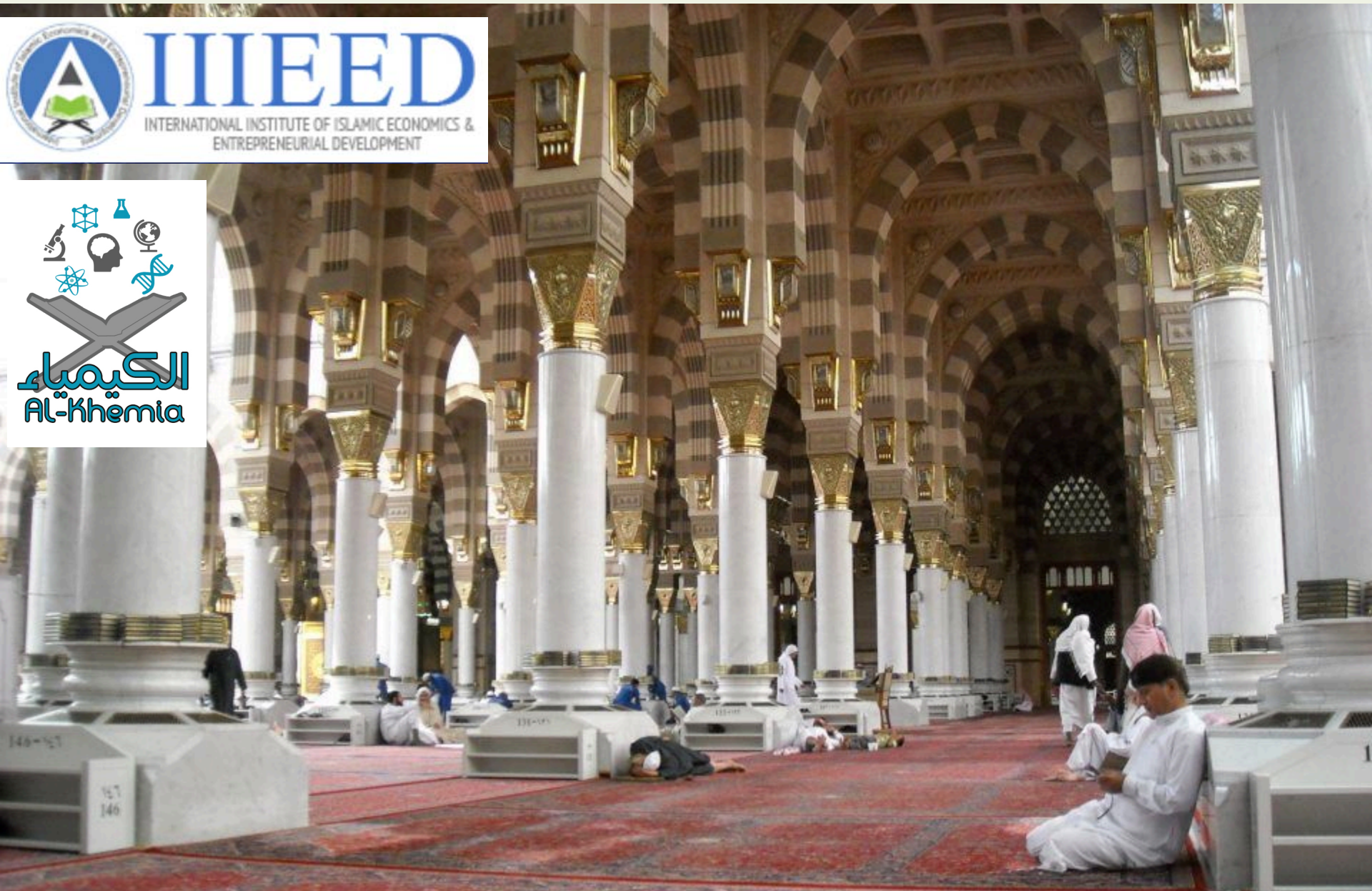


ISLAMIC FINANCE



NIDA KHAN

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Unraveling the Mystery

Islamic finance in its modern form is barely 30 years old and yet it is a rapidly growing part of the financial sector and has survived the recent global banking crisis almost untouched. The size of the market is huge and demand for Islamic financial services exists globally. It is reckoned that nearly 500 financial institutions in more than 50 countries practice some kind of Islamic finance. The Global Islamic Finance Report 2014 had already estimated the size of the global Islamic financial services industry at \$1.813 trillion at the end of 2013. This represents 12.3% annual growth over 2012, an astounding increase of \$182 billion in absolute terms particularly in the wake of dwindling conventional services.

Global assets of Islamic finance have doubled since the start of the economic downturn. The main attraction of Islamic finance is that it offers Shariah compliant banking to its clients and is the closest yet, that any banking institution has managed to get to genuinely ethical and moral banking. It's foundation rests on pure principles, with integrity and a genuine sharing of profit and losses as the building blocks.

Islamic finance is based on Shariah (Islamic law). Shariah provides guidelines for all aspects of human life, including religion, politics, economics, banking, business and the law. Shariah compliant financing (SCF) constitutes financial practices that conform to Islamic law.

Sources of Shariah:-

1.The Glorious Quran

2.The Sunnah-It includes the things that our beloved Prophet Mohammad (Sallallahu Alayhi Wasallam) did

3.Ijma' –Consensus of the opinions of the companions of the Prophet Mohammad (Sallallahu Alayhi Wasallam) or Muslim jurists

4.Qiyas (Analogy)-Used when a solution cannot be found in the above sources, for a certain problem

Islamic Finance-A Brief Introduction

1.The concept of wealth as a trust from God

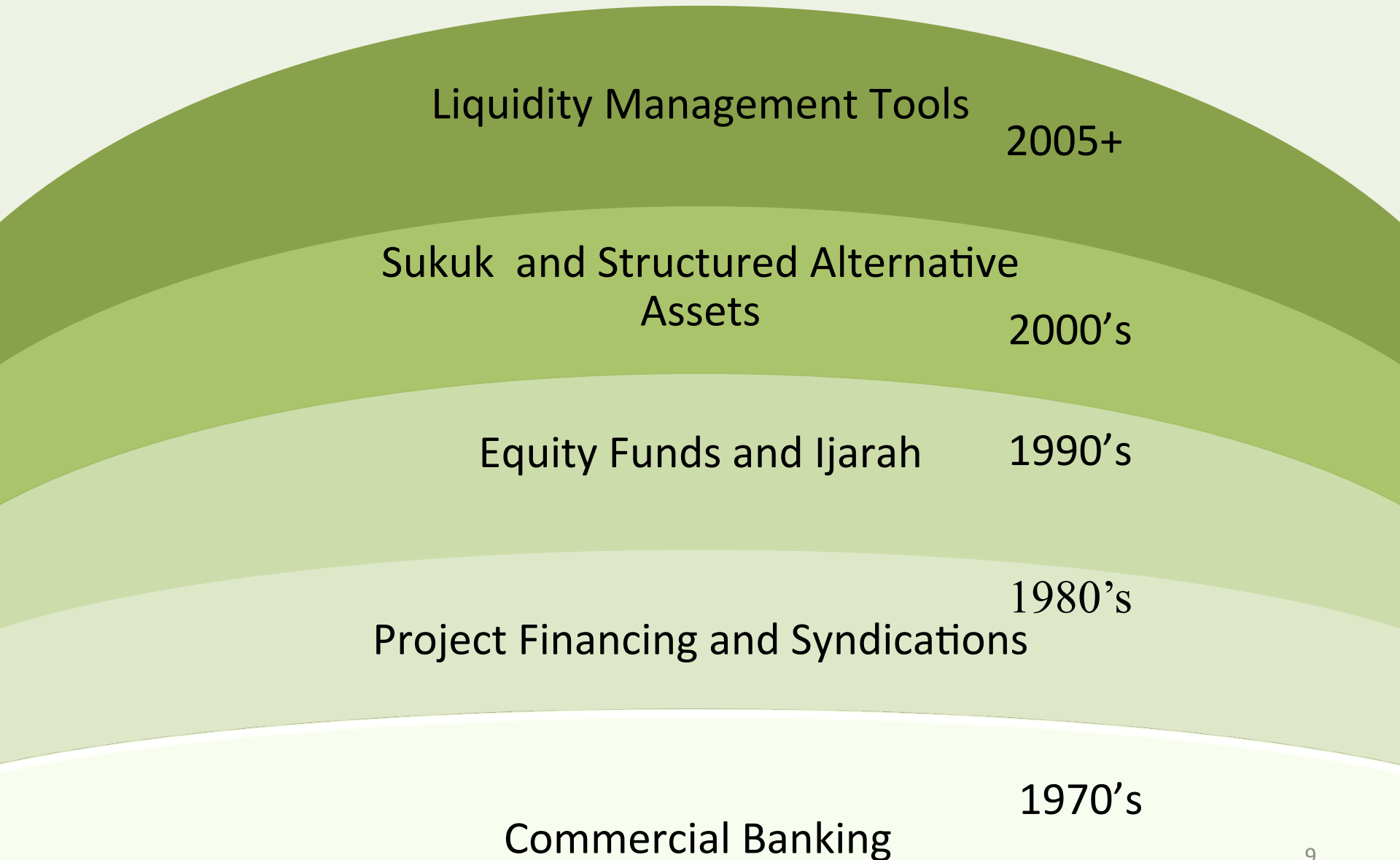
2.The prohibition of unfair / oppressive practices- interest, gambling, cheating, ignorance, uncertainty

3.The promotion of honesty, transparency, justice and fairness in commercial dealings-Risk Sharing

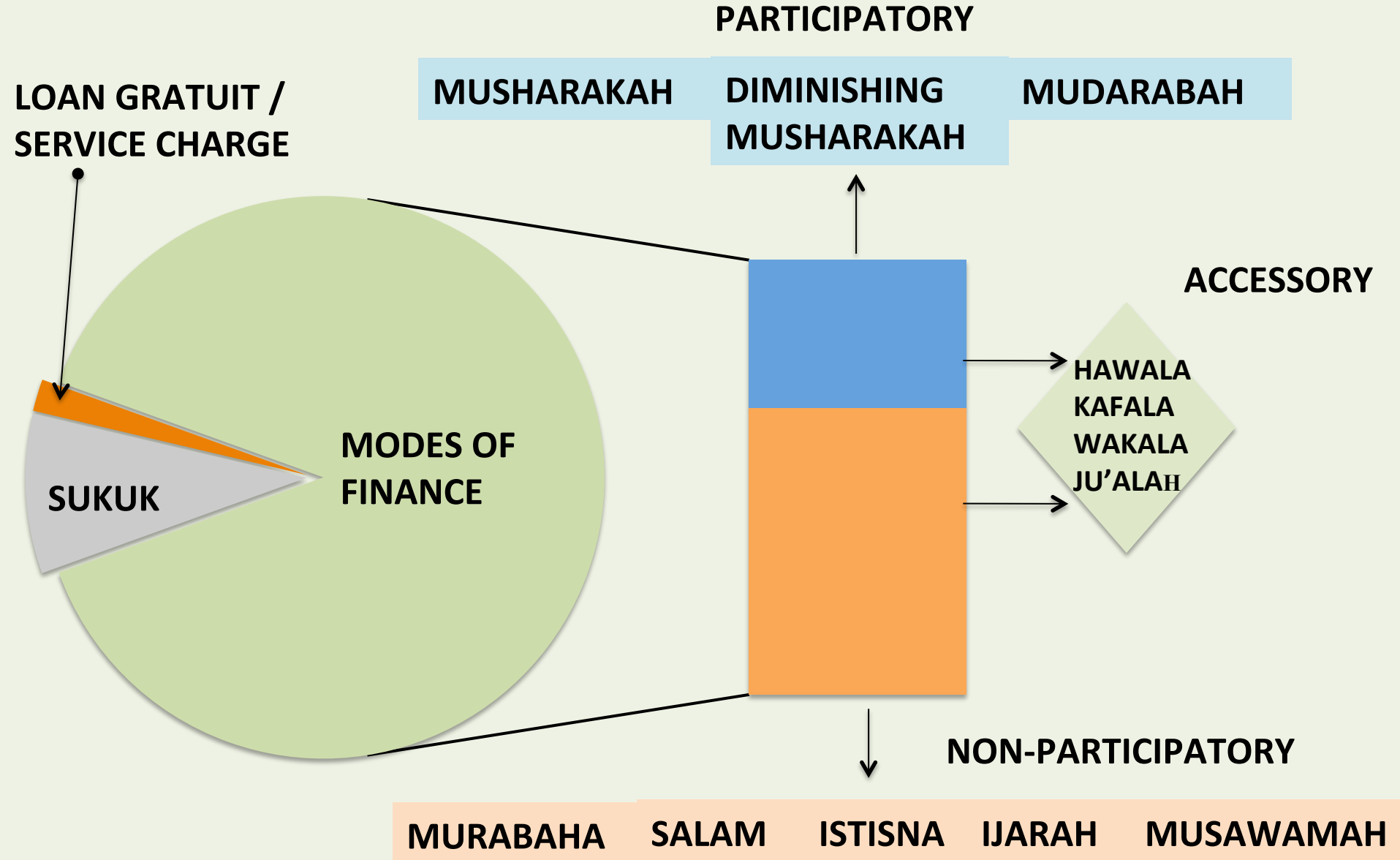
4.Establishing measures to safeguard the contracting parties' interests in the contract / transaction

1. Wider consumer / investor base – Islamic & conventional.
2. Potential universal appeal due to ethical features.
3. Strong fundamentals : asset-backed & real economic activities.
4. Proven track record of competitive return on investment

Evolution of Islamic Finance



Islamic Financing Instruments



Islamic Finance Industry : More Resilient to Crisis

Key causes of the Financial Crisis

1.Excessive lending/borrowing

2.Opaque financial securities

3.Failings in governance

Practices from the Islamic Shariah relevant to addressing the crisis

1.Emphasis on asset-backed financing

2.Limits on sale of debt

3.Greater transparency in debt transfer

4.Introduction of 'ethical supervisory boards'

5.Separation of risk-free and risk-bearing accounts

Islamic banks contributed to financial and economic stability during the crisis, given that their credit and asset growth was at least twice as high as that of conventional banks-IMF SURVEY

Different Concepts Of Paper Money

1. Paper money is a kind of thaman (unit of account to serve as price of anything). They are wanted only for exchange and payments and not for themselves.

2. Currency notes of different countries are considered monetary units of different species and therefore, can be exchanged without the condition of equality but subject to the conditions of Bai al Sarf (currency exchange), i.e. hand to hand.

3.Flat money is money for all practical purposes and is taken as a substitute for gold and silver, the real and natural money but the position of copper Fulus is not that of an independent currency.

4.Money in itself is not an actual capital and takes the form of capital only when it is used into productive activities along with other resources.

5.Interest is prohibited because it prevents people from undertaking real economic activities.

6.The supply or growth of money/credit should match with supply of goods and services.

7. Time valuation is possible only in business and trade of goods and not in exchange of monetary values and loans or debts.

8. Anything which cannot be used without consuming, its corpus cannot be leased out like money, eatables, fuel, etc.

9. Two possible reference scales-

- 1) debt/semi-debt contracts
- 2) equity contracts.

CAPITALISM

SOCIALISM

ISLAMIC FINANCE

Determination
of Priorities

Concept of
selfish interest,
unconditional
individual right
to any
business,supply
& demand

Coconcept of
collective
interest,no
individual right
to
business,State
determines the
priorities

Right to private
property and to
maximize profits
but with some
prohibitions,sup
ply & demand

Allocation of
Resources

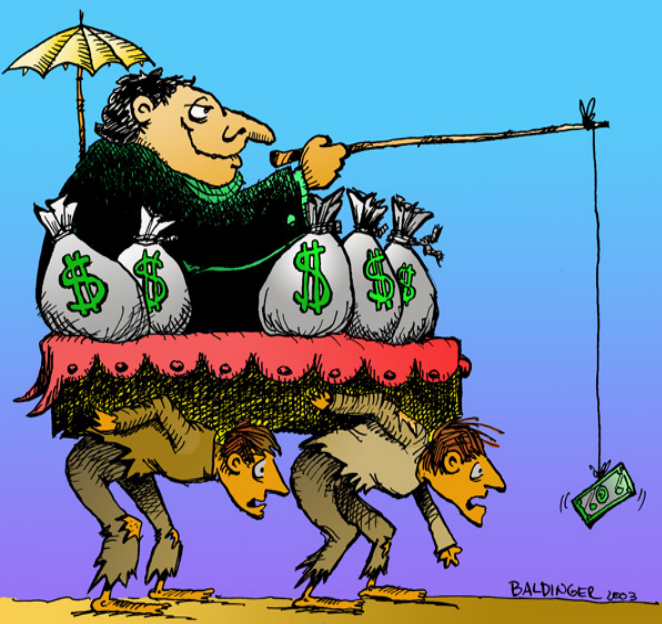
Market forces
decide where to
invest resources

Government
decides where
to invest

Market forces &
guiding
principles for
complete well
being in life &
hereafter

CAPITALISM**SOCIALISM****ISLAMIC
FINANCE**

Development	Market forces will decide	Government will decide	Market forces & govt. both decide as per necessity & times
Distribution of Income	Land-Rent Labor-Wages Capital-Interest Entrepreneur-Profits	Land-Rent fixed by government Labor-Wages fixed by government	Land-Rent Labor-Wages Capital-Profits
Right to Wealth	Rests with the factors of production only	Rests with the govt.-it distributes it to the factors of production	Absolute ownership lies with Allah- one has to spend in the way of Allah



Conventional Finance

It is a myth that it is more profitable as only the rich keep getting richer and the deposits utilized by banks do yield huge profits but the depositors have no share in these profits-the small interest that they get is again consumed by the 'rich' in the mark up of goods sold to the common masses

Islamic Economic System

IES ensures that the banks share in the risks with the depositors, along with profits so an optimum balance is maintained. Further it ensures that each has the basic necessities of life by imposing rules like Zakat -- (charity money) above a certain minimum savings, to save which the rich put their money in business, thereby creating more jobs by increasing the demand for labor



Flaws of Capitalism

- ◆ No bindings / restrictions while maximizing profits
- ◆ Blindly follows market forces that create exploitation of labor and poor people
- ◆ No moral value limitations
- ◆ Monopolies and cartels are created that exploit the society as a whole
- ◆ Government and industrialists join hands for mutual benefit and make laws that exploit common people
- ◆ Imbalance in the distribution of income due to which concentration of wealth takes place

Flaws of Socialism

- ◆ The other extreme of not even giving the natural freedom
- ◆ Perfect planning is assumed to be the 'cure of all ills'
- ◆ Governments are assumed to be angels which can't commit a deliberate mistake
- ◆ Cannot work without forceful dictatorship
- ◆ Creates overall inefficiency in the society. There is no incentive to work efficiently as there is no individual profit motive

Islamic Economic System

In Islam, Riba / interest is prohibited because it encourages

- ◆ Concentration of wealth in few hands
- ◆ Creation of monopolies
- ◆ Greed and selfishness leading to injustice and oppression

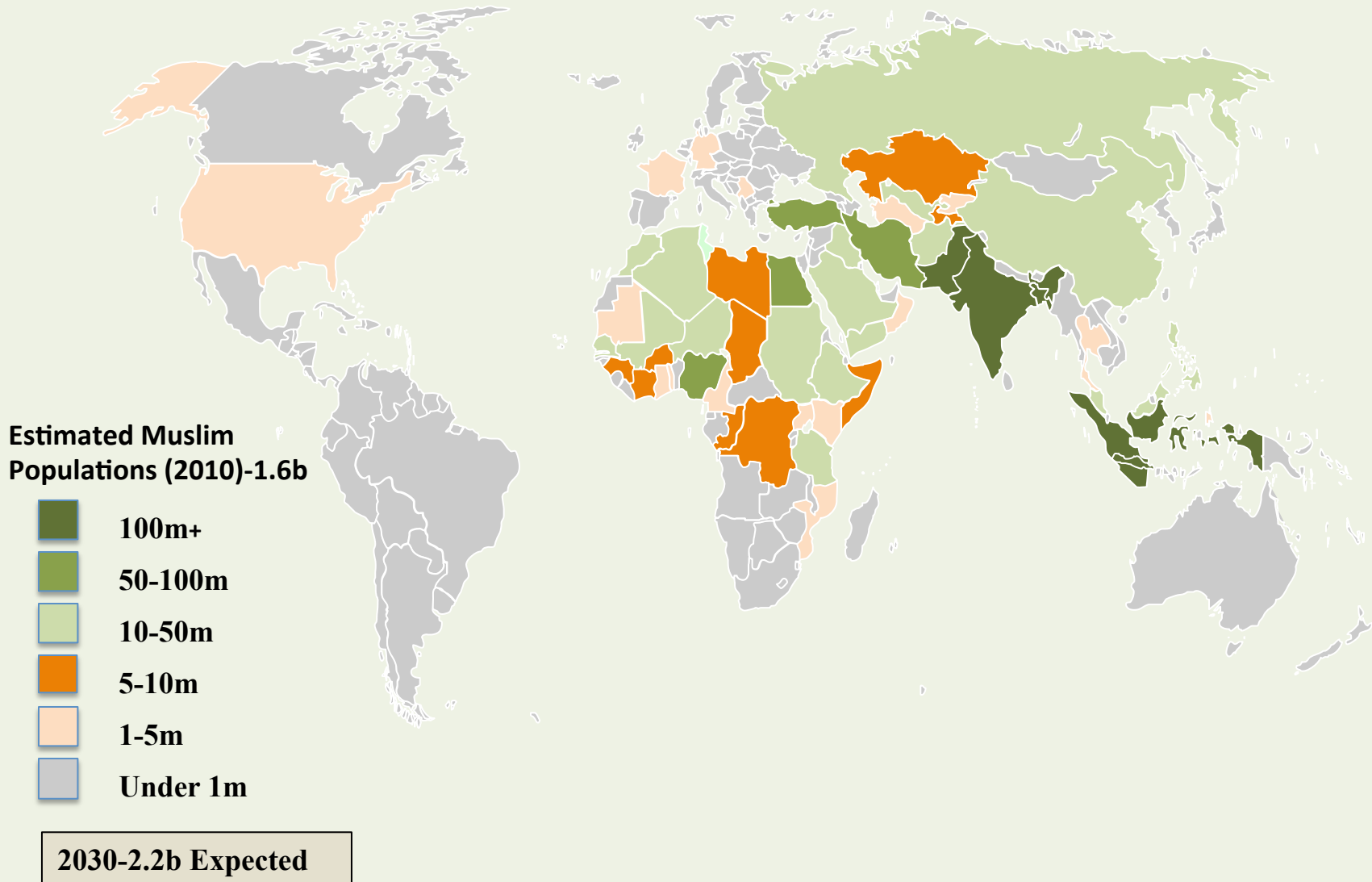
The human goal of achieving the well being of all the members of the society cannot be attained by concentrating primarily on the material constituents of well-being and making maximization of wealth as the main objective of Economics. It is also necessary to raise the spiritual content of well being and reduce all the symptoms of discontent

Capitalism and Socialism have both failed to lead mankind to such an overall well-being and this is exactly what the Islamic economic system aims to achieve, as it had done in the past when this system was implemented by the great Muslim ancestors

Islamic economic system consists of institutions, organizations, and social values by which natural, human and man-made resources are used to produce, exchange, distribute and consume wealth / goods and services under the guiding principles of Islam to achieve “FALAH” (well-being) in this world and also hereafter

	Buddhism	Christianity	Hinduism	Jainism	Judaism	Islam
Religious Texts	In the Jatakas, usury is referred to in a demeaning manner: <i>“hypocritical ascetics are accused of practising it”</i>	Exodus 22:25 <i>“If thou lend money to any of my people that is poor by thee, thou shalt not be to him as a usurer, neither shalt thou lay upon him usury”</i>	In Vedic texts (2000-1400 BC) “usurer” (k usidin) is mentioned several times & spoken of in contempt. Vasishtha made a law forbidding the Brahmanas and Kshatriyas from being usurers/ interest lenders	The Jains articulated it by saying that the poor live to pay the interest and not to enjoy the goods they bought with the loan: <i>“it is usury - this heartless extortion..”</i>	The Law of Moses <i>“Thou shall not give him the money upon Usury nor lend for increase (Lev. 25:37).</i> The Hebrew word for interest is neshekh, literally meaning “a bite”	<i>“...Trade is like usury: but Allah has permitted trade and forbidden usury...”.</i> <i>(Surah al Baqarah-verse 275-280)</i>
Mainstream Finance	X	X	X	X	X	X
Islamic Finance	✓	✓	✓	✓	✓	✓

Fundamental Case for the Islamic Finance Industry remains Strong



Risks and Pitfalls

1. *There is no single absolute set of rules that constitutes a universally applicable Shariah* –If the available standards of AAOIFI and IFSB etc. are strictly implemented in International trade, then this uncertainty can easily be made redundant in global trade and on the domestic front, this very disadvantage can prove to be a boon for INNOVATION as different geographic regions have different needs and hence different set of rules are more apt for greater prosperity. Further these differences arise due to just one of the sources of Shariah, which is not something as paramount as it has been made to be

2. *Ownership Risk /Tax*-Responsibility for these issues is allocated between the borrower and the financier on a transaction-by-transaction basis

3. *Security/Resources*-The financing bank expects to receive a mortgage as security, which tends to reduce the price of the transaction in question and in such issues, the law of the jurisdictions involved varies and will have to be considered in determining whether appropriate security is available

4. *Default*-Default interest on late payment of amount due, practiced in conventional finance cannot be possible as per the rules of Islamic finance. Solutions involve a discount formula for early payment and late payment fees (which is given to charity) but the financier cannot receive any additional amount.

5. *Documentary Complexity*-More often than not, it is always the case that the documentation in a Shariah compliant transaction is more complex than its conventional counterpart

6. Definition-There is no single precise definition of Islamic finance, leading to a lot of questions but it needs to be understood *that Islamic finance is not a man-made system like capitalism or socialism to have a precise definition attributed to a single individual. We are dealing with a system derived from Divine laws found in the Quran and other sources of Shariah. Thus there can be several definitions* making an attempt to explain the system, which was followed by the Muslim ancestors

Musharakah-Equity based Product

The literal meaning of Musharakah is sharing. The root of the word in Arabic is Shirkah, which means being a partner. ***Musharakah means a joint enterprise formed for conducting some business in which all the partners share the profit according to a specific ratio, while the loss is shared according to the ratio of contribution.*** It is an ideal alternative for the interest based financing with far reaching effects on both production and distribution

Shirkah

Shirkat-ul-Milk

(Partnership by joint ownership)

Ikhtiari

Optional

Gair Ikhtiari

Compulsory

Shirkat-ul-Aqd

(Partnership by contract)

Shirkat-ul-Amwal

Partnership in capital

Shirkat-ul-Amaal

Partnership in services

Shirkat-ul-Wujooh

Partnership in goodwill

Basic Rules of Musharakah

Distribution of Profit

1. The proportion of profit must be agreed upon at the time of affecting the contract
2. The ration of profit for each partner must be determined in proportion to the actual profit accrued to the business, and not in proportion to the capital invested by him

Ratio of Profit

The ratio of profit may differ from the ratio of investment in normal conditions. In the case of a sleeping partner, the ratio of profit can never be greater than the ratio of his investment

Sharing of Loss

The loss suffered by each partner should be exactly according to the ratio of his investment

Basic Rules of Capital

The capital in the agreement should be:

- a) Quantified (Maloom) :meaning how much etc.
- b) Specified (Muta'aiyan) : meaning specified currency etc.

Powers and Rights of the Partners

1. The right to sell the mutually owned property, to buy raw material or other stock on cash or credit using funds, to hire people and the right to deposit money and goods of the business as depositor trust
2. The right to use Shirkah's funds or goods in Mudarabah, to give the funds as a gift or loan as a loan on one partner becomes a liability on all the partners

Interest-based Financing

Musharakah

- ★ A fixed rate of return on the loan advanced by the financier is determined irrespective of the profit earned or loss suffered by the debtor
The financier cannot suffer loss

It does not envisage a fixed rate of return. The return is based on the actual profit earned by the joint venture
The financier can suffer loss if the joint venture fails to produce fruits

- ★ Results in injustice either to the creditor or the debtor. If the debtor suffers a loss, it is unjust to claim a fixed rate of return from him. Similarly if the debtor earns a very high rate of profit, it is injustice to give the creditor only the fixed rate of return

The returns of the creditor are tied up with the actual profits accrued. The greater the profits, the higher the rate of return for the creditor.

Diminishing Musharakah

Diminishing Musharakah is a form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him. This transaction starts with the formation of a partnership, after which buying and selling of the equity takes place between the two partners. It is therefore necessary that this buying and selling should not be stipulated in the partnership contract.

In other words, the buying partner is allowed to give only a promise to buy. This promise should be independent of the partnership contract. In addition, the buying and selling agreement must be independent of the partnership contract. It is not permitted that one contract be entered into as a condition for concluding the other

The general rules for partnerships must be applied to a diminishing partnership, especially the rules for Shirkat al-ainan

Mudarabah-An Equity Based Product

If an investment is made from one person and services from the other partner, then the partnership is called Mudarabah. Investor is called 'Rabb-ul-Mal' and the working partner is called 'Mudarib' and the investment is called 'Ras-ul-Mal'

In order to bring about a riba (interest)-free economy, the country's banking system has to be riba-free, its commercial enterprises have to be financed by equity capital, and its investments have to be on a profit and loss sharing basis. A Mudarabah based system takes into account present-day realities and it has no parallel in the conventional economy

Types

```
graph TD; A[Types] --> B["Mudarabah Mutlaqa  
(unrestricted Mudarabah-no restriction from investor in doing business)"]; A --> C["Mudarabah Muqayyada  
(restricted Mudarabah-some restrictions are implemented by the investor)"];
```

Mudarabah Mutlaqa

(unrestricted Mudarabah-no restriction from investor in doing business)

Mudarabah Muqayyada

(restricted Mudarabah-some restrictions are implemented by the investor)

Basic Rules of Mudarabah

Rules of Profit and Loss

Profit may be distributed in any ratio. In case of loss, all loss will be borne by the Rabb-ul-Mal. Mudarib's share of profit will not be given to him in case of loss

Different capacities of Mudarib

Amin (Trustee)

Wakeel (Agent)

Shareek (Partner)

Zamin (Liable)

Ajeer (Employee)

Requirements related to Capital

In principle, the capital must be provided in the form of cash. However, it may be presented in the form of tangible assets, in which case the market-value of the assets is the contribution to the Mudarabah capital

Profit Distribution Mechanism

The parties should agree on the ratio of profit distribution when the contract is concluded. It is also permissible for the parties to change this ratio at any time and to define the duration for which the agreement will remain valid

If the parties did not stipulate the ratio of distribution, then referral should be made to customary practice

Musharakah

Mudarabah

1. Investment from each partner	Investment from one partner with the other as working partner
2. Every partner can work for business	Investor cannot work for business
3. Every partner bears loss according to the ratio of his investment	Only the investor suffers the loss
4. Every partner's liability is limited	Investor is liable up to the amount of his investment
5. If all the partners give investment in joint pool and an asset is purchased from that investment, all the partners will be co-owners of that asset so if the value of that asset is increased, all will gain benefit	Asset purchased from investment of investor, remains in the ownership of investor before sale. Therefore, if the agreement is terminated at this stage, Mudarib will not share in the exceeding price of that asset ⁴⁰

Salam

Mudarabah

- | | |
|---|--|
| 1. Salam is a trade Based Product | Mudarabah is an equity based product |
| 2. Involves a seller and a buyer | Involves a mudarib and a Rab-ul maal |
| 3. Some specific goods are supplied to the buyer | The investor may or may not restrict the ventures into which money can be invested |
| 4. The buyer's liability comes into effect after physical or constructive possession of the goods | Investor is liable up to the amount of his investment |

Murabaha

It is a contract wherein the Islamic bank, upon request by the customer, purchases the asset from a third party supplier/vendor and resells it to the customer either against immediate payment or on a deferred payment basis. It is basically the sale of goods at cost plus an agreed profit mark up where the seller discloses the cost as well as the profit to the buyer

It cannot be used for running finance facility, which provides cash for fulfilling various needs of the client

Stages of Murabaha

-
1. Promise Stage: Credit approval and Purchase requisition
 2. Agency Stage: It is not the condition of Murabaha if the institution make direct purchases from the supplier
 3. Acquiring Possession: Risk of goods is transferred to the bank
 4. Execution of Murabaha
 5. Post execution

Basic Rules of Murabaha

Conditions of Subject Matter

The subject matter must exist at the time of sale, must be in the ownership of the seller, must be in the physical or constructive possession of the seller, must be a property of value, must have a halal utility and must be specifically known and identified to the buyer. The delivery should be certain and it should belong to the category of tangible goods and commodities

Conditional Sale

1. Permissibility of using valid conditions
2. Price may be spot or deferred but fluctuation is not permissible. Use of benchmark at the time of Master Financing Agreement is permissible
3. The expenses incurred by the seller directly in acquiring the commodity like freight and custom duty can be included in the cost price
4. Murabaha, which is used as a mode of financing in Islamic banks is a package of the following contracts:
Master Financing Agreement between bank and customer, Undertaking from client, Agency agreement between bank and customer, Purchase of goods from supplier and Murabaha agreement between bank and client

Important Issues in Murabaha

1. Actual and fresh purchase is an essential part of Murabaha
2. Promise to purchase-Though a unilateral promise is not binding in normal conditions but if the promisee has had to incur some expenses or liability because of the promisor, then the promisor can be compelled by court to fulfill his promise
3. Securities against Murabaha price

4. In case of late payment, the bank cannot charge additional amount as penalty. In order to cover the risk of default, the defaulter will have to pay the charity account maintained by the bank, a certain sum of money calculated on the basis of ...% per annum for each day of default. The amount from this charity will go to help the needy on behalf of the client. This undertaking is a sort of Yameen/Nazar, which is a self-imposed penalty to keep oneself away from default

5. In case of earlier payment, the client cannot claim rebate as his right, nor can such a rebate be stipulated in the agreement. However, if the bank gives him a rebate on its own, it is not objectionable

Murabaha is a sensitive transaction and requires extreme care in its execution. A small mistake at any stage can convert Murabaha into an interest based loan. It is the responsibility of the professionals undertaking it to ensure that Murabaha is executed in the best manner and the income derived from it is Halal (pure) and in true letter and spirit

Ijarah-Semi Debt Based Product

Transferring of usufruct of an asset to another person for an agreed period, at an agreed consideration. The asset should be valuable, identified and quantified. Anything which cannot be used without consuming cannot be leased out e.g. money, wheat etc.

Ijarah

```
graph TD; Ijarah --> Leasing; Ijarah --> Hiring[\"Hiring/ Employment\"]; Leasing --> Operating[\"Operating lease\"]; Leasing --> Islamic[\"Islamic lease\"]; Operating --- OpDesc[\"simple rental agreement with ownership of the leased asset remaining with the lessor\"]; Islamic --- IslDesc[\"Ijarah Muntahia Bittamleek ends with the transfer of ownership of the leased assets to the lessee\"]; style Ijarah fill:#f9a825; style Leasing fill:#add8e6; style Hiring fill:#9370db; style Operating fill:#f08080; style Islamic fill:#f08080;
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Leasing

**Hiring/
Employment**

Operating lease

simple rental agreement with ownership of the leased asset remaining with the lessor

Islamic lease

Ijarah Muntahia Bittamleek ends with the transfer of ownership of the leased assets to the lessee

Basic Rules of Ijarah

Rental of Lease

The rental must be determined at the time of contract. It is permissible to have different amounts of rent fixed for different phases of rental period. It is permissible to tie up the rental amount with a variable benchmark, the ceiling and floor must be determined. The lessor cannot increase the rent unilaterally

Period of Lease

It must be determined in clear terms at the beginning of contract

Lease for Specific Purpose Only

If no specific purpose is identified in the agreement, then it can be used for any purpose for which it is used in normal practice

Responsibility of Lessor

If the asset is destroyed during the lease period, the lessor will suffer the loss. If the asset loses its usufruct without any negligence of the lessee, then the lessor cannot claim the rent. Moreover, the lessor is liable to pay all the expenses incurred in the process of its purchase and import of the country of the lessor, if required. Taxes related to ownership and even registration charges, as in the case of a car, will be paid by the lessor. Insurance is also the responsibility of the lessor

Responsibility of Lessee

The cost of any harm caused due to misuse or negligence will be borne by the lessee, along with the taxes related to the use of the asset. He is also responsible for normal wear and tear

Rentals

The rent or any part thereof may be payable in advance before the delivery of the asset. It can be determined using aggregate costs as in financial leases

Islamic Lease

Conventional Financial Lease

- | | |
|---|--|
| ★ Rent can only be charged after delivery of leased assets | Rent charged from the days the price has been paid even if delivery is delayed |
| ★ Penalty of late payment of rental is given to charity | Penalty of late payment of rental is taken into Income |
| ★ At the end of lease term, the security deposit can be refunded to lessee | At the end of lease, down payment is not refunded to lessee |
| ★ Transfer of asset at the end of the lease period is not included in the lease agreement | Transfer of asset at the end of the lease period is a part of the agreement |
| ★ All risks and rewards of assets will be held with the bank | All risks and rewards of assets transferred to lessee |

Salam

Ijarah

- | | |
|---|---|
| ★ The subject can be any thing | It is a contract that has a service or usufruct as underlying |
| ★ The material is provided by the customer and the manufacturer only uses his labor and skill | Lessor is neither required nor obliged to provide materials |
| ★ The price has to be paid in full in advance | The rent or any part thereof may be payable in advance before the delivery of the asset |

Salam-A Trade Based Product

Salam is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange for an advance price fully paid on spot. Seller and buyer can agree on any price at their free will. Price in Salam can be lower than the spot sale price.

Only those goods can be sold through a Salam contract in which the quantity and quality can be exactly specified e.g. precious stones cannot be sold through Salam. It cannot be affected on a particular commodity or a product of a particular field or farm or the fruit of a particular tree because of uncertainty in delivery

Salam as a Mode of Finance

Salam was originally used to fulfill the needs of farmers and traders. It can be used by banks and financial institutions, especially to finance the agriculture sector. The present day banks and financial institutions can benefit from Salam in the following ways:

1. After purchasing a commodity through Salam, the financial institution may sell it through a parallel Salam contract for the same date of delivery. The period of Salam (parallel) in the second transaction being shorter increases the price and the net difference is profit for the institution.

2.If a parallel Salam is not feasible due to any reason, they can obtain a promise to purchase from a third party. This promise should be unilateral from the expected buyer. Since it is a promise, no advance is expected to be paid and the sale price can be higher. As soon as the commodity is received, it will be sold to the third party at the pre-agreed price

Salam

Murabaha

★	Purchased goods are deferred, price is paid on spot	Purchased goods are delivered on spot, price may be either on spot or deferred
★	Price has to be paid full in advance	Price may be on spot or deferred
★	Salam is not executed in the particular commodity but commodity is specified by specifications	Murabaha can be executed in particular commodity
★	It cannot be affected in respect of things, which must be delivered on spot e.g. Salam between wheat and barley	Murabaha can be executed in those things

Istisna

Salam

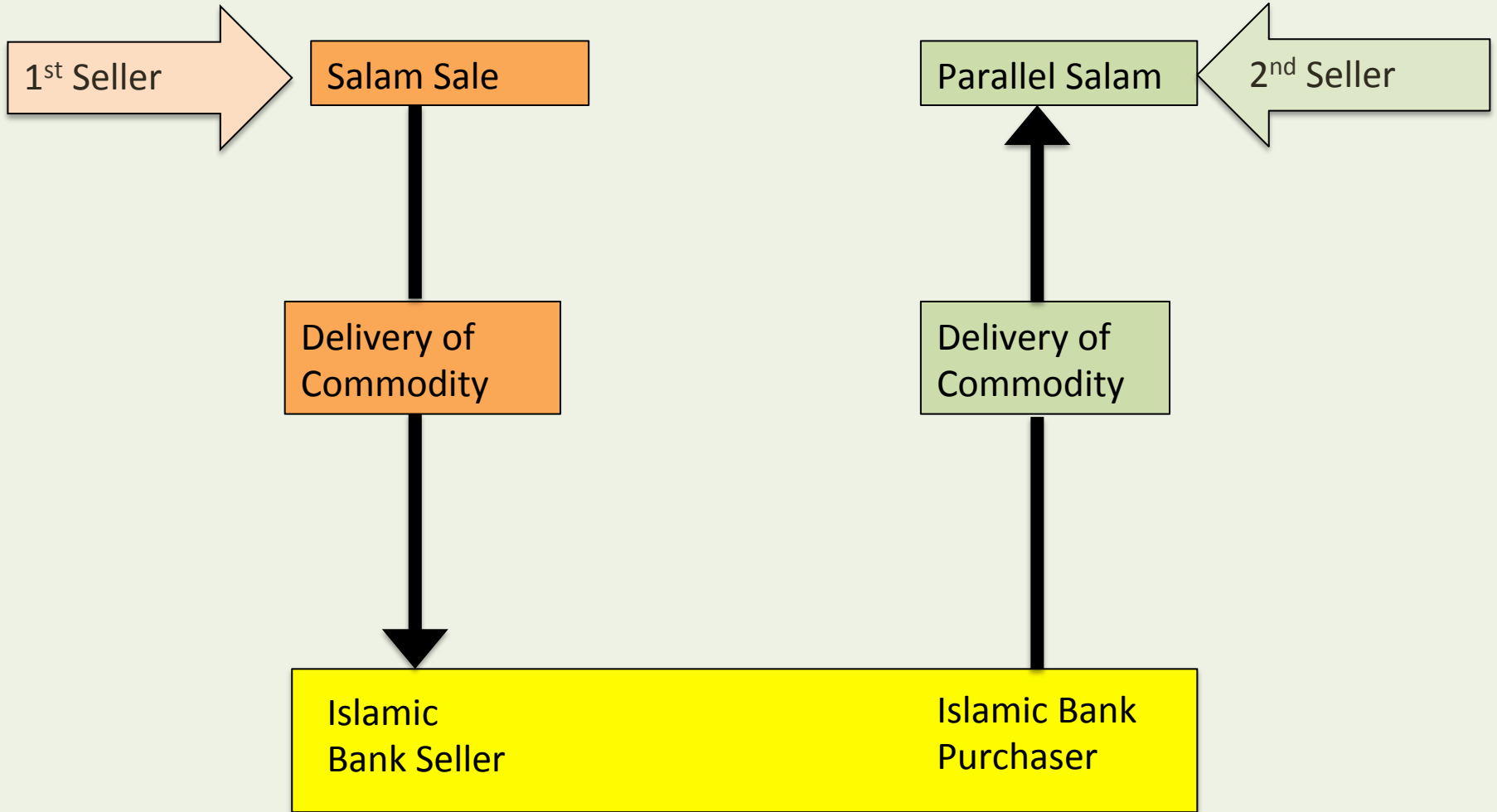
★	The subject is a thing, which needs manufacturing	The subject can be any thing
★	Price need not be paid in full in advance	The price has to be paid in full in advance
★	It is not necessary to fix the time of delivery	Time of delivery is an essential part of the sale
★	The contract can be cancelled before the manufacturer starts working	The contract cannot be cancelled unilaterally
★	The manufacturer either uses his own materials and if not available, obtains it to make the ordered goods	The material is provided by the customer and the manufacturer only uses his labor and skill

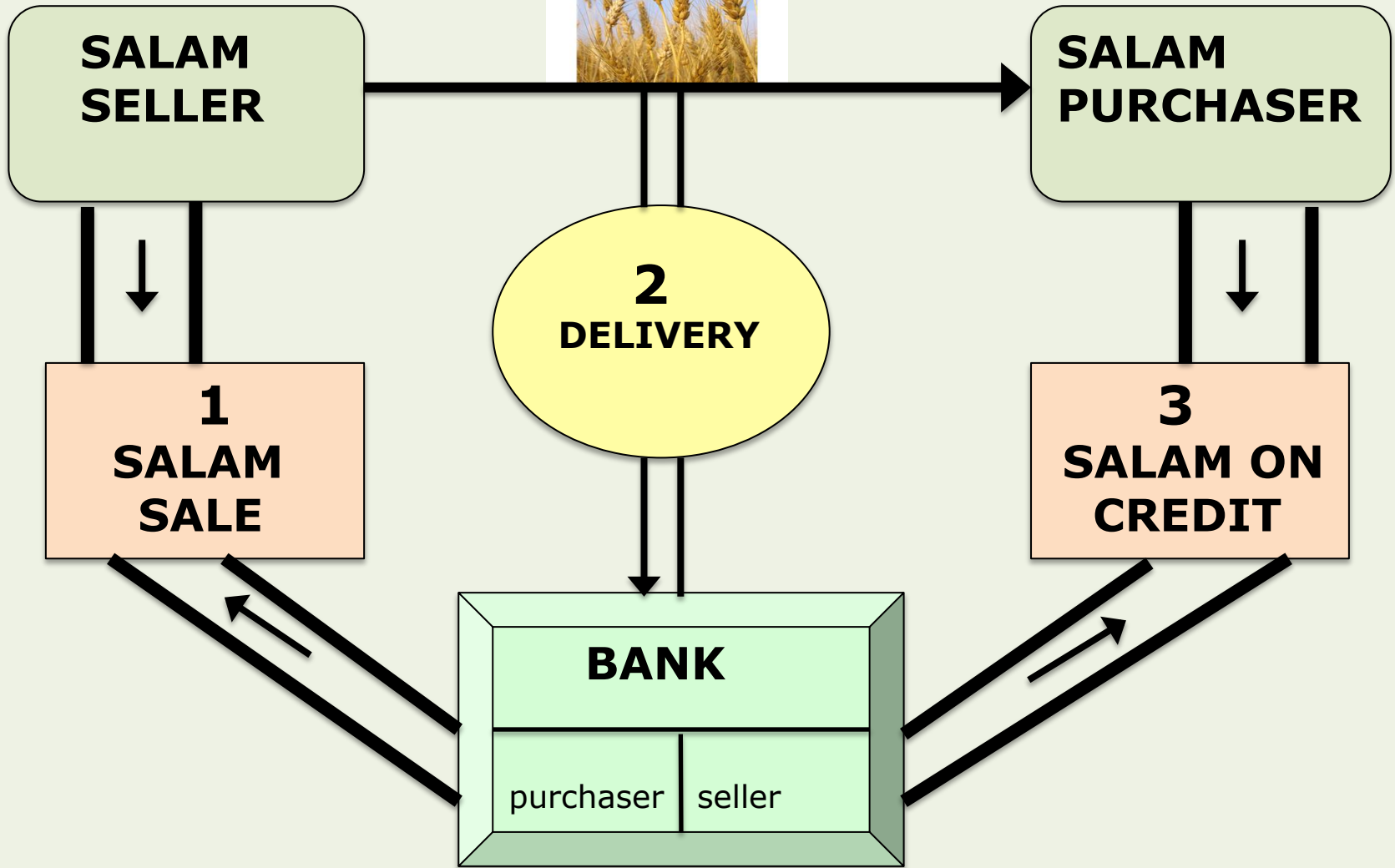
Diminishing Musharakah

Salam

- | | | |
|---|--|--|
| ★ | It is a form of partnership in which one of the partners promises to buy the equity share of the other partner | It is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange for an advance price fully paid on spot |
| ★ | Price is paid by one partner gradually until the title to the equity is completely transferred to him | The price has to be paid in full in advance |
| ★ | There exists only a promise to buy independent of the partnership contract. | The contract cannot be cancelled unilaterally |

Parallel Salam Diagram





Istisna- A Trade Based Product

Istisna is a sale transaction where the commodity is transacted before it comes into existence. It is an order to producer to manufacture a specific commodity for the purchaser

Parallel Istisna

After the execution of Istisna agreement with one party, buyer or seller executes another Istisna agreement with a third party

Conditions of Istisna

1.The subject of Istisna is always a thing that needs manufacturing

2.Manufacturer uses his own material

3.Quality and quantity should be agreed in absolute terms

4.Purchase price should be fixed with mutual consent

Potential of Istisna

The client can get finance for raw material, working capital and other overhead expenses by the execution of Istisna agreement

Applications of Istisna financing-

House Financing

Project Financing

BOT Arrangement

Export Pre Shipment

Istisna As A Mode Of Financing

Price of Istisna

It may be in the form of money, commodity and usufruct. It can be spot or deferred. The price can be in the form of installments, where the installments may be tied up with different stages of involvement

Revoking of Istisna

The contract of Istisna can be cancelled unilaterally before the manufacturer starts working

Security

A security in the form of mortgage, guarantee or hypothecation may be required for Istisna in order to ensure that the manufacturer shall deliver the commodity on the agreed date

Time of Delivery

It is not necessary that the time of delivery be fixed, However the purchaser may fix a maximum time for delivery, beyond which he will not be bound to accept the goods and pay the price

Delivery of Goods being Manufactured

If the goods being manufactured are delivered before the agreed date, then the purchaser can refuse to accept them. Before delivery, goods will remain at the risk of seller. After delivery, the risk will be transferred to the purchaser

Istisna

Salam

★	The subject is a thing, which needs manufacturing	The subject can be any thing
★	Price need not be paid in full in advance	The price has to be paid in full in advance
★	It is not necessary to fix the time of delivery	Time of delivery is an essential part of the sale
★	The contract can be cancelled before the manufacturer starts working	The contract cannot be cancelled unilaterally
★	The manufacturer either uses his own materials and if not available, obtains it to make the ordered goods	The material is provided by the customer and the manufacturer only uses his labor and skill

Istijrar

Istijrar is a type of sale agreement where a buyer purchases goods from time to time in different quantities and payment is made at the end of the term. Each time there is no offer or acceptance or bargain. There is one master agreement where all terms and conditions are finalized

Istijrar

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graph TD; A[Istijrar] --- B[Where the price is determined on spot or after all transactions of purchase are complete]; A --- C[Where the price is determined in advance but the purchase is executed from time to time]
```

Where the price is determined on spot or after all transactions of purchase are complete

Where the price is determined in advance but the purchase is executed from time to time

Rules of Istijrar

1. Validity of sale will relate to the time of possession

2. Ownership of the buyer in the subject matter will be proved from the time of possession

3. Islamic banks, nowadays are involved in the following activities:

a) Murabaha

b) Ijarah

c) Mudarabah

d) Shirkah

The concept of Istijrar can be applied only to Murabaha. In Murabaha the concept can be applied to seller/suppliers of the subject matter of Murabaha

Istijrar In Case of Murabaha

It can be applied to Murabaha, provided the following conditions are complied with, to their full extent:

1. The use of Ta'ati in case of Murabaha transaction is not acceptable, as it leads indirectly to Riba in case the bank does not take possession of the assets before they are sold to the customer

2. If Ta'ati is to be used, then the only way to do it is that the bank should purchase the assets some time before selling it to the customer

Application

Istijrar is used to finance working capital involving repeat purchases from suppliers

Istisna

Ijarah

★ The manufacturer either uses his own material and if it is not available with him, obtains it to make the ordered goods

The material is provided by the customer and the manufacturer only uses his labor and skill meaning that his services will be hired for a specified fee paid to him

★ The purchaser has a right to reject the goods after inspection. The right to rejection exists only if the goods do not conform to the specifications agreed upon between the parties at the time of contract

Right to rejection of goods after inspection does not exist

Tawarruq

Tawarruq is an arrangement whereby a person, in need of liquidity, purchases a commodity from a seller on credit at a higher price and sells the same at lower cash price to a third party / in the market

This transaction is being used, despite being a grey area, by many Islamic banks for liquidity management and as a mode of financing especially for personal financing and credit cards

Difference between Tawarruq and Inah

The difference is that 'Mutawarriq' sells the commodity to a third party, while in Inah, the buyer resells it to the seller from whom he had bought the commodity

If Tawarruq is carried out through the international commodity exchange, it is vulnerable to many violations of the Shariah, because many conditions of a valid sale may be lacking.

Tawarruq practice must be of limited usage only for meeting unavoidable liquidity needs of the corporate sector.

For individual consumers, it should not be included in the Islamic banking practices

Muzarat (Tenancy)

The word Muzarat is derived from Zara, which means to 'sow the seed'. Technically it is defined as a transaction in which "the owner of agricultural land gives his land to another for cultivation on terms of crop-sharing at a fixed rate."

The term Mukhabarat is also used for Muzarat. However some ulema differentiate between the two by holding the view that if the seed is supplied to the tenant by the owner, it would be called Muzarat, but if the seed is purchased by the tenant himself, the term Mukhabarat would be used

The term Masaqat is also used in connection with these transactions. The difference between Masaqat and Muzarat is that Muzarat refers to tenancy of land, whereas Masaqat refers to tenancy of garden on the same terms as Muzarat

There is a difference of opinion among the jurists of Islam on the legality or illegality of Muzarat

Bay' Bithaman Ajil (BBA)

Bay' Bithaman Ajil (BBA) Contract is a sale and purchase transaction for the financing of an asset on a deferred payment basis with a pre-agreed payment period. The sale price will include profit. It is also referred to as Bay' al-Muajjal

It would not be advisable to use BBA widely or indiscriminately in view of the danger attached to it of opening a back door for dealing on the basis of interest

In the Middle East, the same practice of BBA is referred to as Murabaha. However the term of BBA financing in Malaysia is different from the term in other countries. The whole concept of BBA financing in Malaysia is based mainly on Bay'al-'Inah (sale and buy-back agreement). Besides this issue, the practice of BBA in Malaysia inherits some other issues such as the issue of qabd, selling of non-existent property, some clauses in legal documentation, etc. which are against the spirit of the Shariah law

Kafalah (Guarantee)

Literally, Kafalah means responsibility, amenability or surety ship. Legally, in Kafalah a third party becomes surety for the payment of debt, if unpaid by the person originally liable. It is a pledge given to a creditor that the debtor will pay the debt, fine or any other liability

Kafalah

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graph TD; Kafalah --> Kafalah_bil_nafs; Kafalah --> Kafalah_bil_mal;
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Kafalah bil-nafs (surety ship for a person)

Standing surety means assuming liability for the appearance of a debtor or his agent in a lawsuit

Kafalah bil-mal (surety ship for the claim)

It can be independent or additional to the other form of Kafalah

Normally, the Shariah scholars do not allow any remuneration to be received against financial guarantee. However a fee representing the actual administrative expenses incurred in issuing the guarantee is allowed

Hawala (Assignment of Debt)

Hawala of debt is the transfer of debt from the transferor (Muheel) to the payer (Muhai Alaihi). The transfer of right, on the other hand, is a replacement of a creditor with another creditor. The transfer of debt differs from the transfer of right in that in transfer of debt- a debtor is replaced by another debtor whereas in a transfer of right, a creditor is replaced by another creditor

Hawala

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graph TD; Hawala --> RestrictedHawala; Hawala --> UnrestrictedHawala;
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Restricted Hawala

It is a transaction where the payer is restricted to settling the amount of the transferred debt from the amount of a financial or tangible asset that belongs to the transferor and is in the possession of the payer

Unrestricted Hawala

It is a kind of transfer of debt where the transferor is not a creditor to the payer and the payer undertakes to pay the debt from his own funds and to have recourse afterwards, provided the payment was made on the orders of the transferor

Some modern applications of Hawala:

Withdrawal from a Current Account

Overdrawing from an Account or Overdraft

Travellers' Cheques

Remittances

Wakala

Wakala means protection or delegation. Agency is the act of one party delegating the other to act on its behalf in what can be a subject matter of delegation. It is basically a non-binding contract but may sometimes become a binding contract

Wakalah

```
graph TD;
    A[Wakalah] --> B[Particular/Special Agency];
    A --> C[General Wakalah];
    A --> D[Restricted Agency];
    A --> E[Absolute Agency];
```

Particular/ Special Agency

It is made only for a certain known transaction

General Wakalah

It is a general delegation of power

Restricted Agency

Where the agent has to act within certain conditions

Absolute Agency

Where no condition is put for the transaction but the agent has to act as per prevailing customs

**A popular application of Wakala is the Letter of Credit, which the Islamic banks extend to their clients using Wakala, whereby the bank acts as the Wakil or agent of the client*

Ju'alah

Ju'alah is a contract in which one of the parties (the Ja'il) offers specified compensation (the Ju'il) to anyone (the 'Amil), who will achieve a determined result in a known or unknown period. It is suitable for activities for which Ijarah, which requires that the desired work be clearly specified, is not. E.g. bringing back a lost property from an unknown location

Compensation

The compensation should be known, valuable in the eyes of Shariah and deliverable

Applications of Ju'alah


Exploration for Minerals and Extraction of Water

Collection of Debts

Securing Permissible Financing Facility

Brokerage

Loans



Loans in the structure of Islamic banking and finance



Qard-e-Hasan:

As a legal term, qard means to give anything having value in the ownership of other by way of virtue so that the latter could avail of the same for his benefit with the condition that same or similar amount of that thing would be paid back on demand or at the settled time. Jurists are unanimous in this legal definition

Service charge based financing:

It means that banks would provide loans with full guarantee for return of the principal plus a charge that may be just sufficient to cover the administrative costs of the banks/ financing institutions.

Qard-e-Hasan and Service Charge

Loans under Islamic law can be classified as:

- 1.Salaf-Loan for fixed time
- 2.Qard-Payable on demand

Dayn or debt is created as a result of any credit transaction in which one of the counter values is deferred
In qard-e-hasan, the lender has claim only on the principal. By providing such virtuous loans, an individual having surplus funds can help any needy person without any counter value or material consideration. Further the lender is obliged to postpone the repayment of the principal asset, if the borrower's condition is such that he does not have the ability to repay. The same is the case of Dayn or debt, only the principal is to be repaid

Banks are commercial organizations and as such, providing qard-e-hasan would not be a part of their normal business. ***However, on the line given by the central bank/ government from time to time, they can provide economic support to specified classes of the society out of the 'Charity Fund' to which the proceeds of penalty charged on account of default would be created in line with the judgement of the Shariah Advisory Board.*** Keeping in view, the emphasis on repayment of loan in Islam, banks would be required to undertake all possible measures including guarantee, surety or collateral to recover principal of such loans

Similarly service charge based financing would not be a part of the normal business of banks

Unpaid debt-an obstacle in the path to Paradise

Muslim narrated (1886) from ‘Abd-Allaah ibn ‘Amr ibn al-‘Aas that the Messenger of Allaah (peace and blessings of Allaah be upon him) said: “The shaheed will be forgiven for every sin except debt.”

Al-Nasaa’i narrated (4605) that Muhammad ibn Jahsh (may Allaah be pleased with him) said: We were sitting with the Messenger of Allaah (peace and blessings of Allaah be upon him) when he raised his head towards the sky, then he put his palm on his forehead and said:-

“Subhaan-Allaah! What a strict issue has been revealed to me!” We remained silent and were afraid. The following morning I asked him, “O Messenger of Allaah, what is this strict issue that has been revealed?” He said, “By the One in Whose hand is my soul, if a man were killed in battle for the sake of Allaah, then brought back to life, then killed and brought back to life again, then killed, and he owed a debt, he would not enter Paradise until his debt was paid off.” Classed as hasan by al-Albaani in Saheeh al-Nasaa’i, 4367.

Because of this, and other evidences, one should not get deeply involved in debt, taking loans for necessary and unnecessary things, or borrowing large amounts of money in order to get into business when he does not know, perhaps Allaah will not grant him success in this business, and then what will he do? How will he be able to pay off this large amount from his salary that is barely sufficient for his own living expenses? -Hence the wise man should be content with that which Allaah has given him of halaal provision, and not look at those who are above him in terms of worldly gains and wealth. Rather he should look at those who are beneath him and have less wealth than him. If his salary is not enough, then he should look for other work through which Allaah may grant him sufficient provision. As for taking risks and taking loans that he is unable to pay off, this is not right-Islam QA

Shares

In Arabic shares are called 'Sihm'. The shares represent the ratio of ownership which the shareholders have got in the assets of the company. When a company comes into being, it floats its shares in the market. Any person who purchases those shares participates in the business of the company and enters into a Shirkah contract with the company

Buying and Selling of Shares is permissible if the following four conditions are fulfilled:

- 1.The company must not engage in any unlawful kind of business
- 2.The company's assets must not comprise liquid assets only, i.e. cash. If the company does not have any fixed assets, then it will not be permissible to trade these shares above par or below par of their face value

3. The company though engaged in a lawful business is involved in interest-based transactions. The shareholders can buy the shares provided they express their discontent (perhaps in the Annual Meeting of the company) regarding the interest-based dealings, even if they are overruled. This is the opinion of Maulana Ashraf Ali Thanvi and contemporary scholars dissuade from buying the shares of these companies too so we can adopt any opinion

4. This condition is linked to the former one. When a shareholder receives the dividend, he should investigate as to how many percent of the income is from interest through perusal of the income statement. Thereafter that much amount must be deducted from the dividend and given in charity. If 5% of income stems from interest, then 5% from the dividend must be given to charity

Issues Related To Shares

Shares and Capital Gain

There are people who want to buy and sell shares to make capital gain instead of becoming a shareholder in the company, this is permissible provided the four conditions of permissibility are fulfilled

Making up for Difference is Speculation

During times of speculation, which is an integral part of the stock exchange, this kind of buying and selling of shares becomes unlawful as there neither any delivery of shares nor any view of delivering them

Selling the Shares Prior to Delivery

It is not permissible to sell a thing onward prior to taking possession of it. However possession does not merely imply a physical possession but a constructive one also, whereby when a thing comes into our risk, it is sufficient a possession to make an onward sale of it

Possession of Shares

The price of paper that we call as a share-certificate are not the shares. Rather the shares are the ownership that one has in the company, and the shares-certificate is an indicator, a proof and an evidence for that ownership. Hence, if a person's ownership in the company has been established although he has not yet received the shares-certificate, then yet, from the Shariah point of view that person will be considered as owner

The Transfer of Risk is Sufficient

The transfer of risk is sufficient for onward sale but it is difficult to determine when the transfer of risk takes place and hence, precaution demands that onward sale of shares be done after their due delivery

Barter is not Permissible

Bartering is another way of buying and selling shares that is commonly practiced at the stock exchange. Bartering is also one way of financing. However the kind of bartering practiced is just another manifestation of interest and it is strictly prohibited in Shariah

Issue of Paying Zakat on Shares

If the objective of the person buying the shares is capital gain, then he has to pay Zakat according to the market price of the shares.

However if at the time of purchasing he has no intentions of making capital gain but to get paid the dividend and at the same time he also has thoughts of selling them if he gets a good price, then in this case Zakat will have to be paid on that part of the market price of the shares, which stands against such assets of the company for which Zakat is to be paid

Short Sales and Forward Sales

It is not permissible to sell shares, the delivery of which one has not yet received through Spot Sales or Ready Contracts. It is also not permissible to sell shares through Future or Forward Sale as short-selling is practiced more commonly in Futures than in Ready Contracts

Innovation in Islamic Finance

Steve Jobs had said:- ***“Innovation distinguishes between a leader and a follower.”*** Thus, innovation per se is an extremely important tool to help further the cause of Islamic Finance.

Whenever some men have started something new or even adopted some methods , which were prevalent in sometime in world history but had been abandoned, there have always been controversies surrounding it, rejections stemming towards it and numerous challenges confronting it . Let us talk about some of the challenges this industry is facing in implementing innovations :-

1. The first and foremost is lack of skill to match the skills of their counterparts in conventional finance. More efforts should be made towards training people in Islamic Finance and the incentives given to the workers in the form of salary and career enhancement should be made more competent with their counterparts in conventional finance so that this industry gets the cream from the people leaving financial schools

2.The hired individuals should not be just aware of the basic financial knowledge but also with the laws from the Quran and Sunnah, so that they have a fair idea of how compliant the innovative methods being devised are, with the Shariah. This would reduce the dependence on scholars and make the process of innovation less cumbersome

3.The developed strategies should be within the confines of the standards laid down by Shariah

4.The solutions devised should be attractive to not just the Muslim population but also to the people of other religious ethnicities.

Private Equity and Venture Capital are basically Islamic Finance domains as they evolved in other parts of the world after they were introduced by Islam as Mudarabah, Musharakah etc. There is a lot of scope for innovation and advancement in this sector:-
Economic equilibrium shifts, corporate restructuring, and acceptability of selling assets, rapid technological change, and available financing - all provide private equity opportunities and the current economic crisis provides greater opportunities for innovations in private equity and venture capital zones to strike out and take hold of the economy with their strengths

A rise in the wealth of the Muslim countries has provided greater opportunities for increase in PE and VC activities along with a demand for innovation to produce more sophisticated products

Islamic Finance is becoming popular in non-Muslim countries forcing our professionals to innovate and suit the needs of the clients as per their geographical location, tax laws and other legislations in their country

As the major educational institutions in the world have introduced Islamic Finance courses we will have professionals competent enough to take PE and VC to the next level

On account of the Great Depression, there is more attraction towards non-interest bearing products

Further the base of PE and VC is the Quran and Sunnah, which has clearly outlined the prohibited items and declared the rest remaining as permissible, thus giving a very broad foundation for innovations to take place.

Innovation: Need of the Hour

Innovation is extremely crucial for survival in this era of increased competition and availability of various alternatives. It is particularly advantageous to the Islamic Finance industry because :-

1. It would help to broaden the target group so that people from all castes and creeds can use our product and services
2. It would help in producing specific solutions pertaining to a specific client as per his host country and requirements , which can vary a lot posing challenges to our management teams

3.It would give us an edge over the conventional sector and also make our work environment more challenging for the professionals involved to rise above the trodden paths

4.It would help in finding a number of solutions to a particular problem on hand and this versatility would add value addition in the wake of lots of people disguising conventional methods and selling them as Shariah compliant products

5. Islamic financial industry has taken a lot of blame for imitating conventional products and this issue can be resolved by innovation

6. It would enable more people to get attracted towards it by its variety, and increase the hold of companies working in a Shariah compliant way, enhancing the growth of the industry

7. It would give the tool, by which this industry can take over the conventional sector by roping in all their clients through a solid ethical base and creative and designable features through innovation

Understanding Shariah

Islamic finance, being a niche market and a recent introduction, has not been understood by the masses, in general.

The Arabic word Shari`ah literally ***means “a waterway that leads to a main stream, a drinking place, and a road or the right path.”*** From this meaning, the word Shari`ah was used to refer to a path or a passage that leads to an intended place, or to a certain goal.

The sources of Shariah are:-

- 1.Quran
- 2.Sunnah
- 3.Ijma (consensus of thoughts of Muslim scholars)
- 4.Qiyas (analogy derived from Quran and other authentic literature)

Thus , Shariah is that way which leads us to attain 'Falah' implying success both in this world and the hereafter

The sources of Shariah are the base on which the building of the entire Islamic finance industry rests. Further enhancement to this solid foundation was made by books and articles on economics by renowned Islamic scholars and other literature on economics by scholars of the financial world. In all the knowledge accumulated and all that is being accumulated, the initial base remains the same ,unchanged. It is permissible to derive new strategies and methodologies, catering to different needs while simultaneously maintaining the base and resting all the floors of our innovations on that base

Shariah compliancy is the very basic and mandatory requirement for all innovations in our industry, rendering non-compliant products redundant for the market

Role of Islamic Scholar

An Islamic scholar refers to the one, who strives to reach the shar'iah ruling and who has the ability to derive shar'iah rulings from the evidence

This means that he has to acquire the tools (pre-requisites) of ijtihaad (independent interpretation of the sources of Shar'iah). The scholars paid attention to these pre-requisites so that the door is not open to just anyone, old or young, to say about the religion of Allah that of which he has no knowledge.

The pre-requisites are :-

1. He should have knowledge of the texts of the Qur'aan and Sunnah

He should also know what is saheeh (sound) and what is da'eef (weak) in the texts of the Sunnah.

2. He should have knowledge of the issues of consensus (ijmaa')

3. He should be well versed in the Arabic language

4. He should have knowledge of usool al-fiqh (basic principles of Islamic jurisprudence), including analogy (qiyaas), because usool al-fiqh is the foundation for deriving rulings

5. He should have knowledge of what abrogates and what is abrogated (al-naasikh wa'l-mansookh)

6. He should have knowledge of various matters affecting the ruling, such as reports of specific meanings, reports that set limits, and so on, so that he will not issue a ruling that is contrary to that

Thus to be able to derive various products and methods by way of innovation , we need to have an authority capable enough to check the authenticity of the claims of Shar'iah compliancy and this crucially important role in innovation is played by the scholar.

Conclusion

The crisis primarily caused by interest bearing loans, has shown us that the economy, if it is removed from Shar'iah rulings and principles, will wander in darkness and lead to disasters and problems

Our renowned Islamic scholars have said- *“One of the duties of Islamic financial experts is to seek out the principles of the Islamic financial system in the Qur'aan and Sunnah and present them to mankind in a complete, independent financial system, not following other systems or adopting a patchwork approach.*

The Islamic system is not free of riba only, and it is not limited to some rules in exclusion to others. It is not the system that offers Western products with an Islamic veneer; rather it is a complete and independent system that achieves the aims of sharia and justice in all financial transactions.”

Thus it is our duty, to design an economic system, which is Shar'iah compliant and yet flexible, adaptable and specific to the needs and requirements of a particular group, country or for that matter any ethnicity. This can only be achieved through innovation

The Quran and Sunnah have clearly distinguished the forbidden things and the remaining are all permissible and therefore Shar'iah compliant innovation is the need of the hour. Islam has always championed the cause of advancement in all areas of life, as long as the various developments adhere to the Shar'iah permissible

Arabic terms related to transactions

1. **Mitha'q**-It refers to a covenant and refers to an earnest and firm determination on the part of the concerned parties to fulfill the contractual obligations; it has more sanctity than ordinary contracts. The word has been used in the Quran in a number of places and as such has more relevance with social and religious covenants than with economic or financial contracts

2. **'Ahd/W'adah**-''Ahd refers to a **unilateral undertaking**, although sometimes it also covers a bilateral obligation. The glorious Quran has used the word in both the senses

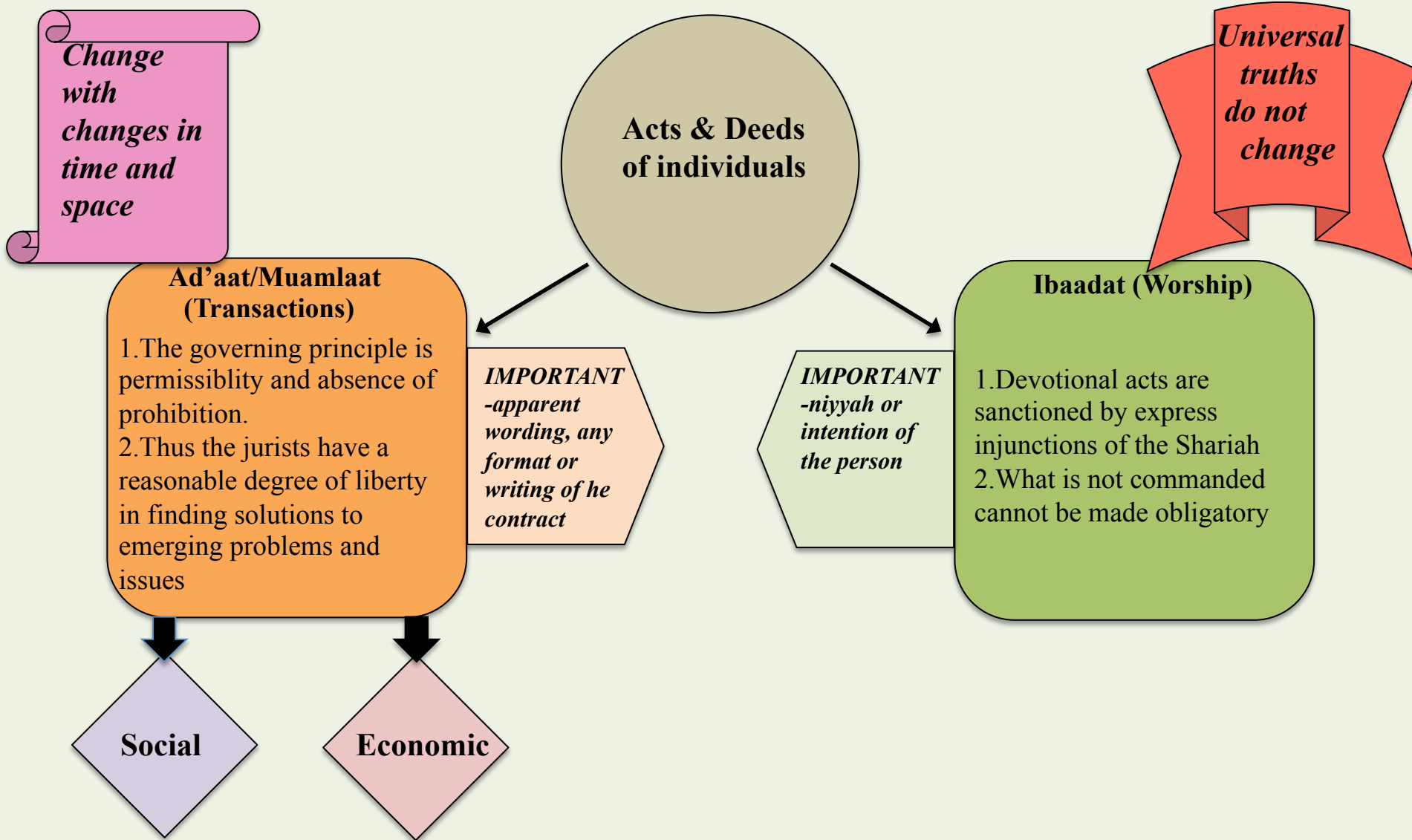
3. **'Aqd**, which lexically means conjunction or to tie, is synonymous with the word 'contract' of modern law. **It is the most crucial tool for Islamic banks for both deposits and asset sides.** It implies obligation arising out of a mutual agreement. It has been used in this sense of conjunction in the glorious Quran as it joins the intention as well as the declaration of two parties. It is used in two senses:-

A) General sense-It is applied to every act which is undertaken in earnestness and firm determination, regardless of whether it emerges from a unilateral intention such as Waqf, remission of debt, divorce, undertaking an oath, or from a mutual agreement, such as a sale, lease, agency or mortgage. In this sense, 'Aqd is applicable to an obligation irrespective of the fact that the source of this obligation is a unilateral declaration or agreement of the two declarations

B) Specific sense-It is a combination of an offer and acceptance, which gives rise to certain legal consequences

Islamic law relating to business generally deals with 'Ahd/W'adah (promise) and 'Aqd (contract)

General framework of contracts

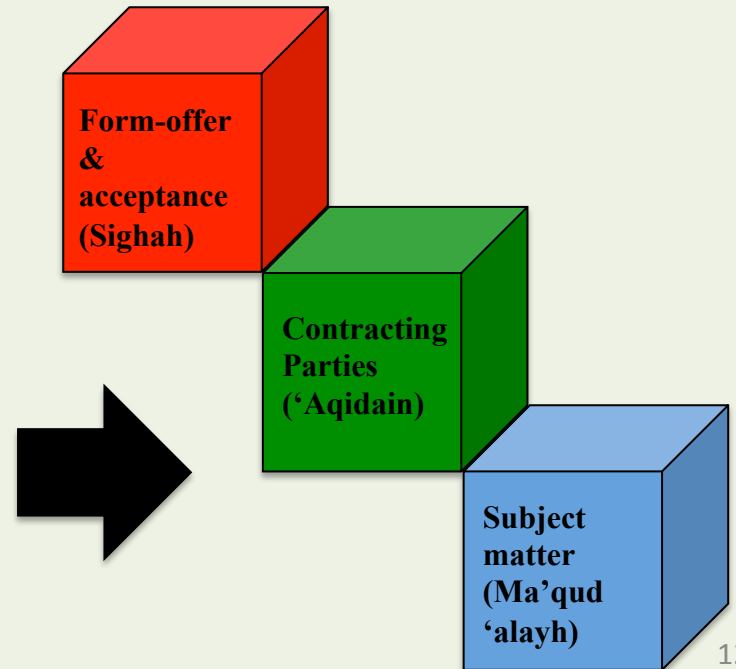


Elements of a Contract

A contract comprises the following elements:-

- 1.The existence of two parties, who must be capable of entering into contracts, i.e. they must be sane and mature
- 2.An offer (Ijab) and acceptance (Qabul)
- 3.A legal (Shariah) basis of union between the two declarations and the contractual obligations
- 4.Free from all prohibited factors

**Essential Elements-If not present properly,
contract is invalid**



Types of contracts

VALID

Depends on:-

1. Legality of the subject matter
2. Delivery or the ability to deliver the subject matter without involvement of excessive uncertainty
3. Precise determination of the price or consideration

Definition:-

1. In accordance with Shariah both in terms of 'Asl (fundamental components, nature or essence) and Wasf (accessory circumstances or external attributes)
2. All the elements are in order

VOIDABLE (Fa'asid)

Factors responsible:-

1. Intrinsic causes-Relate to the basic elements of a contract, such as non-existence of the subject matter
2. Extrinsic causes-Relate to Wasf, i.e. external attributes such as Riba or Gharar

Definition:-

1. Legal in it's 'Asl
2. Not legal in Wasf
3. Can be regularized or validated by removing the cause of irregularity from the contract

VOID (Batil)

Factors responsible:-

1. Absolute uncertainty or speculation
2. Sale with unknown consideration and until an unknown period
3. Fraud and deceit
4. e.g. bidding over the bid, sale of a dirham for two dirhams etc.

Definition:-

1. Do not fulfill the conditions of offer and acceptance, subject matter, consideration and possession of delivery
2. Involve some illegal external attributes
3. Contracting parties are not sane and mature

Valid Contracts

Types of a Valid contract

a) Nafiz: Immediately effective

b) Mawquf: Suspended or tied to any future event

Contracts effective instantly or from a future date

1. Effective from a future date-Ijarah, Istisna, Kafala (surety ship), Hawala (assignment of debt), agency, divorce, a contract of bequest and Waqf

2. Immediately enforceable/effective from any future date-Ijarah

3. Immediately enforceable-Contract of sale

Mawquf contracts

Causes for suspending the effects of a valid contract:-

1. Defective capacity of any of the parties
2. Lack of proper authority as in the case of an agent
3. The right of any third party

Binding (La'azim) and nonbinding contracts

Sahih and **Nafiz** contracts are of two types:-

1. **La'azim**-None of the parties has the unilateral right to revoke (without the consent of the other) unless an option (Khiyar-al-Shart) has been granted to a party by virtue of which the right to revoke can be exercised
2. **Ghair La'azim** (nonbinding)-None has the right to revoke the contract without the consent of the other

Ghair La'azim (nonbinding)

Reasons making a contract nonbinding/revocable:-

- a) Nature of the contract
- b) Khiyar-al-Shart stipulated in the contract

Voidable (Fa'asid) Contracts

Factors rendering contracts as irregular/voidable

1. Defective consent
2. Gharar/Jahl-lack of any value-relevant information
3. Relating to the subject matter
4. Lack of information about consideration
5. Lack of information about the time of performance in sale, lease and other binding contracts. Partnership contract, being nonbinding, is excluded

6.Lack of information about the guarantee, surety or the pledge

7.Defect due to any invalid condition not being collateral to the contract or not admitted by the commercial usage or which gives benefit to one of the parties at the cost of another

8.Invalid and defective conditions may make a transaction voidable.

The following types of conditions may be deemed to be invalid or not permissible:

- a) When it is against the purpose of the contract
- b) When it is expressly prohibited by the Shariah
- c) When it is against the commercial usage
- d) When it is advantageous to one party at the cost of another

Legal Status of a voidable contract

1. It must be revoked without the consent of either party
2. Non-commutative contracts like loan, do not become void with a void condition and only the condition has to be removed
3. Ownership is transferred from the seller to the purchaser by possession taken with the consent of the seller as opposed to mere offer and acceptance as in a valid contract
4. The value of a commodity, i.e. its market price is admissible, whereas in a valid contract the agreed price is paid. In a voidable lease contract, the lessor is entitled to equitable and proper rent in accordance with the market rate, and not according to the rent specified in the original lease agreement. Similarly in a voidable partnership, each partner gets the profit in proportion to his capital and not according to the agreement

Commutative and Noncommutative Contracts



Compensatory-one party can get remuneration. They become void with a void condition

Donation-transfer of ownership without consideration. Do not become void, the void condition becomes ineffective



division by object	division by price	Wakalah	Hibah (gift)	Wasiyyah (bequest)	Kafalah (guarantee)
Ijarah/hiring contract	Istisna/manufacturing contract		Aa'riyah (loan of usable item)	Loan (qard)	Hawala (assigning of debt)

Conditional or Contingent Contracts

As a general rule, conditional contracts are not valid. This, however, requires some detail and some conditions could be acceptable. The Fiqh literature talks about three types of conditions:

- 1. Taliq-conditions which suspend a contract to any future event**
- 2. Idafa-an extension that delays the beginning of any contract until a future time**
- 3. Iqtiran (concomitance) that varies the terms of the contract**

In all of the above cases the contract may or may not be void even if the condition is void.

Conditions can be divided as follows:

1. A condition which is not against the main purpose of the contract is a valid condition. Valid conditions are those that confirm the effects attributed to juridical acts by the Shariah and which are admitted explicitly by it. A condition in aid of a contract is valid. Similarly any condition, which is customary to embody in a contract will be upheld

If a Fa'asid (invalid) condition is put into a valid contract, the contract will remain valid and enforceable, i.e. with no regard to the condition.

2. A condition which is not of advantage to either party is regarded as superfluous and cannot be enforced

3. A condition which is repugnant to a contract or transfer of ownership but is of advantage to one of the parties will make the transaction debauched if made an inseparable part of it

4. A void condition is any condition which directly infringes any rule of the Shariah, or inflicts harm on one of the two contracting parties or derogates from completion of the contract

Conclusion

A condition which is not against the main purpose of the contract is a valid condition. Similarly a condition which has become normal practice in the market is not void provided it is not against any explicit injunctions of the Quran and Sunnah e.g. a condition that the seller will provide five years guarantee and one year's free service is not void.

Sukuk: Islamic Investment Certificates

Sukuk, sometimes referred to as Islamic bonds, are better described as Islamic Investment Certificates. This distinction is as crucial as it is important. The distinction is important as a bond is a contractual obligation whereby the issuer is obliged to pay bond holders, on certain specified dates, interest and principal. In comparison, under a sukuk structure, the sukuk holders each hold an undivided beneficial ownership in the underlying assets. Consequently sukuk holder are entitled to share in the revenue generated by the sukuk assets as well as being entitled to share in the proceeds of the realization of the sukuk assets.

Sukuk are Islamic bonds which behave in practice like any highly-rated conventional bond.

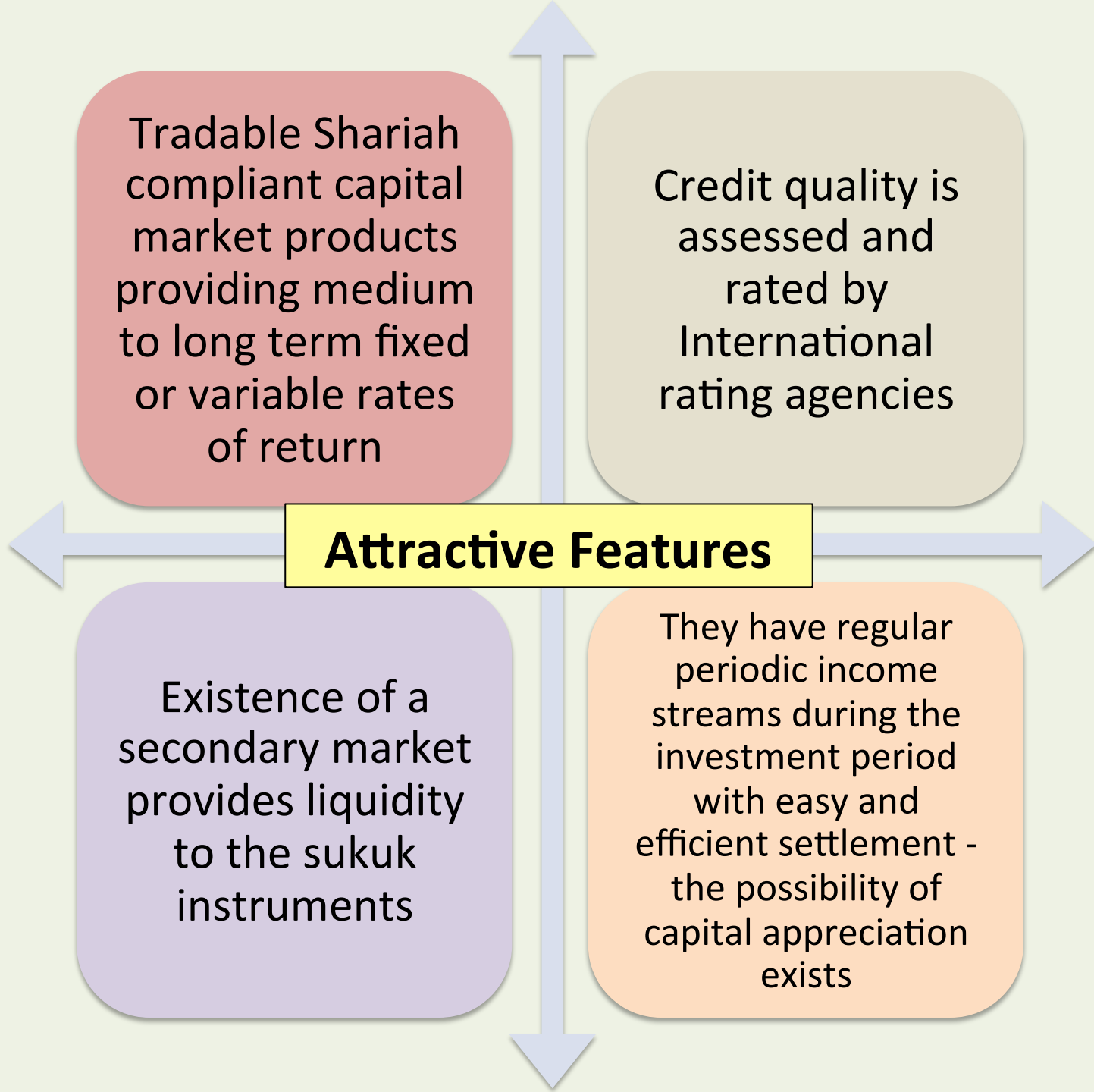
However, sukuk should not simply be regarded as a substitute for conventional interest-based securities. The aim is not simply to engineer financial products that mimic fixed-rate bills and bonds and floating-rate notes as understood in the West, but rather to develop innovative types of assets that comply with Shariah.

The essential underlying concepts of sukuk are:

- ★ Transparency and clarity of rights and obligations
- ★ That income from securities must be related to the purpose for which the funding is used, and not simply comprise interest: and
- ★ The securities should be backed by real underlying assets, rather than being simply paper derivatives

Benefits and Features of Sukuk

- ★ The sukuk certificates serve to replicate the functions of tradable securities, injecting liquidity into enterprises or governments and in providing a stable income for investors
- ★ Sukuk are directly linked with real sector activities and hence, it is hoped that they will not create the same short-term speculative movement of funds and potential financial crisis associated with conventional bonds
- ★ Sukuk investors have an inherent right to information on the use of their investments, the nature of the underlying assets, and other particulars that would otherwise be considered redundant in conventional investments



Types of Sukuk

Pure Ijarah Sukuk

Issued on- Stand-alone assets on the balance sheet e.g. land to be leased/ leased equipment like aircraft
Rental rate of returns- Can be both fixed and floating

Hybrid Pooled Sukuk

Issued on-assets can comprise of Istisna, Murabaha, and Ijarah (at least 51%)
Return-Pre-determined fixed rate of return

Variable Rate Redeemable Sukuk

Represent fully the strength of the issuer's balance sheet
Relatively stable payout rate as compared to dividend payouts

Also called
Musharakah
Term Finance
Certificates

Zero-Coupon Non-Tradable Sukuk

Issued on-More assets are created on the balance sheet through Istisna.**Not readily tradable** Primary asset pool of the nature warranted by Istisna and contracts that create debt obligations

Embedded Sukuk

These could be sukuk whether zero-coupon, pure Ijarah or hybrid, with the embedded option to convert into other asset forms depending on specified conditions

Types of Islamic Bonds

Ijarah Bonds

These are created when the funds raised by the SPV Mudarabah are invested in Ijarah operations

Musharakah Bonds

Similar to Mudarabah bonds except that the intermediary party will be a partner of the group similar to a joint stock company

Muqaradah Bonds

It is an Islamic bond in which no interest is earned, but whose market value varies with the anticipated or expected profits

Istisna Bonds

The suitability for financial intermediation is based on the permissibility for the contractor in Istisna to enter into a parallel Istisna contract with a subcontractor

Types of Investment Sukuk

Investment Sukuk are certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs, and services, or equity of a given project or equity of a special investment activity-Exposure Draft of AAOIFI Shariah Standard No. 18, p.4

Types of Investment Sukuk

*Certificate of
Ownership on Leased
Assets*

**Certificate of
Ownership in
Usufructs**

**Certificates of
Ownership of Services
of a Specified Supplier
or of Services to be
made available in the
future**

**Salam, Istisna and
Murabaha Contracts**

**Participation
Certificates**

**Agricultural Oriented
and Concession
Certificates**

“According to Global Islamic Finance Report 2012, \$1.34 trillion of assets are being managed according to Islamic investment principles. Such principles form part of Shariah, which is often understood to be ‘Islamic Law’, but it is actually broader than this in that it also encompasses the general body of spiritual and moral obligations and duties in Islam”-Wikipedia

Most commonly used Sukuk structures replicate the cash flows of conventional bonds. Such structures are listed on exchanges, commonly Luxembourg Stock Exchange and London Stock Exchange in Europe, and made tradable through conventional organizations like Euroclear or Clearstream

Takaful

Takaful comes from the Arabic root-word 'kafala'- guarantee. Takaful means mutual protection and joint guarantee. Operationally Takaful refers to participants mutually contributing to a common fund with the purpose of having mutual indemnity in the case of peril or loss. Takaful is a form of mutual help (Ta'awun) in furthering good / virtue by helping others who are in need / in hardship

The main characteristic of Takaful is al-Musharakah which means sharing. Thus the word Takaful means shared responsibility, shared guarantee, collective assurance and mutual undertakings

Takaful is not a new concept in Islamic commercial law. The contemporary jurists acknowledge that the foundation of shared responsibility or Takaful was laid down in the system of 'Aaqilah', which was an arrangement of mutual help or indemnification customary in some tribes at the time of the beloved Prophet (Sallallahu Alayhi Wasallam-may the peace and blessings of Allah be upon him). In case of any natural calamity, everybody used to contribute something until the loss was indemnified.

In Quran: “*Help (ta’awun) one another in furthering virtue (birr) and Allah consciousness (taqwa) and do not help one another in furthering evil and enmity*” -Al Maidah: Quran (5:2)

In Hadith: “*Tie the camel first, then submit (tawakkul) to the will of Allah*”

The Hadith implied a strategy to reduce / mitigate risk and Takaful provides the same strategy by virtue of collective risk taking that distributes risks and losses to a large number of participants

Basic Elements of Takaful

- ◆ Mutuality and Cooperation
- ◆ Pertains to Tabarru'at as against mu'awadat in case of conventional insurance
- ◆ Payments made with the intention of Tabarru (contribution)
- ◆ Eliminates the elements of Gharar, Maisir and Riba
- ◆ Wakalah / Mudarabah basis of operations
- ◆ Joint guarantee / Indemnity amongst participants-shared responsibility
- ◆ Constitution of separate 'Participants' Takaful Fund'
- ◆ Constitution of Shariah Supervisory Board
- ◆ Investments as per Shariah

Main drivers of Takaful

- ◆ Piety (individual purification)
- ◆ Brotherhood (mutual assistance)
- ◆ Charity (Tabarru or contribution)
- ◆ Mutual Guarantee
- ◆ Community well-being as opposed to profit maximization

Principles of Takaful

- ◆ Policyholders co-operate among themselves for their common good
- ◆ Every policyholder pays his subscription to help those that need assistance
- ◆ Losses are divided and liabilities spread according to the community pooling system
- ◆ Uncertainty is eliminated in respect of subscription and compensation
- ◆ It does not derive advantage at the cost of others

Judicial Opinions and Fatwas confirming validity of Takaful

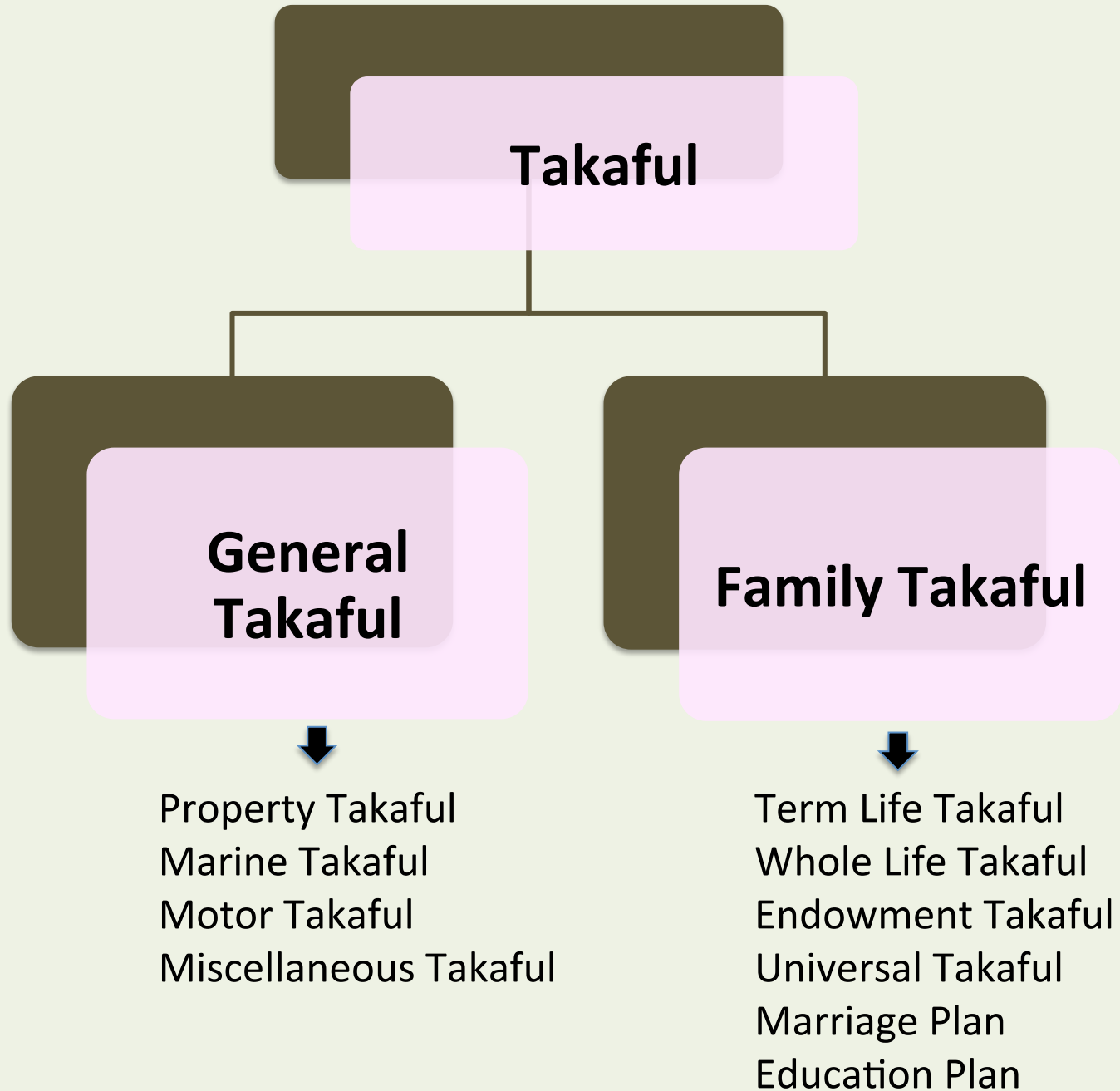
- ◆ Fatwa issued by Higher Council of Saud Arabia in 1397 AH
- ◆ Fatwa issued by the Fiqh Council of Muslim World League in 1398 AH
- ◆ Fatwa issued by the Fiqh Council of the OIC in 1405 AH

Fiqh Academy Resolution 1985

Islamic Fiqh (science of Shariah) Academy, emanating from the Organisation of Islamic Conference, meeting in its Second Session in Jeddah, KSA, from 10 to 16 Rabul Thani, 1406 AH (Dec 1985) issued a resolution, which in summary stated the following:

- ◆ **The commercial Insurance contract is prohibited (Haram) according to Shariah**
- ◆ **The alternative Takaful contract which conforms to the principles of Islamic dealings is Halal, being the contract of cooperative insurance, which is founded on the basis of charitable donation and Shariah compliant dealings**

Types of Takaful



Takaful Models

Tabarru Based Takaful

Non-profit nature, original contribution from promoters as qard hasan, participants make donations to help the members, shortfalls met through qard hasan loans,, closer to the ideal

Mudarabah Based Takaful

Operator as Mudarib, separate fund to help members and to invest for profit:-policyholders fund and shareholders fund, similar to the formation of a Takaful company

Wakala Based Takaful

Operator acts as Wakil or agent, separate policyholders and shareholders funds, operator invests from the policyholders funds in Shariah compatible assets and profits add up to the same fund

Waqala-Waqf Based Takaful

Purified version of the Wakala model, the shareholders create a waqf fund to extend help to the policyholders, all underwriting results belong to the fund, which itself is a separate legal entity

Takaful

Conventional Insurance

Accounts

For General Takaful, the Account is known as al-Tabarru (PSA), which means donation
For Life Takaful, there are two accounts:
PA-treated in line with the principles of Mudarabah
PSA-on the basis of al-Tabarru

The paid premium is credited into the account, known as general insurance account
In life insurance policy, the collected premiums are collected into an account known as life insurance account

Accounting

Cash accounting is generally preferred

Several methods are used like Cash Accrual, Deferred, Embedded values etc.

Takaful

Conventional Insurance

Benefits

Paid from the defined funds under joint indemnity borne by participants

Specified from the outset how profit sharing will take place

This shall be in accordance with the principle of al-Mudarabah, and the share could be in the ratio such as 5:5 or 6:4 or 7:3 etc. as agreed between the participant and the operator regardless of the investment profit made during the year

Paid from the funds legally owned by the company
May offer bonus or profits in general terms only with no exact specification of profit sharing

It may also decide to give or not to give bonus for any particular year depending on the result of the investment returns. The rate of bonus can also vary from year to year and depends on the discretion of the Board of Directors of the company

Takaful

Conventional Insurance

Claims

In a life Takaful policy, if the risk occurs, the beneficiary shall have the right to claim the policy value from the PSA besides the accumulated entire amount from the PA. But if in this category of policy, the participant survives at the maturity of the policy, his/ her claim shall be confined within the amount available in the PA.

In a life insurance policy where the risk occurs, the beneficiary shall have the right to claim whole amount named in the policy.

But, if in case the risk does not occur, the insured shall have the right to claim the policy value at maturity together with the interest if any.

Forfeiture

The paid premiums of the participants can for no reason be forfeited- even for a breach of utmost good faith or any other offence or wrong committed by the participant.

The paid premiums may sometimes be forfeited, especially for the breach of utmost good faith.