Gambling is the wagering of money or something of material value on an event with an uncertain outcome with the primary intent of winning additional money and/or material goods. Typically, the outcome of the wager is evident within a short period.

The main characteristics of gambling are as follows:

1. the outcome of gambling is based on pure chance and not knowledge or skills. In other words, gambling is aleatory in nature.
2. The amount of bet and winning is highly disproportional. For example, a $100 bet can win a $1 million price.
3. The bettor’s intention is to make money.
4. It is a zero-sum game. That is, your winning is someone else’s loses. This is different from a sale, when you pay, say $100 and gets the goods you buy, say a shirt or a shoe.

Islam prohibits gambling (maisir) based on the commandment of Allah swt. in Surah al-Baqarah: “In khimar and maisir, there are some sins and some benefits. But the sins are greater than the benefits”

Derivatives are financial contracts, or financial instruments, whose values are derived from the value of something else (known as the underlying). The underlying value on which a derivative is based can be an asset (e.g., commodities, equities (stocks), residential mortgages, commercial real estate, loans, bonds), an index (e.g., interest rates, exchange rates, stock market indices, consumer price index (CPI) — see inflation derivatives), weather conditions, or other items. Credit derivatives are based on loans, bonds or other forms of credit.

The main types of derivatives are forwards, futures, options, and swaps. Derivatives can be used to mitigate the risk of economic loss arising from changes in the value of the underlying. This activity is known as hedging. In this way, a derivative transfers risk from one party to the other at a price. Alternatively, derivatives can be used by investors to increase the profit arising if the value of the underlying moves in the direction they expect. This activity is known as speculation.
Islam enjoins risk-taking based on the principle of *al-kharaj bil daman* (ie. *with profit comes responsibility*) and *al-ghorm bil ghonm* (ie. *with profits comes risk*). That is, to earn profits one must be willing to take or face potential losses (i.e. risk). It is against Islam to do the opposite as evident in the prohibition of riba. Likewise, when one has taken a position, that is enters into a business contract, say buying and selling (wholesale, retail, import-export), he faces market risk or more specifically price risk, which is a normal thing in any business. The question is can he transfer the price risk to another party at a price?

Price risk refers to the changes in the price of the goods that can be detrimental to the business. If he purchases the goods for $100 when the retail price is at $160, he makes a decent $60 profit per unit. However if market price drops to $120, his profit falls to $20 per unit. Can he protect his business against price volatilities to prevent undue drop in earnings? Can he hedge against price volatilities?

Islam does not prohibit anyone from taking action to protect his business from potential losses due to market volatilities. As mentioned above, hedging is conducted to mitigate the risk of economic loss arising from changes in the value of the underlying i.e the real goods. Hedging is not speculation as the latter intend to increase the profit arising if the value of the underlying moves in the direction they expect.

Thus, any instrument for hedging purposes must comply:

1. with the twin principles of *al-kharaj bil daman* and *al-ghorm bil ghonm*.
2. It must also be free from *maisir*, *gharar* (i.e. ambiguities) and the assistance of *riba*.
3. It must observe the intent of the Shariah (i.e *maqasid al-Shariah*).

One of the major uses of future contracts is hedging. Hedges are created by combining a LONG and SHORT position in the same asset to reduce or eliminate price risk or price fluctuation risk.

a. A buying hedge is designed to protect a buyer against a price increase.

b. A selling hedge will protect a seller against a falling price.

Let is look at one example of derivative, that is commodity future trading.
1. Jim a Kansas wheat farmer expects to harvest 40,000 bushels of wheat in early August.
2. On June 15, the price of wheat is $3.50 per bushel.
3. Jim is concerned that the price of wheat per bushel will fall below $3.50 before his August delivery date.
4. Jerry told Jim that he should hedge his position by selling August wheat futures.
5. By selling wheat futures, Jim can lock in the August price of $3.45 per bushel.
6. Jim took Jerry’s advice and SOLD EIGHT 5,000 BUSHELS OF AUGUST WHEAT FUTURES.
7. When August came, the price of wheat had fallen to $3.00 per bushel.
8. However, Jim’s hedge covered his losses because WHAT HE LOST ON THE CASH CROP WAS OFFSET BY HIS GAINS ON THE FUTURES CONTRACT minus a small transaction charge.
9. The value of the hedge position was calculated as follows:
   a. Revenues from sales of physical wheat = $3.00 x 40,000 = $120,000 revenue.
   b. Sale of 8 wheat futures = 8 x $3.45 x 5,000 = $138,000 revenue
   c. Purchase of 8 wheat futures contract = 8 x $3.00 x 5,000 = $120,000.
   d. Gain of futures contract = $138,000 - $120,000 = $18,000.
   e. Jim’s net cash flow for August was $138,000 = ($120,000 + $18,000).

Islamic View:

1. b and c is a short sale. Jim sold what he does not own in b and give it back through c.
2. a is permissible i.e physical sale at spot price and delivery.

Options

1. An option is an agreement that gives the holder the right (but not the obligation) to buy or sell specified securities a given price (striking price/exercise price).
2. Call Option: Right to Buy
3. Put Option: Right to Sell
Option: Example

1. Jerry paid a premium of $4 per share for one 6 month call option (right to buy) of the Mahony Corporation. 1 option contract = 100 shares.
2. At the time of the purchase, Mahony stock was selling for $56 per share and the exercise price of the call option was $55.
   a) Determine Jerry’s profit or loss if the price of Mahony’s stock is $54 when the option is exercised?
      i) cost of call = ($4 premium) x 100 = $400
      ii) Ending value = (-$400 cost) + (0 gain) = $400 loss
      iii) The option was worthless because the stock’s price is less than the exercise price at maturity.
   b) What is Jerry’s profit or loss if the price of Mahony’s stock is $62 when the option is exercised?
      i) Cost of call = $400
      ii) Ending value = -$400 + ($62 - $55) x 100 = -$400 + $700 = $300 gain.

Bay al-Urbun

1. Urbun: the right to buy based on the partial payment on the price of goods. Bay al-Urbun is a sale involving urbun i.e. the earnest money. The seller does not return the urbun in case the latter does not confirm the contract.
   Example: Ali is keen to purchase X for $5000. He says to the seller that he will put $200 as urbun to secure him the right to purchase X in 2 days. If Ali didn’t settle the remaining balance in two days, the $200 urbun is non-refundable.
2. Urbun sale is permissible in Islam, except in the Maliki school of fiqh. But the TRADING OF URBUN is prohibited by all schools.
3. A call option is similar to bay al-urbun when the buyer did not confirm the purchase and thus forfeited the urbun. But a call option is different from bay al-urbun when in the former the buyer loses the option even though the option is exercised and the contract is confirmed.

The Shariah issues concerning derivatives are more related to gambling and gharar compared to riba and impure goods.
a. **Gambling**: the party that buys or sells commodity futures for hedging or speculation is betting against future uncertain events. He does not know for sure that price will increase or decrease but make bets based on his guestimates. This is none other than a game of pure chance. In the case of option, he loses his bet (i.e. option premium) and gets nothing in return when he found his option worthless (i.e. did not exercise it). He enters into the contract with an intention to make money.

b. **Gharar**: short-selling invites gharar when the person uses shares belonging to strangers to make money. When he fails to return the shares after badly affected by his wrong decision, it will adversely affect the security industry.