to support a hypothesis or opinion (Jerome Hall Law Library, 2019). Concerning Islamic jurisprudence, the Shariah rules and principles is referred to. In this context, the analysis focuses on both Islamic jurisprudence and conventional financial derivatives, comparing their core principles to assess alignment with Shariah. The methodological approach for this study is delineated as follows:

Table 1: Analysis Method of the Study

<b>A. Data Sources</b>	
<b>1. Classical and Contemporary Shariah Texts</b>	The study integrates classical Islamic jurisprudence texts (fiqh) and Hadith books to trace historical rulings on permissible and impermissible contracts. Modern Shariah fatwas and resolutions from bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and BNM offer contemporary interpretations, particularly in the context of financial innovation.
<b>2. Conventional Derivatives Frameworks</b>	Analysis of conventional derivatives is based on ISDA-related documents. These sources provide insights into the legal and operational structure of conventional derivatives and how they function in the markets to form a baseline for comparison. Special attention is given to identifying clauses that conflict with Shariah principles, such as those that attract <i>gharar</i> elements into contractual arrangement.
<b>3. Shariah-Compliant Alternatives</b>	The ISDA-IIFM Tahawwuf Master Agreement and associated documents are analyzed to understand the adaptations made to render Shariah-compliant derivatives. Key contractual elements and mechanisms ( <i>tawarruq</i> and <i>wa'd</i> -based) are used to ensure compliance with Islamic law are explored, particularly focusing on how they differ from conventional derivatives in terms of risk management, asset-backed transactions, and the avoidance of prohibited elements.
<b>B. Analytical Approach</b>	
<b>1. Comparative Juristic Analysis</b>	A comparative analysis is used to juxtapose conventional derivative structures with their Islamic counterparts, including contracts like <i>Salam</i> , <i>Istisnā'</i> , and <i>Wa'd</i> . This comparison focuses on understanding how financial risk is handled in both systems and where they diverge, particularly with respect to Shariah's emphasis on minimizing uncertainty ( <i>gharar</i> ) and avoiding speculative transactions.
<b>2. Conceptual Evaluation</b>	Central to this study is the evaluation of the key Shariah principles that underpin permissible financial transactions.

	Islamic jurisprudence is reviewed to identify which aspects of conventional derivative structures can be harmonized with Shariah. Concepts such as risk-sharing versus risk-transfer, as well as the ethical parameters of trade, are given particular attention to discern whether modified derivatives offer true compliance with Islamic objectives or merely technical conformity.
<b>3. Critical Reflection</b>	The study critically reflects on the results of adapting conventional derivative contracts to meet Shariah requirements. By analyzing current practices in Islamic finance, the study assesses whether these instruments adequately fulfill their economic function while adhering to ethical mandates.
<b>4. Synthesis and Conclusion</b>	Finally, the insights gathered from the doctrinal and comparative analyses are synthesized to provide a holistic view of the state of derivatives. This synthesis underpins recommendations for improving the alignment between conventional derivatives and Islamic principles, addressing both theoretical gaps and practical implementation challenges.

This methodological framework ensures a rigorous examination of both the conventional and Islamic perspectives on derivatives, providing a nuanced understanding of their compatibility and potential adaptation within the Islamic financial system.

## RESULTS

The core elements of derivatives, although not as standalone instruments, seem to exist within some of the *mu‘āmalāt* principles that are permissible in Shariah. Notable examples include forward sales such as *salam* and *istisnā‘*, as well as the binding promise, *Wa‘d Mulzim*. These principles, while distinct from conventional derivatives, offer a framework for structuring financial contracts in compliance with Shariah. A comparative mapping of these contracts and their conventional counterparts is outlined below:

Table 2: Comparative Features of Conventional Derivatives and Shariah Contracts

Conventional Derivatives	Core Features	Shariah Contract/ Principle	Brief Description
<b>Forward (OTC)</b>	Contract to buy/sell an asset at a future date at a price agreed today.	<b><i>Salam</i></b>	Full payment upfront, with future delivery of goods (commodities-focused).
<b>Futures (Exchange Platform)</b>	Standardized forward contract traded on an exchange.  [*Payment is not made upfront for both]	<b><i>Istisnā‘</i></b>	Contract for goods to be manufactured or constructed, with deferred or staged payments.
<b>Options</b>	Right (not obligation) to buy/sell an asset at a predetermined price.	<b><i>Wa‘d</i></b>	Promise (binding) to execute a future action (e.g. buy/sell).
<b>Credit Default Swaps (CDS)</b>	Contract for credit protection via payments and compensation for credit losses	<b><i>Kafālah &amp; Wakālah</i></b>	Standalone <i>Kafālah</i> (guarantee) or <i>Kafālah</i> hybrid with <i>Wakālah</i> (agency): assuming

			specific liability similar to risk transfer of contingent claim features
		<b>Takaful &amp; Retakaful</b>	Islamic insurance and reinsurance, involving risk transfer or sharing.

While some structural similarities can be observed between conventional derivatives and Islamic contracts, the key issue with conventional derivative contracts lies in their failure to meet the essential requirements of Shariah principles. Specifically, these instruments often incorporate prohibited elements, mainly *gharar* (excessive uncertainty), and in some cases, *ribā* (interest) and *qimār/maysir* (gambling), depending on their specific structure.

## DISCUSSION

The origins of derivatives, particularly forwards and futures, can be traced back to informal trading practices where traders negotiated agreements to buy or sell goods at a future date without any formalized contracts or standardized regulations. Prior to the establishment of formal markets, these agreements were private, and there were no standardized frameworks governing their trade. However, in the mid-19th century, the Chicago Board of Trade (CBOT)<sup>1</sup> played a pivotal role in formalizing forward contracts for agricultural products such as wheat. This market allowed farmers and merchants to hedge against price fluctuations by locking in prices for future deliveries, effectively mitigating the risks of price volatility between planting and harvesting seasons. Over time, as these forward contracts evolved, they became standardized into what are now known as futures contracts, traded on regulated exchanges with fixed terms and delivery dates (Pirie, 2019).

In contrast, Islamic finance introduced similar risk management tools through certain contracts such as *salam* and *istisnā'*. These contracts serve the same fundamental purpose of mitigating future uncertainty while ensuring fairness and certainty in transactions, but they are embedded within a Shariah-compliant framework. Importantly, while conventional derivatives often lead to mere speculative practices, Islamic forward sale agreements like *salam* and *istisnā'* are carefully structured to avoid prohibited elements such as *gharar* (excessive uncertainty), *ribā* (interest), and *qimār/maysir* (gambling).

This section examines the Islamic alternatives to conventional derivatives by analyzing the core features of *salam*, *istisnā'*, and *wa'd*, which serve as forward sale agreements and binding promises for risk mitigation within Islamic finance.

### Forward Sale of *Salam*

*Salam*, or *salaf*, represents one of the earliest forward sale contracts permissible in Islamic law. It is defined as forward sale (*mawsufah fi al-zimmah*), where the goods are delivered at a future date, in exchange for a spot payment (Wizarah al-Awqaf, 2006). The AAOIFI Shariah Standard (2015) defines '*salam*' as the purchase of a commodity for deferred delivery in exchange for immediate payment. It is a type of sale in which the price, known as the *salam* capital, is paid at the time of contracting while the delivery of the item to be sold, known as *al-Muslam Fihi* (the subject-matter of a *salam* contract), is deferred. The seller and the buyer are known as *al-Muslam Ilaihi* and *al-Muslam* or *Rab al-Salam* respectively. *Salam* is also known as *Salaf* (literally defined as 'borrowing'). In essence, the

<sup>1</sup> Chicago Board of Trade (CBOT) merged with the Chicago Mercantile Exchange (CME) in 2007 to form CME Group. Today, the CME Group comprises four major futures exchanges (CME, CBOT, NYMEX and COMEX) and has become the world's largest derivative exchange. See <https://www.cmegroup.com/stories/index.html>

feature of *salam* is that the full purchase price is paid upfront by the buyer, while the delivery of goods is deferred by the seller.

The legitimacy of *salam* comes from the Qur'an, the Sunnah, and *Ijmā'* (AAOIFI, 2015). Ibn Abbas RA narrated that when the Prophet SAW arrived in Medina, the people practiced *salam* in fruits for a period of one or two years (in some narrations three years). The Prophet SAW said:

{ مَنْ أَسْلَفَ فِي تَمْرٍ، فَلْيُسَلِّفْ فِي كَيْلٍ مَعْلُومٍ، وَوَزْنٍ مَعْلُومٍ، إِلَى أَجَلٍ مَعْلُومٍ }

Which means, “Who undertakes *salaf* (*salam*), let it be done with a known measure, weight and delivery time” (Hadis. Sahih Muslim. *Bab al-Salam*. 1604).

Al-Nawawi (1972) explained that in *salam*, it is a condition that the quantity must be known either by measure, weight or any other means that provide certainty, thereby avoiding *gharar* (uncertainty). The jurists unanimously agreed on the need to describe the sale object with sufficient detail, as per the Prophet's SAW instruction.

From this, it is understood that certainty is a major concern in the *salam* contract, despite the forward nature of the sale, where the object may not yet exist at the time of the contract. In this regard, Ibn Rushd (2004) summarized that jurists agreed on the permissibility of *salam* for goods that can be measured or weighed, but its prohibition applies to items that cannot be made into a debt (*zimmah*), such as houses and structures. However, they disagreed regarding certain categories of goods and animals due to differing narrations and interpretations of hadith, and the determination of the *salam* object for certainty.

The *salam* contract, established during the Prophet's SAW time, was designed to facilitate agricultural transactions—similar to early forward contracts in the Chicago market. The buyer's prepayment mitigated the seller's risk of non-payment, while the seller committed to delivering the agreed goods at a specified future date. However, unlike conventional forward contracts, *salam* disallows speculative trading and imposes clear conditions to eliminate *gharar*. The goods must be clearly described, and the date and place of delivery must be predetermined, ensuring transparency.

The key difference between conventional forwards, like those from the CBOT, and *salam* is that the latter does not allow for secondary trading. In modern futures markets, contracts are frequently bought and sold before their expiration, often for speculative purposes. *Salam*, on the other hand, is structured to provide certainty in real economic transactions, with the transfer of actual commodities rather than speculative positions. Additionally, the trading of *salam* contracts raises Shariah concerns regarding the sale of debt (*Bai al-Dayn*).

### **Forward Sale of *Istisnā'***

*Istisnā'* is another forward sale contract, typically used for manufactured or constructed goods. It shares similarities with *salam*, but with notable differences. Some scholars define *istisnā'* as a contract for a specified object (*zimmah*), stipulated with a certain action, while others see it as similar to *salam* but requiring the production or construction of goods (Wizarah al-Awqaf, 2006). Contemporary definitions describe it as a sale contract where specific items are to be manufactured or constructed, with an obligation on the manufacturer or contractor to deliver them to the buyer upon completion (AAOIFI, 2015). According to the BNM Policy Document (2015), *istisnā'* is a contract in which a seller agrees to construct, build, or manufacture an asset according to agreed specifications, to be delivered on a specified future date, at an agreed-upon price.

The legitimacy of *istisnā'* is supported by historical precedents from the Prophet Muhammad's (SAW) practices, such as commissioning a wooden pulpit for preaching as narrated by Sahl RA:

{ أَنَّ النَّبِيَّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ أَرْسَلَ إِلَى امْرَأَةٍ مِنَ الْمُهَاجِرِينَ، وَكَانَ لَهَا غُلَامٌ نَجَّازٌ، قَالَ لَهَا: «مُرِّي عَبْدَكَ فَلْيَعْمَلْ لَنَا أَعْوَادَ الْمِنْبَرِ»، فَأَمَرَتْ عَبْدَهَا، فَذَهَبَ فَقَطَعَ مِنَ الطَّرْفَاءِ، فَصَنَعَ لَهُ مِنْبَرًا، فَلَمَّا قَضَاهُ، أَرْسَلَتْ إِلَى النَّبِيِّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ إِنَّهُ قَدْ قَضَاهُ، قَالَ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ: «أَرْسَلِي بِهِ إِلَيَّ»، فَجَاءُوا بِهِ، فَاحْتَمَلَهُ النَّبِيُّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ، فَوَضَعَهُ حَيْثُ تَرَوْنَ }

Which means, “That the Prophet SAW sent for a woman from Muhajirin who had a slave who was a carpenter. The Prophet SAW told her, ‘Order your slave to prepare wood (pieces) for a pulpit.’ So she ordered her slave, who went and cut wood from a tamarisk tree and prepared a pulpit for the Prophet SAW. When he finished the pulpit, the woman informed the Prophet SAW that it had been finished. The Prophet SAW asked her to send that pulpit to him, so they brought it. Then the Prophet SAW lifted it and placed it at the place in which you see it now” (Hadis. Sahih al-Bukhari. Kitab al-Hibah. 2569).

It is also supported by the hadith where a gold ring was made for Prophet SAW as narrated by Ibn Umar RA:

{ أَنَّ رَسُولَ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ اصْطَنَعَ خَاتَمًا مِنْ ذَهَبٍ وَكَانَ يَلْبَسُهُ، فَيَجْعَلُ فَصَّهُ فِي بَاطِنِ كَفِّهِ، فَصَنَعَ النَّاسُ خَوَاتِيمَ، ثُمَّ إِنَّهُ جَلَسَ عَلَى الْمِنْبَرِ فَتَزَعَهُ، فَقَالَ: «إِنِّي كُنْتُ أَلْبَسُ هَذَا الْخَاتَمَ، وَأَجْعَلُ فَصَّهُ مِنْ دَاخِلٍ» فَرَمَى بِهِ ثُمَّ قَالَ: «وَاللَّهِ لَا أَلْبَسُهُ أَبَدًا» فَتَبَدَّ النَّاسُ خَوَاتِيمَهُمْ }

Which means, “That the Prophet SAW had a gold ring made for himself, and when he wore it he used to turn its stone toward the palm of his hand. So the people too had gold made for themselves. The Prophet SAW then ascended the pulpit, removed the ring, and he said, ‘I had it made for me, but now I will never wear it again.’ He threw it away, and then the people threw away their rings too” (Hadis. Sahih al-Bukhari. Kitab al-Iman wa al-Nuzur. 2569. Sahih Muslim. Kitab al-Libas wa al-Zinah. 2091).

The permissibility of *istisnā'* is also based on *istihsān* (juristic preference), general principles of contracts and transactions, and the objectives of Shariah (AAOIFI, 2015). Contemporary Muslim jurists have reached consensus (*ijma'*) on the permissibility of *Istisnā'* (BNM, 2015).

The key distinction between *istisnā'* and *salam* lies in the nature of the goods involved. While *salam* permits the forward sale of goods without requiring that they be manufactured or constructed, *istisnā'* applies specifically to goods that require transformation through a manufacturing or construction process. In short, *salam* deals with ready-made goods that will be delivered later, while *istisnā'* involves the creation of goods through labor and production (AAOIFI, 2015).

*Istisnā'* allows for deferred or staged payments, making it particularly useful for projects that require significant time and resources to complete. The historical roots of *istisnā'* can be seen in practices where artisans and builders took on projects commissioned by customers with payment scheduled throughout the manufacturing or construction process.

In terms of its financial functionality, *istisnā'* shares similarities with modern forward and futures contracts. Both involve the delivery of goods at a future date, with the contract price determined at the time of the agreement, while payment in *istisnā'* can be made in full upfront, in installments, or upon delivery. However, while futures contracts, especially those traded on exchanges like the CBOT, often involve speculation on price movements, *istisnā'* focuses on actual manufacturing or real production and is governed by strict Shariah guidelines to prevent uncertainty or unjust gain (*gharar* or *ribā*).

### **Binding Promise of *Wa'd***

The concept of *wa'd*, or a unilateral promise made by one party to another to perform a certain action in the future (BNM, 2017a), plays a significant role in structuring Islamic financial products, often mirroring certain characteristics of options in conventional finance. For example, *wa'd* can be utilized in Islamic leasing (*ijārah*) contracts, where one party has the right, but not the obligation, to buy or sell an asset at a predetermined price at a future date, akin to call or put options. However, unlike conventional options that are simply traded for speculative purposes, *wa'd* must be anchored in an underlying genuine economic transaction, thus eliminating *qimār/maysir* and uncertainty.

In the conventional system, options can be exercised for profit without an underlying real asset exchange, thus involving *gharar* and *maysir* (gambling). In Islamic finance, *wa'd* is designed to be tied to tangible transactions, such as the transfer of ownership in a *murabaha* or *ijārah* contract, ensuring alignment with Shariah. *Wa'd* offers Islamic financial institutions the ability to structure contracts that provide flexibility while adhering to Shariah principles. The binding promise in *wa'd* creates an obligation but avoids the sale of uncertain assets, which would otherwise lead to *gharar* in conventional options markets.

### **Derivative-Like Features in Islamic Finance**

In addition to structured contracts like *salam*, *istisnā'*, and *wa'd*, Islamic finance employs other derivative-like features for risk management purposes. For instance, the combination of *kafālah* (guarantee)<sup>2</sup> and *wakālah* (agency)<sup>3</sup> mirrors the risk-sharing mechanisms seen in conventional derivatives such as CDS. Similarly, Islamic insurance (*takaful*) and reinsurance (*retakaful*) are structured to transfer and share risks without violating Islamic principles, thus offering an alternative to such contingent claim derivatives.

While Islamic derivatives bear functional similarities to their conventional counterparts, they are carefully structured to avoid *ribā*, *gharar*, and *qimār/maysir*. The primary issue with conventional derivatives is their frequent use for speculative gains, often disconnected from real economic activities. In contrast, Islamic financial instruments emphasize tangible assets, risk-sharing, and ethical compliance, consistent with the principles of fairness and justice in Shariah.

### **Comparative Analysis**

The historical development of derivatives in conventional markets, such as the Chicago forward markets, demonstrates their utility in managing future risks. Islamic finance, through contracts like *salam* and *istisnā'*, shares the same risk management objectives but frames them within a framework that ensures fairness, transparency, and the avoidance of harmful elements like speculation and uncertainty. As Islamic finance evolves, it continues to explore ways to adapt conventional financial tools, like derivatives, while maintaining strict adherence to the ethical and legal guidelines established by Shariah.

A key issue identified with conventional derivatives is their failure to meet the essential conditions of Shariah contracts. As discussed earlier, conventional derivatives such as forwards, futures, swaps and options often contain elements of *gharar*, *ribā*, and *qimār/maysir*, depending on their specific structures. This makes them incompatible with Islamic financial principles, which demand certainty, fairness, and the absence of unjust enrichment.

Islamic alternatives, such as *salam*, *istisnā'*, and *wa'd*, provide viable frameworks for deferred and contingent transactions while maintaining Shariah compliance. These

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<sup>2</sup> Refers to a contract where the guarantor conjoins the guaranteed party in assuming the latter's specified liability. It may be arranged with other Shariah contracts or concepts, including exchange-based contracts and agency (*wakalah*) contracts etc. (BNM, 2017b).

<sup>3</sup> Refers to a contract where the principal (*muwakkil*) authorizes another party as his agent (*wakil*) to perform a particular task on matters that may be delegated, with or without imposition of a fee (BNM, 2016).

contracts achieve similar economic objectives to conventional derivatives but do so within a structure that prioritizes ethical conduct and avoids prohibited elements. For instance, *salam* allows for forward sales but mandates full upfront payment to eliminate excessive uncertainty. Similarly, *istisna'* facilitates futures-like transactions but ties them to real economic production, thus avoiding speculative trading.

However, both *salam* and *istisna'* may not fully address the complexities of contemporary derivative arrangements, particularly in financial markets that require more flexibility and diverse structures. As such, other alternatives are being explored, such as *Tawarruq* and *wa'd*-based structures, as well as *Sarf* for currency exchange. These mechanisms offer additional pathways for creating Shariah-compliant derivatives while adhering to the core principles of Islamic finance.

## CONCLUSION

Defined as financial instruments whose value is derived from an underlying asset, derivatives represent a concept that did not exist in early Islamic jurisprudence. The term itself is rooted in modern financial terminology and is absent from classical fiqh treatises and Arabic dictionaries. As such, derivatives in the form we recognize today were never directly discussed by early Islamic scholars. Tracing the origin of derivatives within Islamic doctrine is therefore challenging, given their absence in historical Islamic legal frameworks.

The modern derivatives we see today were structured and introduced in a financial system that emerged from the Western world, where prohibitions on *ribā*, *gharar*, and *qimār/maysir* were not enforced. These prohibitions, fundamental to Shariah, directly conflict with the nature of many conventional derivatives. Nevertheless, elements of derivative-like transactions can be found in classical Islamic contracts such as *salam* (advance purchase) and *istisnā* (manufacturing contract), as well as in commitments like *wa'd* (promise). These contracts or principles reflect the core mechanisms of forwards and futures, showing that not all aspects of derivatives are inherently non-compliant with Shariah principles.

The challenge lies not in the concept of derivatives per se, but in how they are structured and executed. Modern derivatives often include elements prohibited by Shariah, such as *ribā*, *gharar*, and *qimār/maysir*, leading to concerns about their permissibility. However, Islamic finance has made significant strides in adapting derivative instruments to comply with Shariah. The development of Islamic financial tools, such as the IPRS and ICCS, has demonstrated that derivatives can be structured in a way that meets both financial needs and Shariah requirements.

This paper has highlighted the critical differences between conventional derivatives and their potential counterparts in Islamic finance. By comparing these instruments with Islamic jurisprudence, we can better understand how derivatives can be adapted to align with Shariah principles. Milestones such as the IDMA and the ISDA/IIFM TMA reflect the progress made in bridging the gap between conventional financial markets and Islamic law.

Looking ahead, the future development of Islamic derivatives must continue to navigate the complexities of ensuring Shariah compliance while meeting the evolving demands of global markets. Addressing the structural elements that raise Shariah concerns will be essential in fostering further integration of these instruments within Islamic finance. As the market continues to grow, Islamic finance institutions must maintain a commitment to innovation and Shariah integrity to create robust, compliant financial products that support both risk management and economic growth.

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