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ASSET SIDE OF AN ISLAMIC BANK
Lesson – 9

Every bank manages its liability and asset side separately, in conventional banks both asset and liability sides are governed by loan transactions. However in Islamic banks both liability (deposit) and asset (financing) side of bank are governed through separate rules, as discussed in previous lesson Islamic banks govern their deposit products on either debt or on Mudarabah basis. On the other side financing side of an Islamic bank is entirely different from conventional bank's side; Islamic bank uses numerous Islamic financing techniques to run asset side of an Islamic bank. These financing techniques are given below.

- Musharakah
- Murabaha
- Ijarah
- Diminishing Musharakah
- Salam
- Istisna

In this lesson we will focus on Musharakah contract as a mode of financing. The rest will be discussed in detail in later chapters.

Musharakah

The litereray meaning of Musharakah is Sharing, this word is derived from an Arabic word 'Shirkah', which means being a partner in one property. In Islam, it is used as the context of term Shirk which means 'considering someone as partner to Allah'.

In Islamic Fiqh, Musharakah refers to a joint enterprise which is formed for conducting business, all partners to this enterprise share profit as per agreed ratio and loss is shared up to the ratio of contribution. Musharakah as a mode of financing is considered ideal alternative for interest based financing. Moreover we can see the importance of Musharakah from following Hadiths-e-Qudsi:

"Allah Subhan-o-Tallah has declared that He will become a partner in a business between two Mushariks until they indulge in cheating or breach of trust (Khayanah)."

"Allah's hand is with both the partners unless any one of them indulges in cheating and when any one of them indulges in cheating than Allah takes back his hand from both the partners."

For the purpose of clarity of basic concepts, it is relevant at the beginning to explain the meaning of each term, "Shirkah" means "Sharing" and in the terminology of Islamic Fiqh, it has been divided into two kinds:

1. Shirkat-ul-Milk (Partnership by joint ownership)
2. Shirkat-ul-Aqd (Partnership by contract)

1. Shirkat-ul-Milk:

It means joint ownership of two or more persons in a particular property or it can also be defined as partnership by ownership. This kind of "Shirkah" may come into existence in two different ways:

A) Optional (Ikhtiari): as name refers it comes into existence on the option of the parties. For example, if equipment is purchased by two or more persons, in this case both will own that asset jointly and the relationship between them with respect to owned asset will be called 'Shirkat-ul-Milk Ikhtiari'. In this case, the relationship has come into existence due to their own option and will, as they themselves have chosen to purchase the equipment together.

B) Compulsory (Ghair Ikhtiari): in compulsory partnership, a relationship comes into existence on its own without any effort or option of parties, it will be known as 'Shirkat-ul-milk ghaer ikhtiari'. For example, after the death of a person, all his successors become heir to his property, which comes into their joint ownership as a natural decision the death of that person.

2. Shirkat-ul-Aqd:

This is the second type of Shirkah, which means, a partnership which came into being by mutual contract or agreement. Concisely, it can also be interpreted as "joint commercial enterprise." Shirkat-ul-Aqd" can further be classified into different categories:

A) Shirkat-ul-Amwal (Partnership in capital): in Arabic term the word Amwal means 'Capital'. In Shirkat-ul-Amwal all partners contribute in capital to form a commercial enterprise.

B) Shirkat-ul-Aamal (Partnership in services): in Arabic, the term Aamal refers to 'services', in Shirkat-ul-Aamal all partners combined together to carry out business on basis of their skills and services, a fee is charged for service provided by them which is later distributed as per agreed ratio among partners. For example two tailors agreed to carry out tailoring business together with a condition that all the earning through this business will be distributed at the end of month on equal basis, in this case both the partners have constructed Shirkat-ul-Aamal, which is also called Shirkat-us-sanai or Shirkat-ul-abdan.

C) Shirkat-ul-Wujooh (Partnership in goodwill): The word Wujooh has been derived from Arabic word Wajahat which means goodwill. It is also known as partnership on credit. In Shirkat-ul-Wujooh there is no need to invest funds by partners, here partners by reason of their goodwill purchase material or commodity on credit with a favorable credit terms and sell the commodity on cash on spot. This kind of partnership can only be form in the case of partners' goodwill and creditworthiness. The profit earned in this kind of business is distributed among all partners as per agreed ratio.

D) Shirkat-Al-Mufawada (Capital, Labor & Profit at par): shirkat-al-Mufawada is a very rare kind of partnership in which all partners share capital, management, profit, risk & reward in equal ratio. In this all four categories are essential element that these must be shared in equal terms among all partner; if any one category is not shared equally, it will become Shirkat-ul-Ainan.

E) Shirkat-ul-Ainan: it is the most common type of Shirkay-ul-Aqd in which capital, management and profit ratio are not necessarily be in equal terms. In general terms all these modes of sharing are termed as 'Shirkah', or in Islamic Fiqh it is termed as 'Musharakah'. In common, whenever this term (Musharakah) is used it refers to Shirkat-ul-Amwal in which capital is invested to form a joint commercial enterprise.

The basic rules of Musharakah

Musharakah or Shirkat-ul-Amwal is a relationship established by the parties through a mutual contract. Therefore, all necessary conditions which are essential to a contract must be present here. For example, parties to contract must be capable of entering into a contract, agreement must be signed with free consent of parties, and profit sharing ratio must be agreed upon at the time of contract. There are many important elements which are necessary for a valid Musharakah. They are summarized here:

1) Basic rules of Capital

The capital in a Musharakah agreement should be:

A) Quantified (Ma'loom): Meaning how much a partner is investing money in a particular business.

B) Specified (Muta'aiyan): it refers to the specification of capital in term of currency, for example one all partners are investing in PKR.

C) Liquidity of Capital: In capital investment in Musharakah a common question is asked whether the capital should be invested in liquid form or it can be in the form of commodity or kind. Different school of thoughts has difference of opinion in this, and this issue can be resolved in light of following Fiqhs:

According to the view of **Imam Maalik**, liquidity of capital not a condition for validity of Musharakah. Even if a partner invest in cash or in kind, the partnership remains valid, however if the investment is in kind then the share of partner must be evaluated as per prevalent market price on date of contract.

However, **Imam Abu Hanifa** and **Imam Ahmad bin Hanbal** do not allow investment to be in kind or commodity. The reason for this restriction is as follows:

- Commodities contributed by one partner will always be different from the commodities invested by the other partner; therefore, both commodities cannot be treated as homogenous capital.
- However if capital is invested in different commodities, then redistribution of share capital to partners becomes difficult. There may be a case where the commodities which were invested by partners have been sold in market and redistribution of share capital would not be possible in this case.

For this purpose **Imam Shafi** divided commodities in two categories, Homogenous commodities (which are similar in nature) and Heterogeneous commodities (different in nature).

Imam Shafi holds the opinion that the commodities which are homogenous in nature can be a part of capital, whereas heterogeneous commodities cannot be used in Musharakah contract. In case of Homogenous commodities the redistribution of share capital becomes easy. However in case of illiquid capital, the evaluation must be done as per market price of commodity.

We may so conclude from the above arguments that the share capital in a Musharakah can be contributed either in cash or in the form of commodities. The market value of the commodities shall determine the share of partner in the capital.

C) Mixing of Capital: Before we go for detail in this an example is used to elaborate the importance of mixing of capital. If 'Ali' and 'Zain' agreed to invest Rs.2,000/- each in a garment business and both keep their funds with themselves. Then, if 'Ali' buys cloth with his investment, will it be considered belonging to both or only to Ali? Furthermore, if the cloth is sold, can Ali alone claim the profit or loss on the sale? There is a difference of opinion among Fiqh jurists; this issue can be resolved in the light of the following schools of thought of different fiqhs:

Imam Shafi is of the view that the capital of partners must be mixed up in such a way that it could not be distinguished; further more capital should be mixed before conducting any business. The partnership will not be completely enforceable if we did not mix capital. If capital of partners are not mixed up the investment will remain under ownership of original investor and profit or loss on that investment will be of original investor.

According to **Imam Abu Hanifa**, **Imam Malik** and **Imam Ahmed bin Hunbul**, mixing of capital is not essential for working of partnership. They all are of the view that when Musharakah agreement is made the partnership is complete whether capital is mixed or not. Hence any profit or loss on sale of arising from business activity should be shared according to the partnership agreement.

2) Management of Musharakah

It is the common and normal principle of Musharakah that every partner has equal right to take part in managing the business. However in certain situation partners may agree to a condition that management will be done by only one partner. Furthermore if there is a sleeping partner in a partnership, the ratio of profit for that partner must not exceed the ratio of his investment. Sleeping partner cannot take more than his ratio of investment. In Musharakah all partners will act as agent of others, any work or deal done by one is considered as work done or authorized by all partners

3) Basic rules of distribution of Profit

1. The ratio of profit must denote a percentage of actual profit earned at the end of period. Any rate or ratio tied up to the investment is not acceptable in contract of partnership. For example, if it is decided between partners that 'A' will get 1% of his investment, the contract is not valid.
2. In valid Musharakah it is not allowed to fix a lump sum amount for anyone of the partners. Therefore, if 'A' & 'B' enter into a partnership and it is decided that 'A' shall be given Rs.10,000/- per month as his share in the profit and the rest will go to 'B', the partnership is invalid.
3. It is allowed in Islam to agree upon a condition that no partner will share profit just according to the ratio of investment, whether both take part in management or not. However sleeping partner cannot claim more than his share in investment.
4. Any percentage can be agreed for sharing profit between partners, if a partner is contributing more in managing the business may share more than his ratio of investment.
5. If both are working partners, the share of profit can differ from the ratio of investment. For example, 'Zaid' & 'Bakar' both have invested Rs.1,000/- each. However, Zaid gets 1/3rd of the total profit and Bakar gets 2/3rd, this is allowed. This opinion of Imam Abu Hanifa is based on the fact that capital is not the only factor for profit distribution but also labor and work. Although the investment of two partners is the same but in some cases, quantity and quality of work might differ.

4) Basic rules of distribution of Loss

All scholars are agreed on the principle of loss sharing in Shariah, based on the saying of Syyedna Ali Ibn Talib (R.A) that is as follows:

"الوضیعة علی المال والربح علی ما اصطالحوا علیه" [مصنف عبدالرزاق: ج ۸ ص ۲۳۸ حدیث ۱۰-۷۰]

"Loss is distributed exactly according to the ratio of investment and the profit is distributed according to the agreement of the partners."

5) Termination of Musharakah

Termination of Musharakah contract can be done in following manner:

1. If the purpose of Musharakah has been achieved. For example, if two people formed a partnership to execute a specific project, at the end of the project, profit or loss is shared between the partners and the Musharakah come to an end.

2. In Musharakah, any of the partners may terminate the contract by putting a prior notice to the other partner. This will cause the partnership to end, Musharakah will be dissolved. In dissolution the assets are liquidated and will be distributed between partners,

- If there is no profit and no loss to the assets, they will be distributed on pro rata basis.
- In case of loss as well, all assets will be distributed on pro rata basis.

3. Musharakah will be terminated in case of death, insanity or incapability of a partner.

4. In case of damage to the share capital of one partner before mixing the same in the total investment and before affecting the purchase, the partnership will stand terminated and the loss will only be borne by that particular partner. However, if the share capital of all partners has been mixed and could not be identified singly, then the loss will be shared by all and the partnership will not be terminated.

5. If one of partner wants to terminate Musharakah, on the other hand other partners wish to continue business. This can be done only in a situation where the remaining partners purchase the share of leaving partner. Termination by one partner does not mean the termination between other partners, by mutual agreement leaving partner can terminate his relation.

Difference between Mudarabah and Musharakah

Musharakah	Mudarabah
In Musharakah all partners invest in capital	In Mudarabah only Rab ul Maal invests funds
All partners have equal right to take part in management of business and can work for it.	All management is done by Mudarib; Rab-ul-maal has no right to partake in the management.
In Musharakah loss is shared as per the ratio of investment.	All the loss is borne by Rab ul Maal, because all investment comes from Rab ul Maal provided that Mudarib is working in due diligence.
As soon as the partners combine their capital in a joint pool, all the assets become mutually owned by all of them according to the proportion of their investment. All partners benefit from the increase in the value of the assets even if profit has not accrued through sales.	The goods bought by the Mudarib are solely owned by Rab-ul-maal and the Mudarib can earn his share in the profit only if he sells the goods of the business in a profitable manner.

Uses of Musharakah

Musharakah as a mode of financing can be used in difference banking operations; it can be used in asset side as well as liability side of an Islamic bank.

Asset Side Financing

- Short/medium/long - term financing
- Project financing
- Small & medium enterprises setup financing
- Large enterprise financing
- Import financing
- Inland bills drawn under inland letters of credit
- Export financing (Pre-shipment financing)

- Working capital Financing
- Running accounts financing / short term advances

Liability Side Financing

- For current/ saving/mahana amdani/ investment accounts (Deposit giving Profit based on Musharakah/Mudabah – with predetermined ratio)
- Inter- Bank lending / borrowing
- Term Finance Certificates & Certificate of Investment
- T-Bill and Federal Investment Bonds / Debenture.
- Securitization for large projects (based on Musharakah)
- Certificate of Investment based on Murabahah (e.g: Meezan)
- Riba Free)
- Islamic Bank Musharakah bonds (based on projects requiring large amounts - profit based on the return from the project).

In Pakistan few of Islamic bank are using Musharakah as a tool for financing. As it is a major mode of Islamic finance it must be used excessively in Islamic banks. Running Musharakah is a product which is working on Musharakah basis in Pakistan.

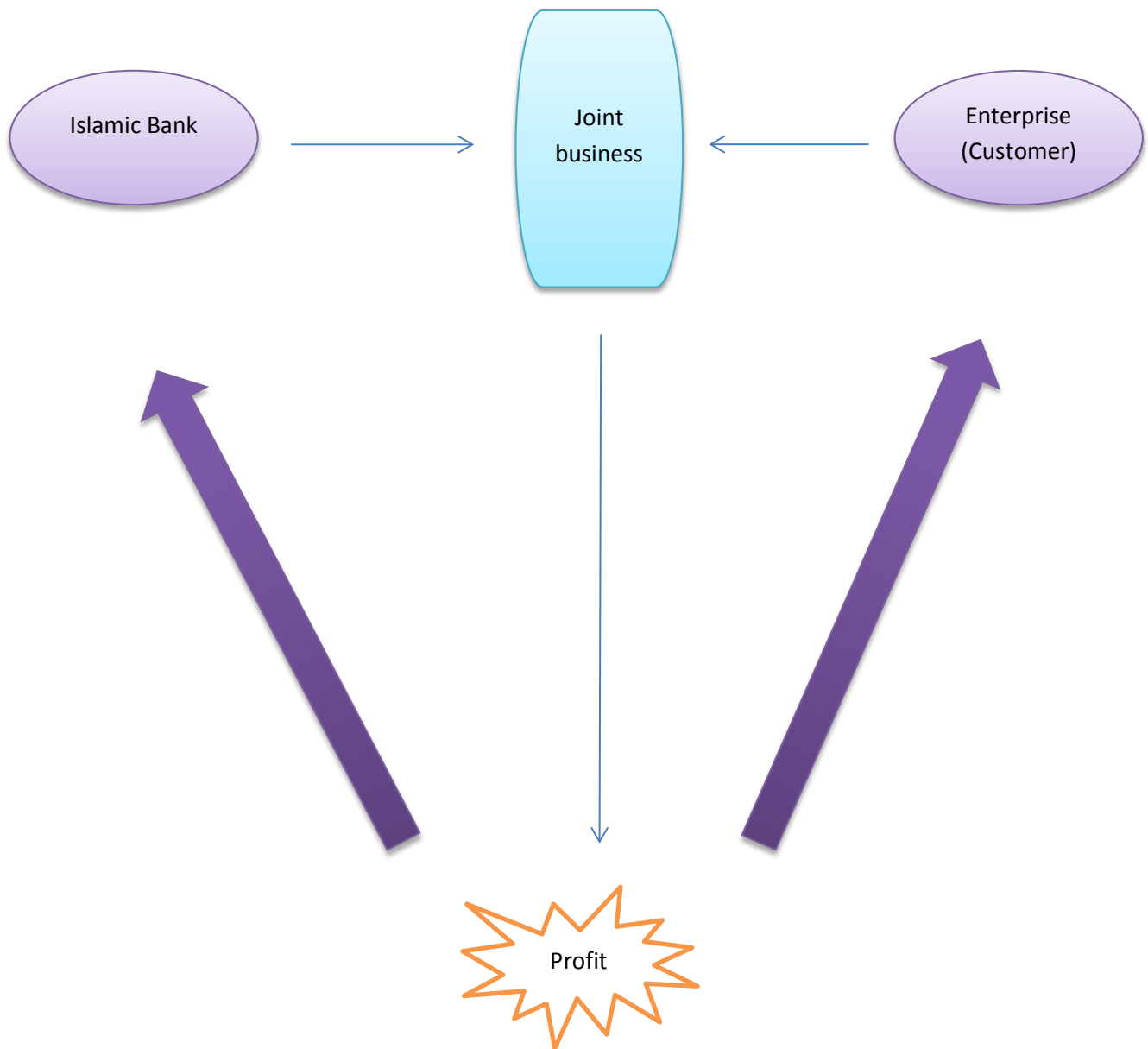
Running Musharakah Account on the Basis of Daily Products

Working capital requirements of an enterprise is financed by many financial institution by opening of running overdraft account in which customers withdraw the amount as per their needs, at the same time surplus can be added back by clients. This process of debit and credit of amounts in running account will go on to the date of maturity of agreement, interest is calculated by bank on daily product basis which is payable by customer.

In Pakistan Musharakah is not very much used as tool of financing, however few Islamic banks are using this contract to operate running accounts, known as running Musharakah. The process of operating running Musharakah is as under:

Working capital requirement can be met by using Musharakah in true letter of spirit, in this contract bank made the arrangement with the customer to invest in his business on Musharakah basis. For this purpose company's financials are required by bank to check the feasibility of the business, after careful examination of financials bank usually signs a Musharakah agreement with client to provide him with funds on Musharakah basis. In most of the cases of running Musharakah Islamic bank being the sleeping partner cannot claim profit more than his investment share.

- Customer (entrepreneur) approaches the bank for financing the working capital requirement.
- After analyzing the financial of customer, the bank will sign Musharakah agreement with customer
- In Musharakah agreement profit sharing ratio is decided before any transaction executed
- In case of loss, it will be borne by investors according to their investment.
- Practically profit is calculated on daily product basis, all amount taken by customer is ascertained for profit calculation
- At the end of month customer will provide his financial to the bank, these statement include actual profit, amount of capital invested by client himself and amount provided by bank under Musharakah
- The profit accruing at the end of the term shall be calculated on daily product basis, and shall be distributed accordingly



In such arrangement between bank and customer is based on basic principle of Musharakah. Practically it means that both Islamic bank and customer have agreed upon to the principle that profit accrued under such Musharakah agreements will be divided based on average capital utilized per day, at the end of period. The average of the profit earned by each rupee per day is distributed between bank and customer as per agreed ratio. This average profit on each rupee per day will be multiplied by number of days each investor has put his money into business

ASSET SIDE OF AN ISLAMIC BANK – II**Murabaha and Diminishing Musharakah****Lesson – 10****MURABAHA****Definition**

Murabaha can be defined as a sale transaction in which cost and profit is known to buyer and seller, here seller mentions the cost and profit of commodity. Thus, it is not a loan transaction on interest rather it's a sale transaction in which cost and profit is known.

Ideally in banks Murabaha transaction must takes place in such a way that bank should offer to sell commodity or material on cost plus profit basis to customers, however to indulge in trading business is not the primary function of a bank. Moreover trading and business activities requires specific expertise which a banker may or may not have. On the other hand it is not possible to train all staff of bank in related trade or business transactions. Islamic banking being on its initial stages cannot afford to maintain inventory storage houses in order to perform banking on trading basis.

Practically Islamic banks execute Murabaha transaction through a separate mechanism which is known as Murabaha to the purchase orderer (MPO). In Murabaha to the purchase orderer the banks are involved to purchase of a commodity from third party on behalf of customer and sell this commodity to customer on cost-plus profit basis.

It is important to mention here that Murabaha is not loan rather it is just sale transaction which is used by Islamic banks to finance their customers.

Almost 2/3rd of financing in Islamic banks are using Murabaha to facilitate customers.

Bai Muajjal

Bai Muajjal is the Arabic name for "sale on deferred payment basis". In Bai Muajjal the payment become deferred by buyer of the product and this amount becomes debt which is payable in lump sum or in installment (as per agreement). In Bai Muajjal, all those items which come under the definition of capital can be sold on deferred payment basis, where quality of an item does not make a difference but the intrinsic value does. Those assets which do not fall under the category of capital where quality can be compensated for by the price and Sharia'h scholars have an 'Ijma' (consensus) that demanding a high price in deferred payment in such a case is permissible.

MURABAHA TO PURCHASE ORDERER (MPO)

As discussed earlier Murabaha to purchase orderer is an arrangement wherein the bank, upon request by the customer, purchases an asset from a third party and sells the same to the customer cost plus profit basis. The method is widely used by most of the Islamic banks around the globe. There are several factors due to which MPO mechanism arises.

1. Banks whether Islamic or conventional, do not usually undertake trading business as it is not the primary function of banks, they might not be maintaining inventories of various goods; they do not want to become traders because inventory storage, space and holding costs might be expensive.
2. Practically it may not be possible for a bank to purchase all assets and commodities in advance for Murabaha sale to their customers, because there could be a long list of goods which are in demand of customers and there could be continuous additions to that list.
3. Another factor is that the customers to a bank may be in need of specific quality of goods which is unknown or unavailable with bank, the bank might not be even aware of the source of availability. If banks keep similar items in inventory, these might not be acceptable to the clients.
4. Regulators or central banks normally do not allow the banks to start trading as their primary business, with the dual purpose of keeping them liquid or saving them safe from market risks related to goods and commodities held by Islamic bank.

As per factors mentioned above, most of the Islamic banks purchase only those goods for which they receive request from customers.

According to the **AAOIFI** (Accounting and Auditing Organization of Islamic Financial Institutions) standard on Murabaha, it is permissible for any financial Institution that they can purchase goods or assets only in response to their customers' request and application, but this request must not be considered as a promise or commitment by customer unless unilateral promise is obtained in due form.

Basic Rules for Murabaha

Following are the rules governing a Murabaha transaction:

1. The existence of subject matter is necessary at the time of sale. Thus, anything which is not in existence at the time of sale cannot be sold and its non-existence makes the sale void.
2. Ownership of the asset is important for validity of sale; the subject matter must be in the ownership of the seller at the time of sale. If the seller sells something that he himself has not acquired, then the sale becomes void.
3. The subject matter of sale must be either in physical or constructive possession of the seller at the time of sale. In Constructive possession the owner of the asset has not taken actual or physical possession of good, but all right and obligation of that asset is passed on him.
4. The sale must be instant and absolute. Thus, a sale effective to a future date or a sale depending to a future happening is void. For example, 'A' tells 'B' on 1st of January that he will sell his car on 1st of February to 'B'; the sale is void because it is attributed to a future date.
5. The subject matter should be a property of value. Thus, a good having no value cannot be sold or purchased. E.g. stone or leaf on a road side.
6. The subject of sale should not be a thing which is non-Sharia'h compliant such as Alcohol, tobacco.
7. The subject of sale must be specifically known and identified to the buyer. For Example, 'A' the owner of an apartment building says to 'B' that he will sell an apartment to 'B'. Now the sale is void because the apartment to be sold is not specifically mentioned or pointed to the buyer.
8. The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.
9. The price of asset must be certain and known to both the parties in a sale contract. It must be specified and quantified. If the price is uncertain, the sale is void.
10. The sale must be unconditional. A sale contract which is conditional and contingent to that condition is a void sale.

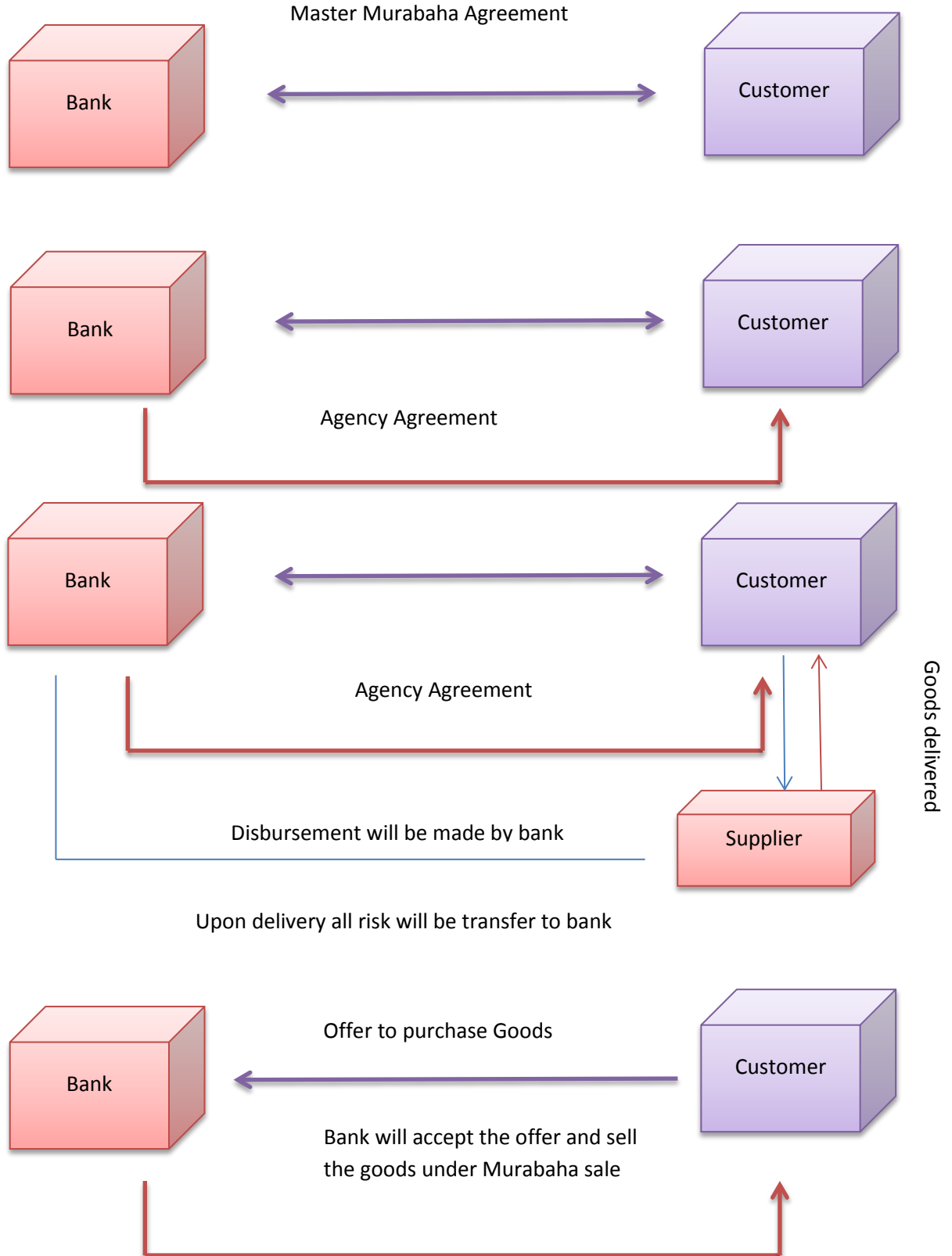
Step by step Murabaha to Purchase Orderer

Keeping in view the above guidelines for Murabaha transactions the following steps are followed by an Islamic bank practically.

1. The customer approaches to bank and ask for material to purchase, bank and customer signs an overall agreement where the customer promises to buy the commodity from bank time to time when ever needed by customer on cost plus profit basis.
2. It is the primary document in Islamic banks which is basically considered as the **Memorandum of Understanding (MoU)**. Most of the Islamic banks in Pakistan use **Master Murabaha Financing**

- Agreement (MMFA)** as MoU. In MMFA all detail of transaction is mentioned in detail, quantity of goods, total amount facility provided by bank, payment methods, and unilateral promise by customer that he will buy goods from time to time from bank.
3. After signing of MoU between Islamic bank and customer, the bank will arrange to purchase the specified material from third party. In this case the bank does not have the expertise to purchase particular kind of asset, for this purpose the bank may appoint the customer his agent to purchase the asset on bank's behalf.
 4. Islamic bank will appoint the customer its agent through **Agency agreement** to purchase the specific asset on behalf of bank.
 5. Agency agreement is not the necessary condition in Murabaha provided that it an Islamic bank can make the purchase directly. However it is advisable to execute Agency agreement because Islamic bank does not have the expertise to identify the asset or negotiate the ideal price. This agreement must be signed before the purchase of the asset.
 6. Customer on behalf of bank identifies the vendor and selects the asset as per specification and make the purchase of that particular asset; if the vendor is specified by customer then the exact quality of asset can be purchased.
 7. Being the agent of bank, the customer takes the possession of asset. After taking possession of asset as an agent of bank the customer will inform the bank regarding the purchase of the goods through a document which is called **Declaration Form**.
 8. As a result of declaration from customer the bank will appoint one of its employees to inspect the actual purchase of the asset. This inspection is done just to ensure the actual fresh purchase of the material and also to ensure that all goods which are purchased are just according to the specification given by customer.
 9. This declaration must contain that customer has inspected all the goods, which are as per requirements.
 10. The bank will provide the **Letter of Disbursement**, which is a request to make payment to the vendor for the purchased asset; preferably payment is made directly to the vendor through pay Order.
 11. At this stage the bank will own the asset and bank will have the constructive possession of the asset, all risk, reward, right and obligation related to that particular asset is transferred to bank.
 12. After taking possession of asset now at this stage Murabaha sale is executed. The customer **offers** bank to buy the asset and bank **accepting** that offer sell its asset to customer on Cost plus profit basis which is known to both the parties.
 13. It is compulsory to decide the Murabaha Price at this stage; otherwise Murabaha shall not be valid.
 14. It is also compulsory to determine the date of payment of Murabaha Price rendering the Murabaha to be valid.
 15. Customer will sign an **Offer to purchase** form and bank will accept his offer in written
 16. At the end **payment schedule summary** is decided by bank and customer. Payment can be made in following manner
 - Lump-sum payment
 - Installment Payment
 - Partly instant and partly in installment
 17. As per payment schedule the customer will pay due amounts in due date.

Process Flow of Murabaha



Issues in Murabaha

Here few of the practical issues which are common in Islamic banking industry:

1) Securities against Murabaha

Practically under Murabaha transaction the payment from customers are deferred and is considered as receivable by bank. To secure the payment from customer and to cater the risk of willful default by client the bank may ask the customer to provide security in form of mortgage or hypothecation.

2) Guaranteeing the Murabaha

To ensure the payment schedule, the buyer can be asked to furnish third party guarantee. In case of default by customer the seller or bank may have recourse to the guarantor; he will be liable to pay the amount guaranteed to him. In guarantee the guarantor cannot charge a fee from the original client.

3) Penalty for default

A very common issue with Murabaha is that in case of default of payment on due date, the seller or bank cannot charge extra amount as penalty. In order to avoid the adverse consequences, an alternative is that the client may be asked to undertake that if he fails to pay installment on its due date, he will pay certain amount to charity. For this purpose, the bank may maintain a charity fund and disburse charity from it under the directions of Sharia'h board of the bank.

4) Rollover in Murabaha

Rollover of Murabaha facility cannot be done; hence it is not possible to roll over the transaction once the old contract ends. We must understand with true letter and spirit that Murabaha is not loan transaction rather it is a sale of the asset, in which payment is deferred to future date. Once the asset is sold, all risks, rights and obligation transferred to customer and it is no more a property of bank. Hence once the sale is executed, seller cannot resale the same commodity.

5) Rebate on Early Payments

In some situations the buyer wants to pay the amount earlier to the due date and want a rebate on the agreed price, majority of Islamic scholar considered it to be as non-Islamic. If the client is needy such discounts can be given to customer to facilitate them, but this should not be made a regular practice and in no way forms a part of the contract.

6) Calculation of cost in Murabaha

The Murabaha can only be affected when the bank can determine the exact cost he has incurred in obtaining the product it wants to sell. If the exact cost cannot be determined then Murabaha cannot take place.

DIMINISHING MUSHARAKAH

The concept of Diminishing Musharakah

Diminishing Musharakah is another type of Musharakah which is developed in near past. Diminishing Musharakah is excessively used by Islamic banks to finance housing facility to customer and sometimes fixed asset can be financed through this mode. In Diminishing Musharakah two partner, one being the financier (Islamic bank) and other is customer; participate either in joint commercial enterprise or in ownership of property and equipment in such a way that one partner keep on purchasing share of the other until the other one walking out of partnership. In practical term the share of financier is divided into equal unit, later on these units are purchased by the other partner.

Examples of DM

- Diminishing Musharakah is a tool which is widely used by many Islamic banks in all over the world as a house financing product. A person who wants to purchase a house approaches the financier to finance him in purchasing the house. The financier or bank agrees to participate in purchasing the house. For example, 30% of the price is paid by the customer and 70% of the price by the bank. Thus, the bank owns 70% of the house while the customer has possession of 30%. After acquiring the property jointly, the customer uses the house for his domestic purposes and pays rent to the financier for using his part of the property. At the same time, the share of bank is further divided into seven equal units; each unit has 10% ownership of the house. The customer promises to the banker that he will buy one unit monthly. Therefore, after one month, the client purchases one unit of the share of the bank by paying 1/10th of the price of the house. This decreases the share of the bank from 70% to 60%. Hence, the rent payable to the bank is also reduced to that extent. This process keep on going until all units are sold by bank and the customer remain the only owner of this house. Such kind of diminishing Musharakah is based on Shirkat-ul-Milk.
- 'A' wants to start the business of ready-made garments but he does not have enough funds to start the business. Another person 'B' who agrees to contribute with him for a period, say three years. 40% of the investment is contributed by 'A' and 60% by 'B'. After contributing capital both start the business on the basis of Musharakah, with an agreed profit sharing ratio. But at the same time, 'B's share in the business is divided into six equal units and 'A' keeps buying these units on regular basis until after the end of two years 'B' comes out of the business, leaving its exclusive ownership to 'A'. Apart from the periodical profits earned by 'B', he gains the price of the units of his share which, in practical terms, tend to repay to him the original amount invested by him. Such diminishing Musharakah is based on Shirkat-ul-Aqd.

Home Financing on the basis of Diminishing Musharakah

The method approved by Sharia'h scholars is that three contracts signed separately, confirming that each contract is independent of the other two contracts. The first contract between bank and customer is entering into joint ownership (i.e. Shirkat-ul-Milk), after that 'Ijarah (Rental)' agreement is signed by bank and customer in which bank will lease its share to the client. An independent unilateral promise to purchase the share of bank is taken from customer, on different time sale agreement is executed for the purchase of bank's share.

Practically in Pakistan house financing facility is provided by diminishing Musharakah, most of the Islamic banks are offering this facility to their customers in three separate ways;

- If a customer wants to construct a new house
- If a customer wants to purchase a built house
- If a customer wants to renovate his existing house.

In all of the above cases the sequencing of contracts should be as follows:

1. A contract between partners to create a joint ownership i.e. **Shirkat-ul-Milk**. The customer makes a unilateral promise to purchase the share of the bank periodically.
2. The share of the bank is given to the client on rent.
3. The bank's share is divided into equal units
4. Promise from the client to purchase the units of share of bank.
5. Actual purchase of the units at different stages.
6. Adjustment of the rentals according to the remaining share of the financier in the property.

Steps in detail of the arrangement

I) The first step in the above stated arrangement of Diminishing Musharakah is to build a joint ownership in the property. It has previously been explained that 'Shirkat-ul-Milk' (joint ownership)

can come into existence in different ways including joint purchase by the contracting parties. All schools of Islamic jurisprudence have expressly allowed this type of contract.

II) The second part of the arrangement is that the banker rents his portion in the house to its customer and demand monthly rent from him for the use of property. This arrangement is also permitted because there is no difference of opinion among the Muslim jurists regarding renting out the undivided share of property to the other partner, however if this undivided share is leased out to third person then its permissibility is questionable among Muslim jurists.

Imam Abu Hanifa and Imam Zufar are of the view that the undivided share cannot be leased out to a third party, while Imam Maalik, Imam Shafi'i, Abu Yusuf and Muhammad Ibn Hasan hold that the undivided share can be leased out to any person. But so far, there is a unanimous decision of all scholars that one can rent his share of property to other partner.

III) The third step in the above-mentioned arrangement is that the customer purchases units of the undivided share of bank. If the undivided share relates to both land and building, the sale of units is allowed according to all the Islamic schools. Similarly, if the undivided share of the building is intended to be sold to the partner, it is also allowed unanimously by all the Muslim jurists. However, there is a difference of opinion if it is sold to a third party.

Now the question arises that whether all above mentioned transactions may be combined together or not. If we combine all the transaction and make each other dependent on other, then it is not allowed in Islam. Because one contract cannot be made condition for other.

However, despite of making two contracts contingent to other, it is preferred to take unilateral promise from customer to use bank's share under Ijarah (Leasing) and secondly to purchase the units from bank's share in property.

Hypothetical Case Study on Housing Finance through Diminishing Musharakah (Partnership by Ownership)

Construction of a house on land owned by the customer would involve purchase/sale and lease-back. Suppose the plot of land is worth one million dirhams and the customer needs 800,000 dirhams from the Islamic bank. The bank would purchase a part of the land from the customer (say 8 units of 100,000 dirhams each out of a total of ten units) to form a joint ownership on the basis of Shirkat-ul-milk. The customer would undertake that he would pay rent on the bank's part of ownership and would periodically purchase the share of the bank according to a pre-agreed schedule of price.

With the proceeds of the land (800,000 dirhams that could be provided in four equal instalments), the client would construct the house; when the house was complete and habitable, the bank would lease its part of ownership to the client at the agreed rental. Up to one year, the client would pay only the rent on the bank's part of the house.

(Case study is taken from Book, Understanding of Islamic finance by Muhammad Ayub)

Calculation of the monthly payment plan for home purchase:

Cost of house:	dirhams 1.0 Mm
Bank financing:	80%
Tenure:	10 years
Rental (return rate equivalent to):	7% p.a. (of investment)
Purpose:	home purchase from the market

Key structure

Monthly payment consists of unit purchase and rent components. Unit purchase will remain constant over the entire tenure. Rent is calculated based on the number of units outstanding. The rent component will decrease every month with the purchase of units.

(Construction of a house on a plot of land already owned by the client, Renovation/ additions to a house owned by him for the payment of an interest-based mortgage loan on a client's house are subject to a different procedure, as discussed in the previous Box.)

Working

Bank's share:	dirhams 800,000; full payment is made in one tranche
Client's share:	dirhams 200,000
No. of bank's units (equal to number of months):	120
Price per unit:	6,666.67 (Principal/number of units)
Rent per unit (annual): for monthly rent]	466.67 [((outstanding investment * rate) / 12)

Payment schedule

Month	Unit	Rent per month	Total	Units	Investment
0	—	—	—	120	800 000.0
1	6666.67	4666.67	11 333.33	119	793 333.3
2	6666.67	4627.78	11 294.44	118	786 666.7
3	6666.67	4588.89	11 255.56	117	780 000.0
4	6666.67	4550.00	11 216.67	116	773 333.3
5	6666.67	4511.11	11 177.78	115	766 666.7
6 to 115	xxxx	xxxx	xxxx	xxxx	xxxx
116	6666.67	194.44	6861.11	4	26 666.7
117	6666.67	155.56	6822.22	3	20 000.0
118	6666.67	116.67	6783.33	2	13 333.3
119	6666.67	77.78	6744.44	1	6666.7
120	6666.67	38.89	6705.56	—	0.0

ASSET SIDE OF ISLAMIC BANK

Ijarah – A Car financing tool

Lesson 11

In Islamic Fiqh the lexical meaning of "Ijarah" is "to give something on rent". The term Ijarah can be used in different manners in Islamic jurisprudence In the Islamic jurisprudence.

1) The first case of Ijarah is "to employ the services of a person on wages given to him as a consideration for his hired services." The employer is called "Mustajir" while the employee is called "Ajir", while the wages paid to the employee are called their "Ujrah".

Example

If 'A' has employed 'B' in his office as a manager on a monthly salary, 'A' is the Mustajir, and 'B' is the Ajir. Similarly, if 'A' has hired the services of a porter to carry his baggage to the airport, 'A' is the Mustajir while the porter is an Ajir and in both cases, the transaction between the parties is termed as "Ijarah-tul-Ashkhas".

2) In second case of Ijarah, usufruct of asset is transferred to other person rather employing of services of human beings. In this sense it will be defined as the transfer of usufruct of particular asset or property to another person in exchange of agreed rent at the end of each month. This form of Ijarah is similar to leasing, here lessor will be called 'Mujir' and lessee will be called 'Mustajir', rent will be paid by Mustajir to Mujir. In this case there is lot of difference between leasing and Ijarah.

Basic Rules of Ijarah

The basic rules of Ijarah are as follows:

1. Transferring of usufruct not ownership

As per definition of Ijarah only the usufruct of asset is transferred to lessee not the ownership, the lessee has only right to use the property not to own it.

2. Subject matter of Ijarah

The subject matter or property which is going to be let out should be valuable, identified and quantified.

3. All consumable things cannot be leased out

In Ijarah only the usufruct of asset is transferred to lessee but the asset remains in the ownership of the lessor/seller. All those things which cannot be used without consuming cannot be the subject matter of Ijarah contract. For example money, wheat, rice etc.

4. All liabilities of ownership is borne by lessor

As the asset of Ijarah will remain in the ownership of lessor, so all rights and obligation related to that asset belongs to lessor. All liabilities evolving from the ownership shall be borne by lessor.

5. Period must be specified in Ijarah

The period of Ijarah/rent agreement must be determined in clear terms. It is very much essential for a valid Ijarah that the subject matter or property is fully identified by the parties.

6. Ijarah for specific purpose

While making Ijarah contract the use of the asset must be specifically known to lessor. The lessee cannot use the asset other than the purpose specified in Ijarah contract. However there may be a case where no purpose is specified by either party then it can be used in normal course.

Important concepts in Ijarah**Lessee as Ameen**

There is certain obligation which lies on part of lessee:

1. The lessee will be liable to compensate the lessor for any damage to the property or asset caused by his exploitation or negligence.
2. The Ijarah asset will remain in the risk of the lessor throughout the Ijarah agreement in the sense that any damage or loss caused by the factors beyond the control of the lessee shall be borne by the lessor.

Ijarah of jointly owned property

1. A situation where a property is jointly owned by two or more persons then it can be rented to a third party and amount of rent will be shared between co-owners just according to the agreed proportion.
2. However Sharia'h allows that one owner of property can lease his share to his co-owner and not to any third person.

Determination of Rental in Ijarah

1. It necessary for a valid Ijarah contract that amount of rental must be determined at the time of contract for the whole period
2. In valid Ijarah it is permissible to decide different rentals for different phases of Ijarah period, on condition that the amount of rent for each phase is explicitly agreed upon at the time of contract. If the rent for a later phase of the lease period has not been determined or has been left at the option of the lessor, in this case Ijarah is not valid.
3. If the rentals are determined, which based on the actual cost incurred in purchasing the asset by lessor, as normally practiced in financial lease, is not against the rules of Sharia'h if both lessor and lessee agreed to it, provided that all essential conditions for Ijarah are fully complied with.
4. The lessor cannot increase the rent unilaterally and any agreement relating to this void.
5. Ijarah period will begin from the date on which the asset has been delivered to lessee.
6. If the asset has totally lost the function for which it was rented, the contract will stand terminated.
7. Before delivery of the asset to lessee, the lessor may demand advance amount which will remain with the lessor and shall be adjusted towards rent after being due.

Ijarah as a mode of financing

Ijarah originally is not a mode of financing. It is simply the transfer of usufruct of an asset from one person to another for an agreed period of time against agreed rentals for its use. However some of the financial institutions adopted leasing as a mode of financing rather than lending amount on interest.

Many conventional banks use financial lease as a financing tool, which subject to certain conditions. There is substantive difference between conventional leasing and Ijarah.

Conventional Leasing	Ijarah
In conventional lease asset is not owned by the bank	In Ijarah the asset is fully owned by the bank.
In case of any loss to asset, the bank is not held responsible to bear that loss.	All risk and rewards relate to bank, any loss occur to asset will be borne by bank unless this loss is caused by negligence of customer.
In conventional lease the rent is charged and demanded before delivery of the asset.	In Ijarah rent cannot be charged or demanded before the delivery of the asset to lessee.
The conventional lease agreements give unilateral right to bank to terminate the Lease Agreement without any reason.	Since Ijarah is a compulsory agreement therefore, neither party can dismiss it without mutual consent unless if there is a breach of contract by either party.
Late payment penalty is charged	Penalty on late payment cannot be charged.

IJARAH IN ISLAMIC BANKS:

ISLAMIC BANKS’ IJARAH MUNTAHIA-BI-TAMLEEK (IJARAH WA IQTINA)’

Islamic banks uses Ijarah as a mode of financing and this procedure is excessively used in financing cars in market. Ijarah Muntahia Bi Tamleek, sometimes known as Ijarah Wa Iqtina is used in banking industry to provide car facility which is free from interest. For this purpose Islamic banks have adopted operational procedure of Ijarah Muntahia-bi-Tamleek, according to which the transaction basically remains one of Ijarah and the ownership transfer is kept separate from the main Ijarah contract.

For Ijarah Muntahia-bi-Tamleek/Ijarah wa Iqtina, Islamic banks normally purchase the asset in response to specific requests from customers to get the asset on a lease that ends with transfer of ownership after the lease term through a separate and a formal sale or gift contract. According to the AAOIFI Standard on Ijarah, transfer of ownership in the leased property cannot be made by a sale contract (along with the Ijarah) to be made effective on a future date. Ownership can be transferred using one of the following means:

- By means of a promise to sell for consideration.
- By promise to give it as a gift (for no consideration) at the end of the lease period.
- By promise to gift upon the payment of the remaining instalments.

In all above forms the transfer of ownership is kept independent of the Ijarah contract, and these are not included as the main part of contract. The promise should be one-sided and binding on the promisor only.

Procedure for Ijarah Muntahia-bi-Tamleek/Ijarah wa Iqtina

The Ijarah wa Iqtina is technically a leasing agreement that ends with ownership, is a innovated Islamic banking product. The distinguishing feature of this contract is that the bank purchases the asset on request of customer who intended to own the asset through lease that ends with possession. At the completion of the tenure the banks transfer the ownership of asset through gift or a separate sale agreement.

The Practical Steps of a Lease Purchase Operation

1. In first step the client tells his requirement of asset to the bank and signs a MoU which covers the overall Ijarah structure. The bank required an initial amount from customer as Hamish Jiddiyah (Himasih Jiddiaya is the money provided in start of transaction as pure intention to buy and after completion of transaction seller give back the amount to buyer) to ensure that the customer is serious in his deal. Furthermore the bank will get undertaking from customer that he will take the asset on lease when it is purchased by the bank. Hamish Jiddiyah will be considered as advance rental in Ijarah contract. Once the Ijarah contract starts between bank and customer this amount is considered as advance rental and will be adjusted during

the period of lease. If there is termination of Ijarah due to negligence of lessee then, bank is eligible to deduct actual damages from remaining advance rental if but if it is the case of theft or destruction then while remaining amount of advance rental must be given back as it is to customer.

2. As per customer's request the bank will make to purchase of particular asset, for this purpose the bank can directly or indirectly purchase the asset by appointing an agent for the purpose of purchase. In this situation the bank can appoint the customer its agent to purchase the asset on behalf of bank, if customer is appointed as agent of bank in this case asset can be purchased just according to the required specification. The bank will pay all duties, taxes or any other cost incidental to purchase of asset to the supplier. According to the AAOIFI Standard, third party agent is preferable in purchasing the asset, but the client can also be appointed as agent. If the vendor of the asset is also indicated by the client, the bank can get a performance bond from him to the effect that the asset supplied will be acceptable to him. The bank, however, will remain liable for ownership-related risks and expenses.

Process Flow of Ijarah Wa Iqtina

1. The purchase contract of assets

The bank: In fulfilment of the customer's request to purchase the asset/car and will be leased out which ends will ownership, the bank purchases the asset either directly or by appointing an agent from the seller, pays the price and gets its possession.

The vendor: Agrees on the sale, signs the bill and agrees with the bank about the place of delivery.

2. Delivery and receipt of the commodity

The Vendor: Delivers the asset to the bank directly or to any party designated by the as agent of bank in the contract.

The bank: Authorizes its customer to receive the asset/car and demands a notification of arrival and satisfaction of the required specifications. At this point when asset is delivered to bank or its agent, all right and obligations related to that asset/car will come under control of bank.

3. The lease contract

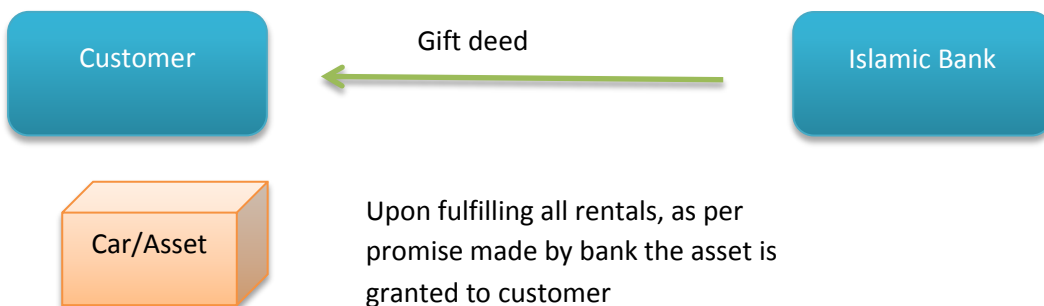
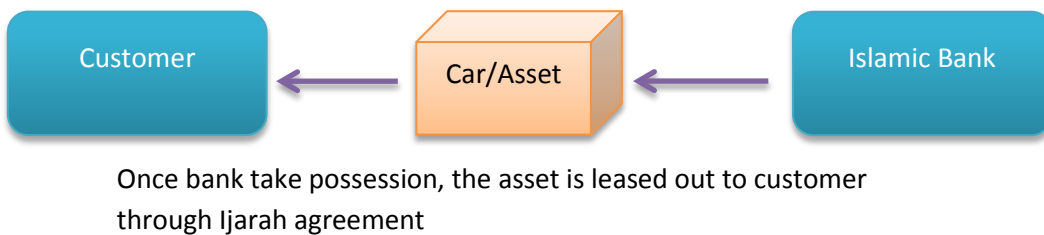
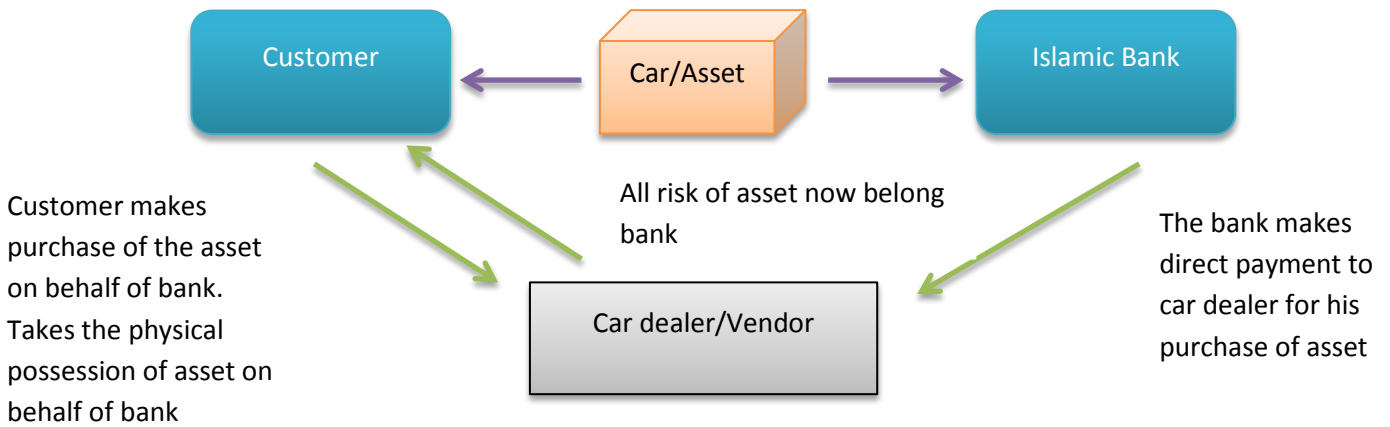
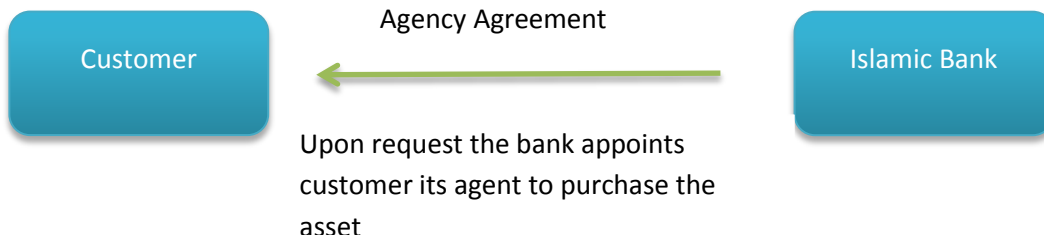
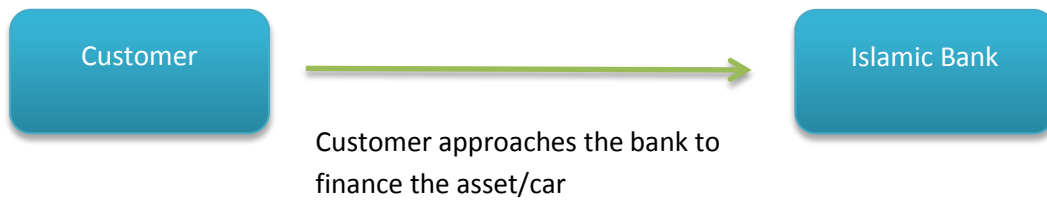
The bank: Once the asset is in possession of bank whether actually or constructively, after notification by customer of its delivery the bank can lease out this asset/car to the customer. Along with lease agreement a unilateral promise is made by bank to customer that if he pays all rentals regularly then bank will gift the asset/car at the end of period. .

The customer/lessee: pays the rental installments at the agreed upon periods.

4. Transfer of ownership

The bank: At the end of the lease period when the lessee pays all the installments due, the bank assigns the asset to the benefit of the lessee as a grant or sale as promised.

The lessee: Ownership of the asset transfers to the lessee.



Areas of Applications

The Islamic banks can use Ijarah with option to purchase especially

- Real estate
- Vehicles
- Computers,
- Machinery
- Equipment

In all situations, the Islamic bank gives their customers the freedom of choice to acquire the assets as agent of bank, after that asset will be given for use for a specified period on rent.

Issues Concerning Modern Use of Ijarah

With respect to the modus operandi of Ijarah, Islamic banks face five sets of issues and problems.

1. One major question is asked regarding maintenance cost of asset, whether these expenses would be borne by lessee or by the lessor. For this sharia'h provides that other than normal maintenance, the major expenses would be borne by owner (lessor), provided that damages to the asset are not due to the negligence of lessee.
3. If any damage occurs to the asset during the supply stage, the lessee (client) serving as agent is not responsible for it until any fault on his part is proved. The rental, if received in advance, should be adjusted accordingly, unless it is agreed that the lease be extended by an equivalent period after its original expiry date.
2. Another problem may come in Ijarah contract is of lack of knowledge of staff member of Islamic banks. The basic principle of Ijarah is that Ijarah contract must be signed only when asset is in possession of banks and is delivered to customer. If due to lack of knowledge Islamic banks make Ijarah contract before physical or constructive possession then it will be void. Moreover Ijarah will be effective only when asset is delivered to customer rather than when making payment to supplier, and consequently rent will only be charged from the date of delivery of asset rather than date of making payment supplier.
5. A big problem appears in the case of a default in payment of rental by the lessee, if it is proven that customer defaulted willfully then as a penalty taken for late payment has to be given to charity. Nothing is charged in bank's account out of this amount.

ASSET SIDE OF ISLAMIC BANK
Salam, Istisna', Istijrar and Tawarruq
Lesson – 12

SALAM

Salam is a kind of sale in which payment is made in full in advance and while delivery of the commodity is deferred. It is basically an exception to sale in which subject matter does not exist and seller undertakes to deliver specified goods to the buyer at a future date in exchange of an advanced price fully paid at spot.

Permissibility of Salam

Permission of Bai' Salam can be found from the life of holy Prophet (PBHU) and has been permitted by the holy Prophet (pbuh) himself, without any difference of opinion among the early or the contemporary jurists, anyhow the general principle of the Sharia'h that the sale of a commodity which is not in the possession of the seller is not permitted. Upon migration from Makkah, the Prophet (PBUH) came to Madinah, where the people used to pay in advance the price of fruit (or dates) to be delivered within one, two and three years. But such a sale was carried out without specifying the quality, measure or weight of the commodity or the time of delivery. The holy Prophet (PBUH) ordained: "Whoever pays money in advance (for fruit) (to be delivered later) should pay it for a known quality, specified measure and weight (of dates or fruit) of course along with the price and time of delivery".

Conditions for Salam

The conditions for Salam transactions are as follows:

- 1) First condition for validity of Salam is that the buyer must pay the price in full to the seller at the time of sale. If payment is deferred, it will be equivalent to sale of debt against debt which is strictly prohibited in Islam. However if payment is deferred in Salam then basic purpose of allowing Salam transaction will not be achieved i.e. to fulfill the instant need of seller.
- 2) In Salam quantity and quality of sold commodity must be easily specified, only those commodities can be sold through a Salam in which the quantity and quality can be exactly specified for example we cannot sell precious stones cannot on the basis of Salam because every stone differs in size, weight, quality and their exact specification is not possible
- 3) Salam cannot be linked to a particular commodity or product of specified field or farm e.g. Supply of rice of a particular field or the fruit of a particular tree. We cannot relate Salam transaction to a particular field because there is a possibility that the crop may get destroyed before delivery and the delivery remains uncertain.
- 4) The quality of goods sold must be clearly specified in all aspects with no ambiguity, which may lead to a dispute.
- 5) It is also necessary that the quantity of the goods sold must be agreed upon in absolute terms.
- 6) The exact date and place of delivery must be specified in the contract.
- 7) Those commodities whose defer payment may involve risk of Riba cannot be the subject matter of Salam. For example, if gold is purchased in exchange of silver, it is necessary that the delivery of both commodities be on spot without any deferment, thus gold or silver cannot become the subject matter of Salam if the price is given in gold.
- 8) As per the rulings of Shaafi, Maliki and Hanbali schools of thought, the subject matter or goods of Salam should be readily available in market at the time of delivery.
- 9) In Salam generally price paid in advance is lower than the price paid in spot transaction. Period for delivery of goods must be long enough to affect the prices. The difference in price is a valid profit for buyer.
- 11) To ensure the delivery from seller, a buyer can require some guarantee or security for this.
- 12) Only the commodity will be delivered by seller not money.

Purpose of use:

Bai Salam can be used as a mode of financing by modern banks and some financial institutions.

- Salam can be used to meet the needs and requirements of small farmers who need financing to grow their crops.
- To meet the need of traders for the purpose of import and export business. It is allowed to sell the goods in advance in Salam and receiving the cash price in advance to fulfill their expenses for aforesaid business. Salam is beneficial to the seller as he receives the price in advance and it is beneficial to the buyer also as normally the price in Salam is lower than the price in spot sale.

Parallel Salam

A situation where after purchasing goods by Salam, the bank can sell it through another Salam contract to third party for same date of delivery. The period of Salam in the second parallel Salam contract is shorter and the price is higher than the first contract. The difference between the two prices shall be the profit earned by the institution.

1. In an arrangement of parallel Salam, there must be two different and independent contracts;

- a) In first Salam, where the bank is a buyer.
- b) Second Salam, in which bank is a seller.

In parallel Salam two contracts are performed separately, none of the contract is made contingent on other. For example, if 'A' has purchased from 'B' 2,000 bags of wheat by way of Salam to be delivered on 30 September, 'A' can contract a parallel Salam with 'C' to deliver to him 2,000 bags of wheat on 30 September. But while contracting Parallel Salam with 'C', the delivery of wheat to 'C' cannot be contingent with taking delivery from 'B'. Therefore, even if 'B' does not deliver wheat on 30 September, 'A' is duty bound to deliver 2,000 bags of wheat to 'C'. He can pursue whatever alternative he has against 'B', but he cannot rid himself from his liability to deliver wheat to 'C'.

Similarly, if 'B' has delivered faulty goods, which do not conform to the agreed specifications, 'A' is still obligated to deliver the goods to 'C' according to the specifications agreed with him

ISTISNA'**Introduction**

Istisna' is another exception to sale where goods are sold before they exist. It is basically an order to manufacture, in which a commodity is transacted before it is manufactured. The buyer puts an order to a manufacturer a specific commodity to seller, the seller using his own material and his skill to manufacture the ordered commodity and agreed to deliver it in near future

Basic rules of Istisna'

1. Istisna' is a sale contract of those goods which need to be manufactured by human effort not by natural process such as growing of crops, fruits etc.
2. Items with unique attributes, which are not very common in market can be manufactured through Istisna'
3. If the subject matter already exists, Istisna' contract cannot be made for those goods.
4. While specifying the goods to be manufactured, all terms such as, quality, quantity, type, dimensions, period and place of delivery of asset.
5. The seller (manufacturer) may construct the goods from other manufacturer to fulfill the requirement
6. Price of Asset should be known in order to avoid ignorance and dispute
7. Buyer can pay the price in advance or in installments
8. Once the price is settled, it cannot be changed later on.

9. The bank may be acting in the capacity of the manufacturer, may give or demand a security deposit (Arbun), which can be considered as a part of the price if the contract is completed, and surrendered if the contract is rescinded
10. Fixing the exact date of delivery is not possible in Istisna' hence it is not necessary. However, the buyer and seller may fix a maximum time for delivery which means that if the manufacturer (seller) delays the delivery after that particular period then, buyer will not be bound to accept the goods or to pay the price.

Istisna' as a mode of financing in Islamic banks

Istisna' contract now days widely used by banks as a financing tool, following are the possible financing structures which can be achieved by Istisna':

- Islamic banks use Istisna' sometimes for house financing. If customer owns land and wants to build a house on it, he may enter into a contract with financier to manufacture the house on Istisna' basis. The financier (bank) does not manufacture the house by its own but he enter in parallel Istisna' with third party to hire his service as contractor to build the house. The bank will calculate the cost of the house and fixes the amount of Istisna' with some profit. The customer will make payment to the bank either in advance or in installments, further payments can be secured by bank by taking title deed of property from customer.

The financier (bank) will be responsible to strictly conform to the specifications in the agreement for the construction of the house. Financier will examine the house manufactured by contractor and make payment to third party. On agreed period the house will be given in the ownership of customer.

- Istisna' can be used by banks to finance similar projects like installation of an air conditioning plant in the client's factory, building a bridge or a highway etc.
- The modern BOT (Built, Operate and Transfer) agreements may be formalized through an Istisna' agreement as well. So, if the government wants to build a highway, it may enter into an Istisna' contract with the builder. The price of Istisna' maybe the right of the builder to operate the highway and collect Toll Taxes for a specific period.

Working Capital Financing Using Istisna

Apart from above financing structures Islamic Bank can also finance the Working Capital requirements of a manufacturer or company:

1. Customer (Manufacturer) approaches the bank in need of funds for its fulfilling its working Capital requirements, Islamic bank upon his request places an order to manufacture the goods of specific attributes and agreed on the terms with fix price.
2. Islamic bank may make the agreed payment of Istisna Price at lump sum or in installments.
3. After the finished goods are ready for delivery, the seller (manufacturer) delivers the goods to bank.
4. After receiving the goods, the bank will sell these goods in the market, either directly or through some agent, to recover its cost price and earn some profit from the transaction.

Uses of Istisna'

- House financing
- Financing of plant / factory / building
- Booking of apartments

- BOT arrangements
- Construction of buildings and plants

Salam	Istisna'
The subject may be anything which may or may not need manufacturing	Subject matter must need to be manufactured
Price should be paid in advance	Spot full payment is not necessary in Istisna', it can be deferred
Time of delivery must be specifically known	Exact date of delivery cannot be determined, certain time frame can be decided
Once Salam contract is signed, no one can cancel the contract unilaterally	Contract can be rescind before manufacturing work start.

ISTIJRAR

Istijrar is not considered as specific mode; rather it is a repeat sale/purchase arrangement of normal sale in which buyer and seller transact in number of commodities from time to time. The seller may deliver the goods in different consignments, the price either is determined in advance or at the end of period. For each time of purchase there is no offer and acceptance or bargain.

In Istijrar there is one master agreement where all the terms and conditions are determined. There can be of two types of Istijrar:

- Where price is determined in advance before any transaction, the purchases are made from time to time
- When all the transactions are complete then total price is finalized.

These kinds are permissible with certain conditions.

1) if seller discloses the price of commodity at the time of each transaction, in this case sale will only be valid if buyer possesses the goods and price will be paid after all transactions are complete.

2) If the price of the subject matter is not known at the time of possession or the contractors agreed on a condition that whatever the price will be they will make transaction. In this case if there is significant change in the market price and the agreed price, it may lead to conflict. In all given situations sale will only be valid when payment is settled among parties.

The validity of Istijrar is related the time of possession. The ownership of asset or commodity will be determined at the time of possession. After the payment of price, the buyer's usage of the subject matter will be valid from the time of the possession.

Uses of Istijrar in Islamic bank

Practically Islamic banks can make use of Istijrar in Murabaha financing in the following manner:

In Islamic banks Istijrar is used in purchasing the goods from supplier from time to time and sell those to customers on profit on defer payment basis. Istijrar is used in execution of Murabaha transaction in which bank make purchase from supplier and sell them to customer on profit. The goods will remain in the ownership and risk of bank till the goods are sold to the customer, making the contract of sale valid and earning profit on such a transaction will be permissible (Halal).

In order to make Istijrar a practical, following mechanism may be adopted by banks:

1. The bank signs an Istijrar contract with the customer to sell him commodities from time to time on a certain limit on cost plus profit basis.
2. The customer sends a purchase requisition to request bank to purchase the specified commodities.
3. The bank at the same time or just after signing the Istijrar agreement with customer (purchaser), the bank enter into a parallel Istijrar agreement with the supplier to purchase the commodities from time to time on spot/credit basis on market price, payment can be made in advance or can be deferred.
4. The bank after receiving the purchase request from customer sends a purchase requisition letter to supplier to deliver the goods. Goods can be delivered directly to bank or its authorized representative or to customer directly on behalf of bank. After taking possession of the goods and making the supplier its agent to deliver the goods to the customer, the goods will remain in the ownership and risk of the bank.

In purchase requisition a complete detail of good must be mentioned. A confirmation letter should also be sent from the supplier to the bank and then from the bank to the purchaser describing all details of the goods and their prices, in order to avoid any ambiguity in the subject matter as well as in the price that may lead to any dispute.

TAWARRUQ

Tawarruq refers to “buy on credit and sell at spot value with the objective of getting cash.” A very rapidly recognize transaction used by many Islamic banks for liquidity management and as a mode of financing particularly for personal financing and credit cards.

A person who is in need of money or who simply wants liquidity, he can get by purchasing commodity on credit and selling those to third party on cash. According to Sharia’h it is allowed to sell these commodities to third person, however if goods are sold to the person from whom he purchased on credit, then it is not allowed.

Permissibility of Tawarruq

Tawarruq has been mainly discussed by the Hanbali and Shafi jurists; but Tawarruq is different from Bai Al’ Inah. In Tawarruq the person who gets the liquidity sells goods to third person while in Inah transaction the goods are sold to the same person from whom these are purchased with a different price on sale or purchase. Maliki jurists, who are very strict about ruling of Bai Inah, do not see a major impermissibility in Tawarruq. They consider it a way to avoid Riba.

The majority of the Hanafi jurists are of the view that Bai Inah is limited to a situation where the commodity is sold back to the person from whom it was purchased on credit but if it is sold to third person or in the market, the transaction is valid and permissible

This is the position with regard to the original concept of Tawarruq, but the ruling changes if the transaction is infiltrated by some other elements. If a bank purchases a commodity having brisk market and sells the same to the Mutawarriq, who sells it in the market, there is no Sharia'h problem.

But, if the bank appoints the Mutawarriq its agent to purchase the commodity on its behalf and then to sell the same to himself, the transaction will not be valid, as the two transactions of purchase and sale are interdependent and the bank has not taken the possession and the business risk.

However, if the bank appoints him as an agent only for the purchase of a commodity on behalf of the bank, then, once it is purchased, the bank itself sells it to him through a separate contract with proper offer and acceptance, the transaction is valid, but not advisable.

Despite permissibility on legal grounds, use of such financing on an extensive level needs to be avoided. The Sharia'h scholars and experts in Islamic finance advise that Tawarruq practice must be of limited use only for meeting unavoidable liquidity needs of the corporate sector

The Tawarruq process seems to be very simple. However, extreme care should be taken while undertaking such transactions and it should be ensured that the transaction does not become a mere exchange of papers between two brokers and one or two banks. Islamic banks need to understand that Tawarruq arrangements should be used in extreme cases where no option is available to avoid interest.

Excessive use of Tawarruq may be harmful for Islamic banking industry in any country

FINANCING OF FOREIGN TRADE

Import, Export, Project financing

Lesson – 13

IMPORT FINANCING**Import financing in conventional banks**

One of the important aspects financing side of a bank is Import Financing. Most of the international traders need finance to carry out import or export trading. In normal course of banking trader approach bank for import financing due to several problems like involvement of foreign currency, opening of letter of credit (LC), huge payments other tax benefits etc.

In import financing a bank open a letter of credit for importer in which bank provide guarantee to exporter confirming the payment. In import financing service charges are taken from customer for opening LC and Interest is charged on the LCs if not paid on due date.

Letter of credit is basically a guarantee provided by bank to exporter ensuring him to pay the purchase price if importer defaults. According to Sharia'h guarantee contract is a gratuitous contract, no fee or commission can be charged on it. Secondly charging interest on advancing any money in loan, it should also not be allowed to ask any compensation only for undertaking to pay an amount of loan.

Service Charges for Import

The bank may charge only service charges for following services only if the bank does not aim to recover any profit from importer,

- Documentation charges
- Credit Assessment fee
- Correspondence charges
- Account Maintenance Services
- Monitoring Service charges

All above charges can only be charges on actual cost which should be mentioned in schedule of charges of a bank. These charges on actual cost are considered valid in light of sharia'h. Some of these charges are one time in nature, some can be charged on time over time.

Import Financing in Islamic banks

Islamic banks use different contract to finance import transactions, there are several ways to finance the traders to import. There are mainly three modes which an Islamic bank uses while financing the import facility

- Murabaha
- Ijarah
- Musharakah

Each of them is discussed in detail as follows:

Murabaha

As we already discusses Murabaha in detail in previous lesson. It is generally defined as the sale of a commodity in which cost and profit margin is known to both buyer and seller. This tool can be used if customer needs to purchase raw material, goods or equipment. Bank purchases that material or equipment and sell it to customer on cost plus profit basis.

Certain mechanism of Murabaha is used by Islamic banks for financing import

Practical Procedure of Murabaha Import Financing

1. The customer approaches the bank finance his import. After getting requirement of goods to be purchased/imported. The bank will appoint importer as its agent to import the goods on bank's behalf. In this step, Agreement to Murabaha and an Agency Agreement will be signed
2. All charges like documentation Credit Assessment, LC opening charges on actual cost basis will be included in cost of the asset to be purchased by bank.
3. Exporter according to term and condition of LC ship goods and will send documents to the bank through negotiating bank.
4. Once the material is purchased and received, the bank will offer the asset to sale the commodity on Murabaha basis including its profit margin. The bank will ask the customer for availability of funds, if customer does not have funds then payment will be deferred.
5. Once the profit is calculated and agreed, sale price of Murabaha transaction will be calculated keeping in view all the costs including LC commission, takaful etc.
6. After taking delivery or receiving Bill of Lading, Murabaha contract will be executed.
7. The bank will release documents to client.
8. The Importer will pay Murabaha price to the bank on the due date.

Ijarah

As we already know that Ijarah is a lease contract. In context of Islamic banks, it refers to a lease contract under which the bank leases equipment or a building to its customer for agreed period and rent.

Certain mechanism can be adopted to finance import transactions by Islamic banks

Practical Procedure of Ijarah Import Financing

Its step by step details are as follows:

1. The bank will appoint the importer as its agent to import the goods on its behalf. In this step Agency Agreement is signed.
2. All charges like Takaful, LC opening charges and documentation etc. will be calculated on actual cost basis. The bank may also choose to add these charges to the cost of goods while calculating its rental.
3. Exporter will ship goods and send documents (Bill of Lading) to the bank through bank.
4. Bank will release the LC and will hand over the bills of lading to the importer
5. The Importer will release the goods and take delivery, at this point the bank will enter into an Ijarah agreement with the customer. A specific rental for agreed period will be decided.
6. After the term of Ijarah agreement is completed, the bank may sell the asset to the importer at an agreed price.
- 7.

Musharakah

Musharakah or Shirkah can be defined as a form of partnership where two or more persons combine to carry out business and share capital, management, profit or loss and other rights and obligations

Musharakah can also be used to finance imports, especially those commodities which are sold at certain fixed price in local or international markets.

Practical Procedure of Musharakah Import Financing

1. The bank and the importer will sign Musharakah Agreement.
2. The purpose of the Musharakah would be to import and sell the commodity in the local market.

3. The bank and the importer may agree on any profit sharing ratio, however, as the importer would be the working partner, his sharing ratio should not be less than his share of investment.
4. The bank may ask the importer to make payment of his share upfront.
5. The bank will open LC in favor of the exporter.
6. Exporter will ship goods and will send documents to the bank through negotiating bank.
7. The bank will make payment to the exporter and will release documents to the importer.

EXPORT FINANCING

Export financing is often considered as a key sale factor in banks, exporters who want to export goods need funds at different stages. Exporter usually wants to get paid as soon as possible, on the other hand importers want to delay payment until they resell the goods in market.

Classification of Export Finance

Financing the exporters can generally be classified in two categories, depending upon the stage of exporter at which he wants to finance his activity. Exports financing represents asset side of a bank in which bank made investment to finance export activity.

The two types of export financing are:

- Pre shipment
- Post shipment

1. Pre Shipment

If financing is provided to exporter before shipment of goods, it is termed as Pre shipment finance.

2. Post Shipment

If exporter avails financing facility after shipment of goods is termed as post shipment finance.

Islamic banks use different contracts for export financing both in pre and post shipment financing.

Pre shipment financing: In pre shipment financing Islamic banks uses contracts like

1. Murabaha
2. Istisna
3. Musharakah

Post shipment financing: Following contracts can be used for post shipment financing.

1. Wakalah/Qurdh-e-Hassana
2. Salam
3. Murabaha

Pre-shipment Financing

1. Murabaha

In pre shipment financing Murabaha contract can be used for financing purpose. Banks usually do Murabaha when there is need to purchase commodity or material. As normal Murabaha transaction as we discuss it in previous lessons, the bank will purchase commodity from market and resell it on profit.

Steps Involved in the Murabaha Export Finance Scheme

It can only be used when customer need to purchase raw material, commodity or goods from market.

1. Exporter/customer will approach a bank and ask for export financing. After completing credit worthiness by bank, the exporter and bank will enter into Murabaha agreement.

2. To ensure future payment from customer, bank may demand security from the exporter under Murabaha Agreement.
3. Exporter will select the goods for which it needs the Murabaha facility and request the bank for disbursement.
4. The bank will appoint the customer as its agent to purchase the goods from the market. The bank will make payment to vendor for this purchase. When the bank receives the title and ownership of the goods, bank will sell the goods to the Exporter on Murabaha basis.
5. On agreed terms the customer will make payment to bank as per agreed commitment. Once the good are produced by customer, he will export the finish goods in international market.

2. Istisna

Istisna is basically an exception to sale, in which a commodity is sold before it comes to existence. It is an order to a manufacturer to manufacture a specific commodity for the purchaser.

Bank can use Istisna in pre shipment export financing, when the goods need to be manufactured for importer. The customer/exporter will use its own material, if customer does not have material with him, then initial amount of Istisna can be paid for purchasing the material.

Steps Involved in the Istisna Export Finance Scheme

1. Exporter/customer will come to bank for financing his pre shipment export to manufacture specific goods. The client will give the ideas of expected sale price of asset in market, after checking feasibility of product the bank and customer will enter in Istisna contract.
2. The bank places the order to manufacture and provide him with funds to manufacture and deliver the goods in future.
3. A security can also be demanded by bank to ensure future payments
4. Once the customer manufacture and deliver the goods, it will be the property of bank.
5. When the goods are in possession of bank, the bank will appoint customer its agent to export it on bank's behalf, an agency agreement will be signed at the point
6. Exporter will now export the goods, acting as the Bank's agent.
7. The proceeds from Exports will be remitted to the Bank, and bank will disburse the service charges to customer of agency contract.

3. Musharakah/Mudarabah

The most appropriate method for financing exports is Musharakah or Mudarabah. Bank and exporter can make an agreement of Mudarabah provided that the exporter is not investing; otherwise Musharakah agreement can be made. Agreement in such case will be easy, as cost and expected profit is known. The exporter will manufacture or purchase goods and the profit obtained by exporting it will be distributed between them according to the pre-defined ratio.

Steps Involved in the Musharakah / Mudarabah

In this case, the process is as follows:

1. Exporter will inform the bank about the expected cost and expected profit from the transaction.
2. The bank may verify the information provided by the exporter.
3. After finalization of profit margin, exporter and the bank will decide the profit sharing ratio.
4. Exporter will manufacture/procure and export the goods.
5. After the remittance is received, exporter will pay the profit share of the bank.
6. In order to further secure itself from any negligence on the part of the exporter, the bank may put a condition that it will be the responsibility of the exporter to export the goods in full conformity with the conditions of the LC and/or contract.

7. However, being a partner of the exporter, the bank will be liable to bear any loss, which may be caused due to any reason

Post Shipment Financing

Post shipment financing in export mainly covers the discounting of bills. In conventional banks, the customer in needs of funds come to the bank and discounts his bill and gets the liquidity.

On the other hand, Islamic bank have different contracts which can be used in post shipment export financing, they are as follows;

1. Wakalah Agreement grant

A simple method can be adopted through Wakalah-Riba free load agreement. The procedure is discussed below:

1. An agency/Wakalah contract will be signed by customer and bank, the bank acting as an agent of customer will collect the receivable on his behalf, agency fee will be paid to bank for its service.
2. It is important note that, to charge such fee from all the Exporters are necessary who have executed the Wakalah Agreement with the Bank.
3. Upon need of customer, the bank will lend a Riba free loan to exporter equivalent to or less than amount receivable
4. The bank would advance an interest free loan to exporter equivalent to or less than the amount of receivable. Loan will be payable after agreed period, which could be same as maturity period of bill.
5. In case the payment is delayed by importer, exporter/customer will repay the loan acquired from the bank on the due date from its own sources.
6. When bank receives amount from importer on behalf of customer, agency fee will be provided to bank.

2. Salam Agreement

Salam can be used to purchase foreign bills. The process of the Salam transaction is as follows:

1. Exporter/customer comes up with export documents to the bank.
2. Bank and customer will enter into a Salam transaction in which bank will purchase foreign currency (FCY) from exporter in advance which is to be delivered in future on specified date, and price is paid in PKR on spot.
3. Payment is made by bank in advance in local currency, and customer will deliver foreign currency in future.
4. The delivery of FCY is not made contingent to the maturity of export documents. If exporter did not get payment from importer then he has to fulfill his obligation and will arrange FCY from market.
5. Price of Salam which is paid in advance in PKR is usually decided on less exchange rate than the exchange rate of that foreign currency in future
6. The Bank may ask the exporter to assign its receivable, under the LC, to the Bank.
7. The Bank may also ask the exporter to furnish other securities

Murabaha Agreement

Post shipment financing can be done through Murabaha agreement, the Bank may also offer alternative to Bill discounting based on this contract.

Once the exporter has exported the goods and need liquidity for further procurement of material, Islamic bank may financing such need on the basis of Murabaha.

1. The export document from exporter can be taken as security
2. The bank extends Murabaha facility to cover up the need of liquidity of exporter.
3. Bank will appoint exporter as an agent and will instruct the exporter to purchase material from market on behalf of bank.
4. Upon receipt of the goods, the bank will sell the goods to the customer on deferred payment basis. The Murabaha price will be equivalent to the face value of the bill and the deferred payment date may be the date of the maturity of Export proceeds.
5. When customer receives the proceeds of export, he will make payment of Murabaha to bank. However, if importer fails to pay the price of export, then customer will pay the price from his own source on due date.
6. Difference between the cost price of the goods and selling price of Murabaha (which is equal to the face value of the Export bill in most of the cases) will be a valid profit for the bank from this transaction.

Islamic exports refinance scheme.

Currently, the State Bank of Pakistan provides this facility by entering into Musharakah agreements with Islamic Banks. The mechanism starts by identifying a pool of funds based on Sharia'h Compliant financing products. The SBP will invest in this fund out of which, financing will be provided to the exporters. The compensation to the SBP will be provided from the income of the pool, which will be shared between SBP and Bank on a pre-agreed profit.

PROJECT FINANCING

Islamic contracts can be used for financing a whole project by using Musharakah and Mudarabah. Based on basic principles of Mudarabah and Musharakah, Islamic banks can finance short and long term projects to facilitate their customers.

Let us have a look at these basic principles before touching the details:

Basic Principles of Musharakah & Mudarabah for Project Financing

1. Financing a project means contribution in the business and in the form of Musharakah, sharing in the assets of the business up to the ratio of investment/financing.
2. Both the partners in Musharakah based contract must share the loss incurred by the business to the extent of his investment.
3. The partners are at freedom to determine, with mutual consent, the ratio of profit allocated to each one of them, which may differ from the ratio of investment. However, the partner who has expressly excluded himself from the responsibility of work for the business cannot claim more than the ratio of his investment.

Musharakah and Mudarabah based project financing:

Keeping in view these basic principles, Project Financing is discussed below.

In the case of project financing, the traditional method of Musharakah or Mudarabah can be simply implemented. If customer wants to finance the whole project from bank, then on Mudarabah basis funds will be provided by bank as financier while customer will use his skills and expertise to run business. If project is financed partially then both the parties may invest fund and run business on Musharakah basis. In this case, if the management is the sole responsibility of one party, while the investment comes from both, a combination of Musharakah and Mudarabah can be brought into play according to the rules already discussed. Participation of management, profit sharing ratio and other rights and obligation related to partnership is pre decided in project financing.

However the profit distribution ratio or mechanism should not be difficult according to the normal accounting standards. One situation may occur in financing a project is that one partner wants to withdraw

his share and other wants to continue business; in this case the later can purchase the share of the former at agreed price.

In practical terms financial institution does not want this partnership in long run, bank usually sell its share to customer on agreed price and withdraw from project gradually. If the sale of the share on one time basis is not possible for the lack of funds in the project, the share of the financier can be divided into smaller units and each unit can be sold after a suitable interval. Whenever a unit is sold, the share of the financier in the project is reduced to that extent, and when all the units are sold, the financier totally comes out of the project.

Project financing in Import and Export

Project financing based on Musharakah and Mudarabah can be used to finance projects of importer and exporter. A customer may ask an Islamic bank to finance his import transaction on the basis of Musharakah or Mudarabah. Project financing for importer can be done by either Musharakah or Mudarabah and sometimes combination of both can be used. Once the goods are imported and received by customer, the sale proceeds of that good will be shared by bank/financer and customer on pre agreed ratio.

Both methods can also be used for financing a project for exporter who has to prepare the good and need to export them. Selling price of goods can be ascertained beforehand, and bank can easily estimate the expected profit. An Islamic bank will finance such projects on Musharakah or Mudarabah basis and amount of export proceeds will be shared as per agreed ratio

Lesson – 14

Financial markets around the globe are now starting focusing on the importance of Islamic banking internationally. The importance of Islamic banking can be validated with the fact that apart from full-fledged Islamic banks, other commercial banks are planning to establish separate windows and separate Islamic banking branches.

Different products and services have been developed by Islamic banks to meet the need of many customers. The interbank dealing and treasury operations of an Islamic bank is still in its infancy stage, this lesson will provide you to learn different tool for treasury operation with suggested solution for Islamic banks.

The need of separate interbank market and for smooth functioning of treasury operation of Islamic banks is actually felt with the increase of number of Islamic financial institutions. Many of the countries like Malaysia and Bahrain has done remarkable development in creating Islamic interbank market.

Treasury Operation in a bank

Conventional banks are usually involved in the following operations which relate to treasury department.

- Short term acceptances
- Short term investment & liquidity management
- Bill purchase & discounting of receivables
- SPOT FX as well as, forward purchase and forward sale
- Derivatives & options

The first two activities are usually practiced through the borrowing and lending on the basis of interest without underlying asset structures in the conventional capital/money market. Involvement of Riba/interest in such transactions renders them prohibited according to Islamic Sharia'h. The last three activities are also not allowed in Sharia'h because of involvement of Gharar as well as Riba.

However all these activities are extremely important for smooth functioning of any bank whether Islamic or conventional, in order to facilitate trade activities for corporate clients no one can deny these operations in a bank, therefore there is strong need for developing it.

Solutions for treasury operations in Islamic banks

The Islamic alternative for each of operation carried out by conventional banks are as follows:

1. Short term Acceptances

If Islamic bank needs funds for shorter period, they can access the Islamic alternative to money market on following basis.

Musharakah/Mudarabah contracts

Musharakah and Mudarabah contracts can be used to accept funds from market participants on short term basis.

For this purpose Islamic bank at first step will create a pool of assets with high net worth clients of bank. In this pool may comprise of assets like Ijarah, Istisna, Salam and Murabaha

- Islamic bank will create or securitize a pool of assets comprising Murabaha/Salam/Istisna and Ijarah products/assets preferably booked with high rated clients of the bank. The size of assets booked under Ijarah should be at least 51% of the total pool size. For trading of mixed funds, the tangible assets should be more than 51 %, while the liquid assets less than 50 %

- The assets booked under above mentioned modes make the profit volatile of that particular pool.
- When Islamic is in need of funds, for this purpose any financial institution can be contacted to invest funds in these assets on the basis of Musharakah or Mudarabah, the profit arising from these pools are distributed between parties
- Each financial institution is assigned a specific weightage and profit sharing ratio to distribute the profit from these assets; once the investment is matured the profit is distributed among all FIs.
- However, in order to ensure the exact sources and utilization of funds it is necessary to implement an efficient pool management team in Islamic bank to identify and balance the amount of investment all the time.
- In order to segregate each and every part of investment of each financial institution, a unique identification number (pin) is assigned to the FI pool. Later this pin is used for asset allocation, deal extension and other calculation purposes. By allocating the assets to specific pools ensures that risk and reward of these assets are limited to specific pool.
- These pools can only be formed when profits arising from these pools are easily predictable or reasonably acceptable, so that an Islamic bank can easily know the feasibility of the project.

Tawarruq

If Islamic banks are in need of funds, Tawarruq contract can be used for this purpose in the following manner

- Islamic bank by consulting with other financial institution may select any commodity which is liquid in nature such as share of a company or metal solid etc.
- After selecting the commodity, the financial institution purchases that commodity from market and sells it to Islamic bank on credit.
- After taking possession of commodity the Islamic bank will sell the same in open market on spot in order to get the liquidity. Once the commodity is sold Islamic bank will pay the amount due to other financial institution on due date.

In some of Islamic banks this procedure is adopted for short term liquidity needs, this is also called commodity Murabaha or reverse Murabaha

However the use of Tawarruq contract is not widely accepted by Sharia'h scholars, it should not be used as regular practice.

2. Placement and Liquidity Management

In normal practice as compared to conventional banks, Islamic banks have excess liquidity problems; the main reason for excess liquidity is the limited options for Islamic banks to place the liquid funds because of Sharia'h permissibility issues. Funds can be placed in the following manner:

Musharakah/Mudarabah

Some of the financial institution like investment banks and leasing companies invests funds in both conventional and Islamic assets pools. Islamic banks can organize and monitor the working of these booked assets to segregate the accounting treatment of assets which are booked under Islamic modes. A pool of Islamic booked assets can be formed to invest excess funds by Islamic banks.

After monitoring the pools of assets booked under Islamic structures, Islamic banks can place their excess funds whenever needed on the basis of Musharakah or Mudarabah on agreed weightage and profit sharing ratio. Once the investment tenure matures the profit will be distributed to Islamic banks and other financial institution on agreed terms.

3. Forward Purchase and Sale of Currencies

In conventional banks future buying and selling of currencies in order to hedge the price of import and export proceeds plays a very important role in facilitating corporate clients. As we discussed in previous lessons that Islamic banks cannot enter into future contracts so future sale and purchase of currency are prohibited in Islam.

However in certain situation where covering the risk of loss is indispensable by Islamic banks due to the volatility of market situation, promise to sell or purchase can be made. Promise to sell and purchase foreign currency should be unilateral in nature and can only be used in genuine need of trade rather than speculative purpose.

On spot Sale and Purchase of currencies can be traded in the same way as practiced in conventional banks. In Islamic perspective the term spot refer to delivery of both currencies at the time of execution of contract. In conventional banks the term spot refer to the delivery of currency after two days of execution of sale contract. Consequently, in all those dealings where delivery of either of the currency is deferred, they will not fall under spot sale but Islamic Alternative of Promise to Sell/Buy will be used in such transactions.

4. Bill Purchase

As discussed in previous lessons that selling of debt is not allowed in Islam because it involves high degree of uncertainty and sometimes interest.

However, assignment of debt (Hawalah Al Dain) is allowed where original creditor is responsible for repayment of loan in case of other person defaults.

However different alternatives are being used by Islamic banks for honoring and discounting of bills, few of them are already discussed in previous chapters of import and export. The following modes can be used as alternative of discounting of bills:

- Wakalah & Hawalah
- Bai Salam of Currencies
- Murabaha
- Musharakah/Mudarabah

The first three methods are already discussed in previous lesson, here only Musharakah/Mudarabah is discussed.

Musharakah/ Mudarabah

Once the exporter exported the good but did not received the export proceeds, the bank can enter into Musharakah or Mudarabah contract with exported in order to meet his need for funds, bank will invest the amount equivalent to amount receivable (which is to be discounted). These funds can be used for normal course of business for manufacturing and supplying of goods to specific customer. Profit arising from this business will be shared between bank and exporter as per agreed terms.

Once the amount received against export bill, the bank will retain his amount of investment and part of profit which was earned by Musharakah agreement

5. Call and Put Options and Derivatives

The Option to Sell and Option to Purchase (Call and Put Options) are allowed in Sharia'h. However, fee charged on the options separately on selling these option which is known as "Derivatives" having Gharar are not permissible because these Options are right to sell/purchase of a subject matter given by the buyer/seller to seller/buyer and this right cannot be sold as per Sharia'h.

Similarly, short sale is not allowed in Shariah, as Islam prohibits selling anything which is not owned and possessed (physically or constructively) by the seller. Therefore, long sell (after taking possession) is allowed and short sale is not allowed. However, it can be structured through promise to sell in case of any genuine need, it should also be noted that to sell a thing before ownership and possession is allowed only in Bai Salam and Bai Istisna transactions.

Therefore, if required, transactions can be structured by using any of these modes complying with all the conditions of Salam and Istisna.

Lesson – 15

One of the distinctive features of an Islamic bank is to have an independent Sharia'h audit and compliance unit, it provides an independent opinion about the working of financial products according to the sharia'h principles. The existence of Sharia'h audit and compliance unit is very important for every Islamic financial institution (IFI), which could monitor the practices and procedures according to Islamic principles.

Sharia'h audit of an Islamic bank can be defined as the inspection of financial and operational data of IFI according to Sharia'h principles. Sharia'h audit is generally conducted to express an independent opinion on policies and procedures of an Islamic bank in order to secure the interest of stakeholders, that all procedures and practices of IFI adhere to the rules of Sharia'h.

In principle, every staff member of an IFI is responsible to ensure compliance to the rules of Sharia'h in their respective capacity of work. In order to make everyone responsible to ensure adherence to Sharia'h principles, a culture must be developed in IFI that every member realizes their responsibility for Sharia'h compliance.

Sharia'h compliance department provides the guidelines and assessment about the manner in which the responsibility of Sharia'h compliance is guaranteed and demonstrated by the staff member.

Sharia'h Advisory Board

The sharia'h board is a key component of an IFI, carrying the responsibility to ensure the procedures and practices of that institution are in compliance of Sharia'h ruling. Furthermore the role of Sharia'h advisory board is equally important as a policy maker of the institution, which provides the rules and regulation of Sharia'h products provided that all rules and laws are derived from major sources of Sharia'h (Quran, Sunnah, Ijma, Qiyas). The role of the Sharia'h board includes overseeing all the existing and potential products in light of Sharia'h, approving the new product concept and related documentation and respective process flow, ensuring compliance of the sharia'h guidelines on products offered by bank, conducting and supervising annual Sharia'h audit, sometime board may be called on special request to monitor or to make judgment on individual cases whether specific business sector is suitable for institution.

Guidelines for Sharia'h Compliance

In order to make a proper sharia'h compliance framework in the Islamic bank, the following point must be kept in mind while implementing Sharia'h compliant products designed by Sharia'h board.

- All existing and potential products and services which are to be offered by the Islamic bank must be permitted by the Sharia'h Advisory Board (SAB).
- All contract and agreements which are to be used for conducting transactions must be approved by SAB
- All financial and accounting entries for making a transaction must be approved by Board reflecting the true accordance of Sharia'h rules for each product.
- The deposit pool management and profit distribution mechanism must be approved by the Sharia'h board.
- If Islamic bank is charging fee on specific products or services, it must be approved by Sharia'h board. No one within the organization is allowed to charge any fee which is not approved by Sharia'h board.
- If a security is to be held by Islamic bank in order to mitigate the credit risk, the treatment of security must be guided by SAB accordingly.
- If IFI make any investment whether local or off-shore, such investment cannot be made without prior approval of Sharia'h board.

Role of Sharia'h Audit

An independent Sharia'h audit unit directly reporting to Sharia'h advisor or Sharia'h board is necessary for neutral and fair evaluation of Sharia'h compliance in any Islamic bank. The Sharia'h audit department is expected to execute the following functions:

- Sharia'h Audit will monitor and assess, whether all the activities and procedures of the Islamic bank are being conducted as per the guidelines approved by Sharia'h advisory board.

- After reviewing of a period, the audit review report must be submitted directly to Sharia'h advisor or Sharia'h board and top Management of the bank by audit department.
- The accounting, financial and procedural system approved by Sharia'h board is evaluated by Sharia'h audit to assess whether all procedure are in compliance with the Sharia'h board's instructions

Sharia'h Audit Methodology

Sharia'h audit involves the review of the following:

1. Documentation, Procedures and Implementation
2. Product level Audit
3. General environment of bank

1) Documentation, procedure and Implementation

In order to evaluate the Sharia'h compliance process of Islamic banks, sharia'h audit must review the documentation first which will be used as a process of transaction. For this purpose in Islamic banks documentation is divided into three types.

Master Agreements

Generally Islamic bank uses Master agreement as memorandum of understanding between the customer and bank itself; it describes the overall relationship of customer and IFI. Information regarding credit limit, guarantees, security, type of asset and other terms and conditions are prescribed in this document.

These documents are evaluated to ensure the compliance of Sharia'h board's guidelines

Transaction Documents:

These are product specific documents varies from product to product. In order to ensure the sharia'h compliance, the sharia'h board may specify a set of documents which may vary from transaction to transaction. Sharia'h audit will review the transaction document just according to the guidelines provided by the board. Sharia'h compliant products may include but not limited to Murabaha, Ijarah, Istisna and Salam etc.

Security Agreements/Documents

In financing products, Islamic banks may require some kind of security document in order to ensure and secure its financing. These agreements and contract must be finalized after consulting and taking approval from Sharia'h board. Moreover only sharia'h compliant securities can be taken by Islamic bank in order to secure its receivables. Few examples of security documents include Letter of Hypothecation, Letter of Lien, General Financing and Collateral Agreement, Letter of Pledge, Guarantee

2) Product wise Audit Guidelines:

Audit Guidelines for Murabaha:

While reviewing the Murabaha transaction, the following points must be kept in mind.

- The process flow and sequence of documents and steps in Murabaha cannot be changed without prior approval of Sharia'h board.
- While choosing subject matter in Murabaha, it must be ensured that these must be Halal other than currency, silver and gold. All those matter where the transfer, ownership and possession are ambiguous cannot be selected as subject matter in Murabaha. Description of asset must be clearly known.
- Offer and acceptance of Murabaha sale transaction must only be signed only when the bank has taken the delivery and possession of that asset.
- One of the most important aspects of Murabaha is that the goods must not be used before offer and acceptance.
- When bank make purchase of the asset, it must be ensured that the purchase of asset must be done by bank itself or its agent.

- Sharia'h audit must ensure the genuineness of invoices provided by the suppliers according to the market practice.
- Sharia'h audit must ensure that Murabaha should not be rolled over.
- Once the price is decided for Murabaha transaction it must not be changed or rescheduled by increasing it later.
- It must be confirmed that profit is not accrued by the bank before sale of asset i.e. before Offer and acceptance with the client.

Audit Guidelines for Ijarah

While reviewing the Murabaha transaction, the following points must be kept in mind.

- It must be ensured that the Ijarah agreement which is being used is approved by the Sharia'h Advisor.
- Ijarah contract can only be signed when the asset is delivered to customer.
- The bank has taken the ownership and possession of the asset before giving it on Ijarah.
- The purpose of the asset must be known to bank, it must be used for Halal purpose only.
- If there is a need to execute sale and lease back, it must be done with prior approval of sharia'h board with two separate and independent contracts
- The asset can be transferred to customer at the end of Ijarah tenure if needed, by a separate contract of sale.

Audit Guidelines for Diminishing Musharakah Transactions

While performing audit of Diminishing Musharakah transaction, Sharia'h Audit must evaluate the following:

- Process flow of transaction and sequence of the set of the standard Diminishing Musharakah agreement must be approved by the Sharia board.
- Ensure that each step of the transaction is followed by the next step and only the relevant document of that step is executed.
- Diminishing Musharakah cannot be used for running finance.
- Sharia'h has to confirm that joint ownership has to be created in proper way.
- Expenses must be distributed according to the equivalent ownership in the asset.
- Sharia'h audit should evaluate that the Ijarah agreement is to be executed only after bank has taken possession of the asset.
- If the contract is terminated before maturity, it must be ensured that termination is done as per approved guidelines of sharia'h advisor.

Guidelines for Auditing Deposit Side

Following guidelines are useful for auditing deposit side of an Islamic Bank, where deposits are taken on Mudarabah basis and the funds of the depositors become part of a deposit pool.

- Mode of deposit acceptance such as Mudarabah or Wakalah is clearly known to the Depositor.
- Sources & Consumption of funds are: Identified and balanced
- Risk & rewards are appropriately marked against each deposit pool.
- Profit sharing ratio is properly assigned and weightages are clearly communicated for a given period.
- At the end of the periods when profit arises, it must be distributed as per agreed guidelines.
- Losses, if any arise, must be shared in the pool as per the proportionate share of each depositor.

3) General Environment and Staff Understanding

In broader sense, sharia'h compliance of an Islamic bank is not limited to the financial and operational activities but it is also necessary to cover the general environment of bank to be sharia'h compliant. The following points must be kept in mind sharia'h audit:

- Islamic teaching must be depicted from the dress of the employees of Islamic bank.
- Special care must be adopted to maintain the ethics and moral values of Islamic teaching among the staff members in their dealing and interaction between customers and colleagues.
- Sharia'h audit team must assess and evaluate the general and basic concept of Islamic banking of the employees.
- Fatawas and all other Sharia'h and product related polices, guidelines and FAQ are available in the branch.
- Training of staff must be carried out periodically.