UNIT-9

Forward Sales: 'Salam and Istisna'a'

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Discuss the benefits of SALAM and the Economic Role of BAI'SALAM
- ✓ Explore the features of a Valid SALAM Contract
- ✓ Discuss the Importance of Guarantees in SALAM and ISTISNA

Unit 9

Forward Sales:‘Salam and Istisna‘a’

Introduction

As discussed earlier there are three basic conditions for the validity of a sale. These are: the commodity to be sold must exist; the seller should have acquired the ownership of that commodity and as such its possible risks; and the commodity must be in the physical or constructive possession of the seller. These conditions are imposed to avoid the possibility of Gharar and dispute regarding the subject matter. However, there are two exceptions: **Salam and Istisna‘a**. Exception is accorded on the ground that some condition shave been advised, fulfilment of which renders them free from Gharar. As in both of these sales delivery of the subject matter is deferred to the future, these can be termed forward sales. In the Islamic framework, commodity markets can exist for the future delivery of goods subject to the rules relating to Salam and Istisna‘a. The modern futures markets that deal in futures like options, derivatives, swaps, etc. do not qualify under these rules.

BAI‘ SALAM/SALAF

Bai‘ Salam is an ancient form of forward contract wherein the price was paid in advance at the time of making the contract for prescribed goods to be delivered later. The two terms “Salam” and “Salaf” have been used interchangeably in Hadith literature to describe the contract for future delivery of specified goods with up-front payment of the price. The parties stipulate a certain time for supply of goods of specified quantity and quality. This is contrary to Bai‘ Mu’ajjal, in which goods are delivered to the purchaser in advance and the agreed price is paid at a stipulated date in the future. The word Salaf or Taslif, which literally means payment in advance, referring to a sale by advance payment, was used by jurists of Hijaz, while the jurists based in Baghdad, Iraq mainly used the term Salam for forward sale transactions. As the commodity to be delivered in future against prompt payment becomes a debt on the part of the seller, the transaction is termed Salaf and implies a loan without any benefit.

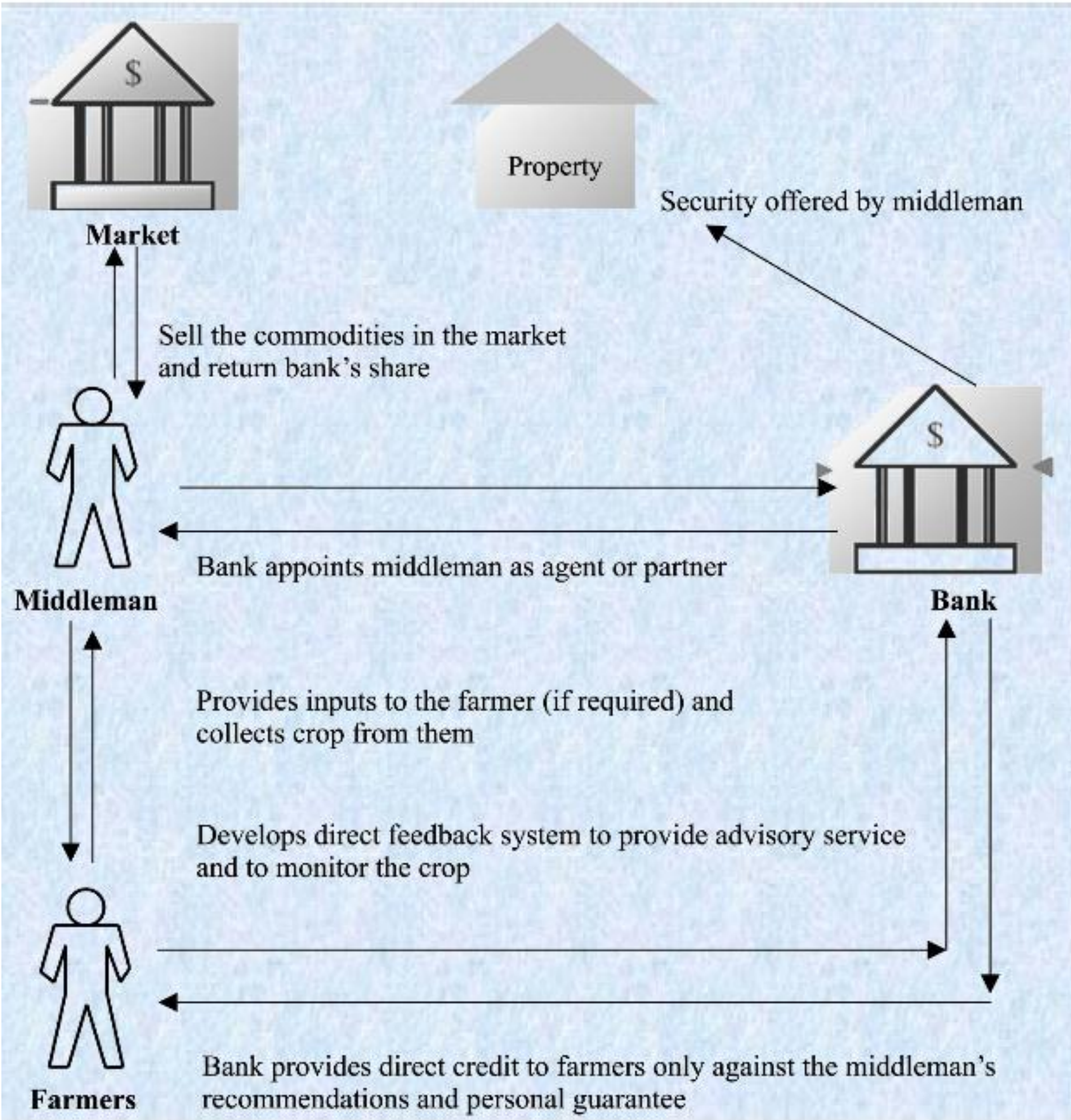
Market
Property
Security offered by middleman
Sell the commodities in the market
and return bank's share
Bank appoints middleman as agent or partner
Middleman
Bank
Provides inputs to the farmer (if required) and
collects crop from them
Develops direct feedback system to provide advisory service
and to monitor the crop
Bank provides direct credit to farmers only against the middleman's
recommendations and personal guarantee
Farmers

Fig: 9.1

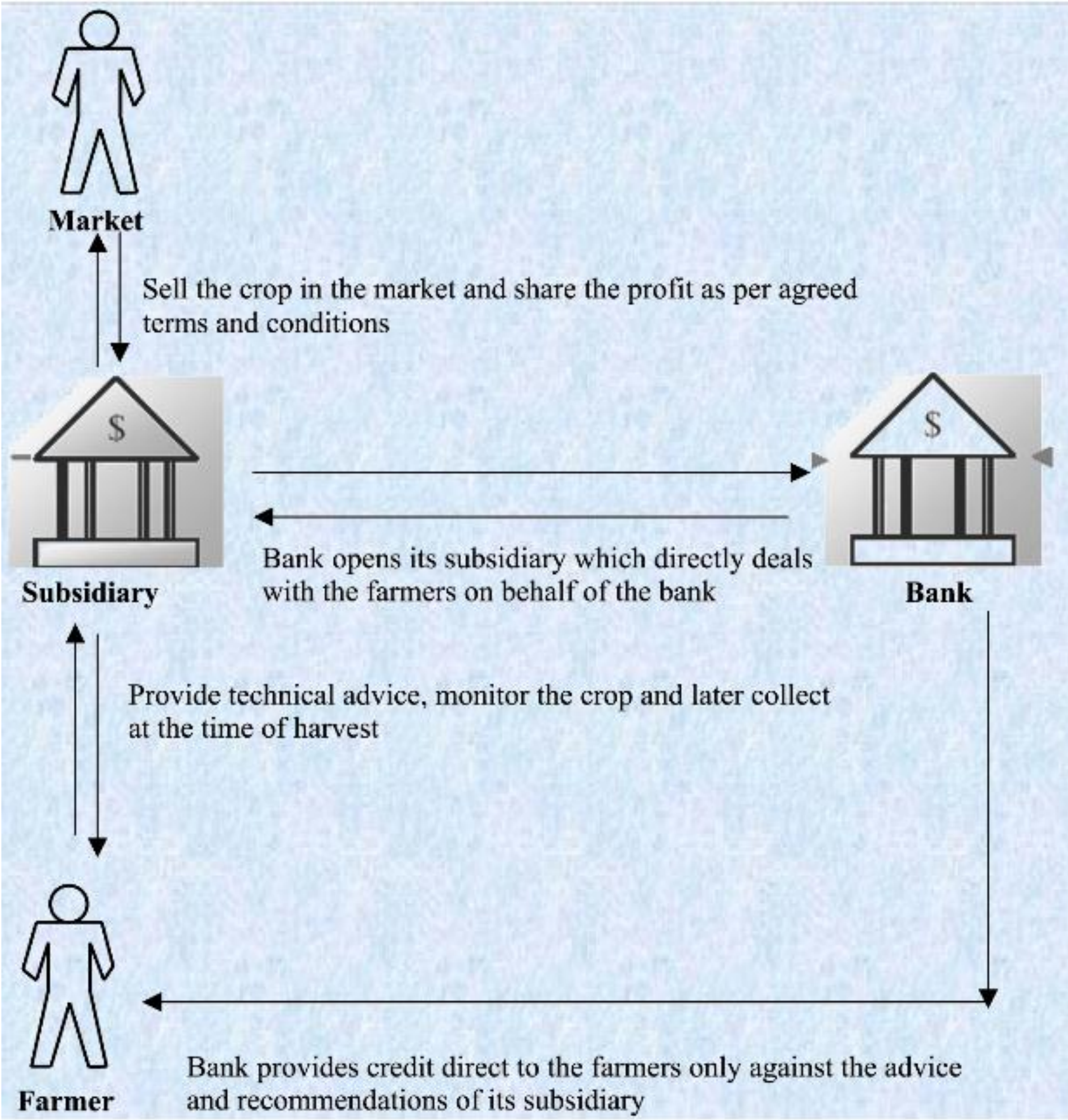

Fig: 9.2

As, in the emerging Islamic finance movement, Salam is normally used to denote a forward transaction of a defined nature, we have used the word "Salam" through out the course. Salam has been permitted by the holy Prophet (PBUH) himself, without any difference of opinion among the early or the contemporary jurists, notwithstanding the general principle of the Shar¯ı´ah 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".

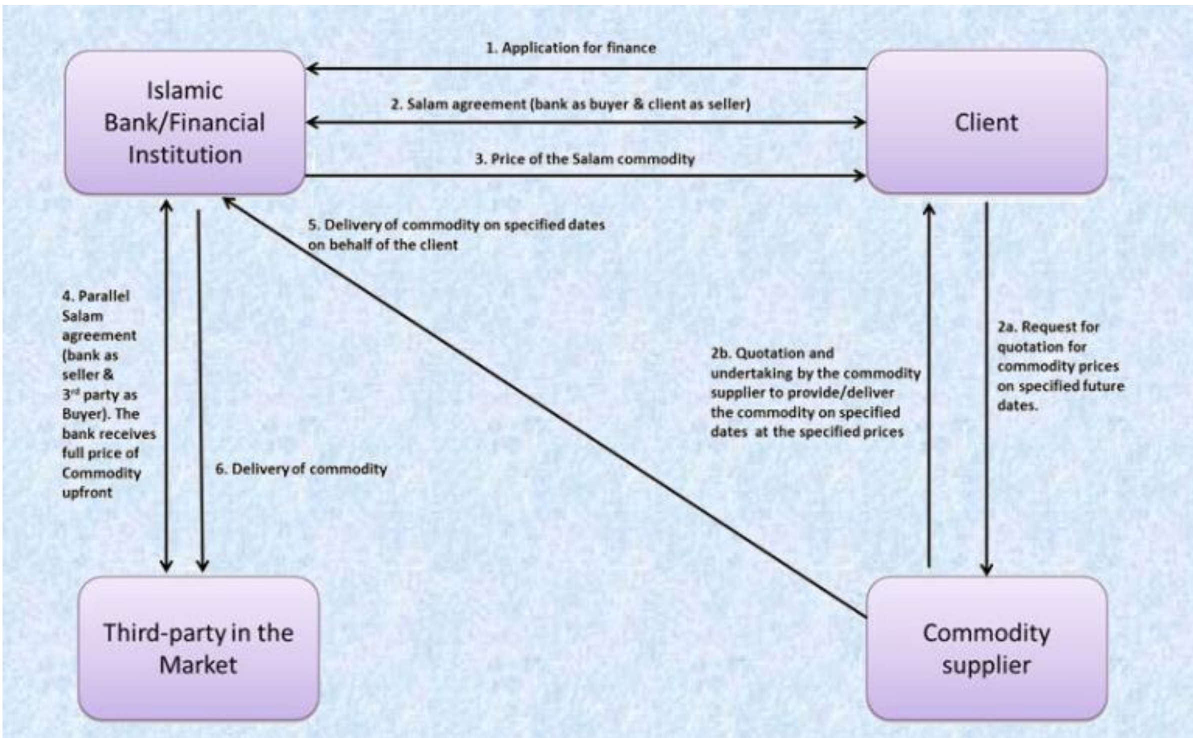

Fig: 9.3

The rationale for this permission, as described by S.M. Hasanuz Zaman, is the concept of "necessity". He adds:"It is stated that the practice, as qualified by the Prophet (pbuh), continued during his life and subsequently. The later jurists unanimously treated it as a permissible mode of business. The list of items covered by Bai' Salam suggests that it benefited the owners of farms and orchards. For example, the Madin an list of cultivation covered wheat, barley, dates and grapes. The conquest of Syria added to it such items as olives and dried large grapes. _ _ _ Barring a few exceptions, the jurists have expanded the list of items, in regard to which Salam is permissible, to cover all the commodities that could be precisely determined in terms of quality and quantity."

BENEFITS OF SALAM AND THE ECONOMIC ROLE OFBAI' SALAM

Forward sale in the form of Salam has been allowed by the Shari'a with such a structure that it becomes free from Riba, Gharar and, therefore, from exploitation of one party by the other. It is rather based on genuine need of the business and, therefore, beneficial to both buyer and seller. The seller gets in advance the money he needs in exchange of obligation to deliver the commodity later. Thus, he benefits from the

Salam sale by covering his cash/liquidity needs in respect of personal expenses or for productive or trading activity.

The purchaser gets the commodity he has planned to trade at the time he decides. He will also benefit from cheap prices, because usually the Salam price is cheaper than the cash market price. This way he will also be secured against fluctuations of price. S.M. Hasanuz Zaman has given a detailed account of this aspect of Bai‘ Salam. The Hadith legalizing the practice suggests that it was meant to meet the financial requirement of farmers who needed funds for a period ranging from one to three years. The economic role which Bai‘ Salam is supposed to perform can be summarized as follows:

- The period of delivery ranging from one year to three years suggests that the amount of advance was not small; otherwise this should have been adjusted earlier than the harvesting of crop or fraction of the garden.
- In view of the period involved in the deal, it can be claimed with confidence that the buyers were not consumers of the product; they were traders or prospective traders.
- The popularity of this practice leads us to believe that the price received in advance might have met both the productive and consumption requirements of the cultivators.
- Fixation of three years as the time of delivery suggests that money was also required for fixed investment like improvement of land and growing gardens. In the context of Syria, digging of wells and providing irrigation facilities could also be a possible purpose of the request for advance payment.

From the point of view of the farmers, Bai‘ Salam might be a preferable way of taking financing as compared to a loan with interest, because first, it did not make an increase in cost as interest did and, second, it saved them from the hardships and the risk involved in marketing their produce. It is not certain whether the institutions of Bai‘ Salam brought about any change in the role of intermediaries in the rural economy. It is, however, certain that it paved the way for a direct relationship between the grower and the trader in the city, who generally was the supplier of funds.

As the buyer in a free market would always choose to purchase at a price which gives him good income on resale on the stipulated date and during the supply season, Bai‘ Salam could prove an effective means of stabilizing the price at a moderate level during periods of seasonal fall in demand. And because the Shari’a does not allow resale of Salam goods before they are actually transferred to the buyer, this would protect the prices from exposure to speculative rise and stabilize them at a lower level. Contrary to this, financing production/inventory building through loans with interest automatically increases the cost of production/stocks. This increase is further shot up by speculative transactions for anticipated brisk trade seasons.

Salam provides a price hedge for the buyer and protects both the buyer and the seller from the respective risks of revenue and price-indexed debts. There is less incentive on the part of the seller to transfer any additional risks to the buyer by manipulating his reported revenues, as could happen in the conventional commodity forward market. Part of the variation in revenue has been already transferred to (and accepted by) the buyer in the form of a predetermined price, and the other (quantity) part is contractually fixed.

As a forward contract, it gives the buyer the required hedge against possible future price increases. It gives the seller the required price protection and does not involve any predetermined cash debt on either party. One can get financing directly from buyers without involving any intermediary. However, banks can participate as a buyer on a Salam basis in a competitive environment. Hence, a Salam contract can bring about the benefits of a swap without the involvement of interest and at a lower cost. The transaction costs associated with a Salam contract are likely to be much lower than those of a swap.

FEATURES OF A VALID SALAM CONTRACT

- Alternatives for Marketing Salam Goods
- Getting Promise for Purchase
- Parallel Salam
- Agency Contract
- DISPOSING OF THE GOODS PURCHASED ON SALAM
- SECURITY, PLEDGE AND LIABILITY OF THE SURETIES
- Penalty for Nonperformance
- Amending or Revoking the Salam Contract
- Khiyar (Option) in Salam
- Period and Place of Delivery
- Mode of Payment
- Payment of Price: Salam Capital
- Salam in Currencies
- Subject Matter of Salam

A valid Salam contract requires the following conditions (it goes without saying that itshould also fulfil the conditions of a normal valid sale).

Subject Matter of Salam

On which items Salam can be conducted is the first important aspect. There is a consensus that everything that can be precisely determined in terms of quality and quantity can be made the subject of Salam sale. There is also unanimity on the point that the commodity should be well-defined but not particularized to a specific unit of farm, tree or garden.

Only those fungible (Mithli) things various units of which do not differ from each other in a significant manner can be contracted under Salam.

Salam cannot take place where both items of exchange are identical, e.g. wheat for wheat and potato for potato. Similarly, the commodity to be sold through Salam should, in itself, not be of the nature of money, like gold, silver or any currency.

Differences existed among the traditional jurists regarding the list of commodities that can be sold under Bai‘ Salam. The advocates of Bai‘ Salam in animals and their flesh argue that the quality of these items can be defined in terms of their species, kind and quality. Similarly, controversy existed in respect of items like cane, grass, fodder, bread, honey, milk, vegetables, oils, cheese, birds, fish, trained dogs, leopards, precious stones, heaps of charcoal wood, musk, aloe, perfumes, hide and skin, wool, hair, animal fats, paper, cloth, carpets, rugs, mine dust construction bricks, bowls, bottles, shoes and drugs. The cause of controversy is understandable, because standardization of most of these items was a very difficult job in the days when the jurists compiled their Fiqh (fourth–sixth century Hijrah).

They were generally inclined to approve only the sale of those items where various units did not differ, so as to remove any possibility of Gharar and dispute at the time of delivery.

The contemporary scholars have come to the conclusion that all goods that can be standardized into identical units can become the subject of Salam.

For example, wheat, rice, barley, oil, iron and copper or other grains of this type, products of companies which are regularly and commonly available at any time, like carpets, tin packs of various consumption items, etc., can be sold through Salam. The commodity should be generally available in the market.

Hence, the Salam commodity of defined specifications is made the responsibility of the seller, so that he can supply them by taking them from the market. As reported by Imam Bukhari in his Sahih, Abdur Rahman bin Abza and Abdullah bin Abi Aufa, Companions of the holy Prophet (pbuh), upon asking about Salam goods said, “ _ _ _ when the peasants of Syria came to us, we used to pay them in advance for wheat, barley and oil to be delivered within a fixed period”. They were again asked, “Did the peasants own standing crops or not?” They replied, “We never asked them about it”. Therefore, it is not necessary that the Salam seller himself produces the goods to be delivered in the future; rather, such specification has to be avoided to enable the seller to make available the item from where he can arrange.

Salam in Currencies

The majority of jurists do not allow Salam in gold, silver, currencies or monetary units, although a few jurists have allowed it and, as such, a few Islamic banks have been using

Salam in currencies as an alternative to bill discounting. As this issue is of far-reaching implications, it needs to be discussed in detail.

As discussed we have discussed, money is treated differently from other commodities. Gold, silver and other metallic money like Fulus of copper or other metals can be used for some purposes other than for making payments; hence, they can be traded keeping in mind the Shari'a principles. However, paper money can be used only in payment of a price; it cannot serve as a commodity to be sold. The currency notes in vogue are monetary values. They have no value in the absence of government commitment and are wanted only for the purpose of exchange and payments and not for themselves. Accordingly, the present fiduciary money in the form of currency notes is cash money or monetary value and unlimited legal tender for making payment, as creditors are obliged to accept it for the recovery of debts.

The counter values to be exchanged in Salam include prompt price payment on the one hand and deferred delivery of the commodity on the other. However, if the price in Salamis US Dollars, for example, and the commodity to be purchased/sold is British pounds, it will be a currency transaction which cannot be made through Salam, because such exchange of currencies requires the simultaneous payment on both sides, while in Salam, delivery of the commodity is deferred.

Payment of Price: Salam Capital

Price is normally stipulated and paid in the form of any legal tender. However, it can be in terms of goods as well, on the condition that it should not violate the prohibition of Riba in barter transactions as laid down by the shari'a. Usufruct of assets can also be considered as Salam capital, which is regarded, particularly by Maliki jurists, as immediate receipt of the capital on the basis of the legal maxim that says: "Taking possession of a part of a thing is like taking possession of the whole thing". Hence, making usufruct capital of Salam does not mean debt against debt, which is prohibited.

Outstanding loans/debts due on the part of the seller cannot be fully or partially fixed as price, nor can a loan outstanding on a third party be transferred to the seller in future adjustment towards the price, as this amounts to an exchange of obligation for obligation(debt for debt), which is forbidden. This is also to avoid Gharar. This emphasis by the jurists is justified since the equity in Salam contracts depends on the very existence of the Salam capital, otherwise such transactions are invalid. The very term Salaf (Salam) means advance payment; if payment is delayed, it cannot be called Salam.

Mode of Payment

Cash payment is not necessary in Salam; the price can be credited to the seller's account. Crediting the agreed amount in the seller's account can be termed, in letter, a debt for adebt, but in spirit, it does not fall under the prohibited form of a debt for a debt. Hence, it will not be necessary for banks to pay hard cash for Bai' Salam; they may credit the seller's account or issue a pay order in favour of the seller, which may be cashable on demand. In all such cases, money may remain in the bank but is placed at the disposal of the seller.

Period and Place of Delivery

In Salam it is necessary to precisely fix the period/time of delivery of goods. Place of delivery also has to be agreed. As regards the time or the period of delivery in Salam, the early compilations of the Hadith mention the practice of fixing a period of one to three years for delivery of farm products. The later jurists, who expanded the application of Salam, reduced the period to fifteen days, some even to one day, which, as they argued, was the minimum period necessary for the transport of a commodity from one market to an other. Some jurists believed in precise fixation of the date on which delivery was to be made, while some others approved of a rough date but a definite period or occasion of delivery; for example, on harvest.

Contemporary scholars recommend that the due date and place of delivery must be known.

The period could be anything from a few days to a number of years, depending upon the nature of the commodity involved. Delivery can also be made in different consignments or instalments if mutually agreed. Before delivery, goods will remain at the risk of the seller.

Delivery of goods can be physical or constructive. After delivery, risk will be transferred to the purchaser. Transferring of risk and authority of use and utilization/consumption are the basic ingredients of constructive possession.

If a place of delivery is not stipulated at the time of the Salam agreement, the place at which the contract was executed will be regarded as the place where the goods will be delivered. The parties can also mutually decide about the place, keeping in mind the customary practice.

Khiyar (Option) in Salam

The jurists disallow the operation of the Islamic law of option (Khiyar alShart) in the case of Bai‘ Salam because this disturbs or delays the seller’s right of ownership over the price of the goods. The purchaser also does not have the “option of seeing” (Khiyar al Ro’yat),which is available in the case of normal sales. However, after taking delivery, the purchaser has the “option of defect” (Khiyar al‘Aib) and the option of specified quality. This means that if the commodity is defective or it does not have the quality or specification as agreed at the time of contract, the purchaser can rescind the sale. But in that case, only the paid amount of price can be recovered without any increase.

Amending or Revoking the Salam Contract

In Salam, a seller is bound to deliver the goods as stipulated in the agreement. Similarly, the buyer has no right to unilaterally change the conditions of the contract in respect of the quality or quantity or the period of delivery of the contracted goods after payment is made tothe seller. Both parties, however, have the right to rescind the contract with mutual consent in full or in part. The buyer will thus have a right to get back the amount advanced by him; but not more or less than it.

The seller may often be willing to rescind the contract if the market price of the contracted goods is higher at the time of delivery than what the bank has paid to him. Similarly, the bank may be inclined to withdraw from the purchase if the price of the contracted item goes down at the time of delivery. It is, therefore, advisable, to make Bai' Salam between a bank and a supplier an irrevocable contract. The only exception may be the complete absence of the goods in the market or their becoming inaccessible to the seller just at the time of delivery. Only in this situation may the seller be allowed to rescind the contract, provided the bank refuses to extend the period of delivery until the next supply season. In the case of revocation of the contract, the bank will charge exactly the same amount that it had paid.

If the seller supplies the goods before the stipulated time, generally the jurists do not bind the buyer to take possession of it. Those who relax the rule subject it to the interest of the buyer. The buyer can refuse to accept the goods only if they are not according to the stipulated specifications. Any change in prices would allow neither the seller nor the buyer to rescind the contract or to refuse to give or take delivery. Hence, according to the majority of jurists, Salam is considered a non revocable sale except with free mutual consent.

Jurists allow the purchaser to take any goods in place of the agreed goods, after the due date falls, provided both parties agree and the new item is of a different genus from the original commodity and the market value of the substitute is not more than the value of the original commodity at the delivery date. Further, it should not be stipulated in the Salam contract.

Penalty for Non Performance

The seller can undertake in the Salam agreement that in the case of late delivery of Salam goods, he shall pay into the Charity Account maintained by the bank an amount which will be given to charity on behalf of the client. This undertaking is, in fact, a sort of self-imposed penalty to keep oneself away from default. Clause 5/7 of the AAOIFI's Salam Standard says: "It is not permitted to stipulate a penalty clause in respect of delay in the delivery of the Muslam Fihi (Salam commodity)." This implies that any such penalty cannot become part of the bank's (seller's) income. A penalty can be agreed in the contract in order to avoid wilful default. If the seller fails to fulfil his obligation due to insolvency, he should be granted an extension of time for delivery.

SECURITY, PLEDGE AND LIABILITY OF THE SURETIES

It is permissible to ask for security or a pledge in a Salam transaction as proved from the Sunnah of the holy Prophet (pbuh). Imam Bukhari has captioned two chapters "Kafeel fis Salam" and "Al-Rihn fis Salam" and reported the Hadith of the holy Prophet borrowing grain from a Jew against the pledge of an iron breastplate. This Hadith has no mention of Kafeel. Ibn Hajar in *Fathul Bari* has explained this by saying that Imam Bukhari intended to describe the permissibility of Kafeel in Salam by copermitting Rihn and Kafeel.

The seller can be required to furnish any security, personal surety or a pledge. In the case of a pledge, the bank, in the event of the seller's default, has the right to sell out the pledge and purchase the stipulated goods from the market in collaboration with the customer or take away his advance payment out of the sale proceeds and return the balance to the owner.

If the bank gets its money back, it cannot be more than the price paid in advance, as the advance price is like a debt outstanding on the seller. Purchase of the stipulated commodity by the bank from the sale proceeds of the pledge should not result in any exploitation of the customer. He, therefore, may be involved in the process. If a seller has furnished a personal surety, the latter will be liable to deliver the goods if the former fails to do so. If revocation of the contract is required, only the seller is authorized to revoke and not the surety; only the price paid will be taken in that case. The seller can, with the permission of the purchaser, shift the liability to the transferee on the basis of Hawalah, subject to acceptance by the latter. The liability of the surety or the transferee will automatically cease if the contract of Bai' Salam is rescinded. As a result, the pledge will also be released.

DISPOSING OF THE GOODS PURCHASED ON SALAM

First, the Salam buyer cannot sell the commodity onward before taking its delivery. There is a difference of opinion among Muslim jurists regarding the legality of selling the purchased goods in a Salam contract prior to taking delivery. The majority maintain that the Salam purchaser is not allowed to enjoy ownership rights nor he has the right of disposal of such goods until he has received them.

Alternatives for Marketing Salam Goods

There are a few options for disposing of or marketing the goods purchased through Salam.

The options available to Islamic banks are: (i) enter into a Parallel Salam contract; (ii) an agency contract with any third party or with the customer (seller); and/or (iii) sale in the open market by the bank itself by entering into a promise with any third party or direct selling upon taking delivery. One thing must be clear, however, that such goods cannot be sold back to the Salam seller. Hence, Parallel Salam cannot be entered into with the original seller – this is prohibited due to being buy-back. Even if the purchaser in the second contract is a separate legal entity but owned by the seller in the first contract, this would not amount to a valid Parallel Salam agreement.

One deviation from the above principle would be that after settlement of the Salam transaction, i.e. transfer of ownership/risk to the bank (buyer), there might be a totally separate Murabaha or Musawamah deal with the same client. The State Bank of Pakistan, while giving the Shari'a essentials of Islamic modes of financing, has allowed this option.

Accordingly, one Islamic bank in Pakistan had been selling carpets purchased through Salam, the day after the culmination of Salam, to the Salam seller, who used to export the carpets as per the concerned L/C. However, as the majority of Shari'a scholars were not inclined to accept this arrangement, the bank shifted to the alternative of appointing the client as agent to export the goods on behalf of the bank. We give hereunder the procedure of the above options.

A bank may take a promise from any third party that he will purchase the goods of stipulated specification at any stipulated price. This promise would be binding on the promisor, and in case of breach of promise, he would be liable to make up the actual loss to the promisee. The bank also has the option of waiting to receive the commodity and then selling it in the open market for cash or deferred payment. In this case, it may have to create an inventory that could be useful for the bank from a business point of view, subject to proper risk mitigation and the concerned regulatory framework.

Agency Contract

If the bank considers that it is not suitable for it to keep inventory of the goods and/or it has no expertise to sell the commodities received under a Salam contract, it can appoint any third party or the customer as its agent to sell the commodity in the market. It is necessary, however, that the Salam agreement and agency agreement should be separate and independent from each other. A price can be determined in the agency agreement at which the agent will sell the commodity, but if the agent is able to get a higher price, the benefit can be given to the agent.

Parallel Salam

In Salam, both the seller and the buyer can enter into a parallel contract. The bank, as seller, can sell the goods on Parallel Salam on similar conditions and specifications as it previously purchased on the first Salam, without making one contract dependent on the other. The date of delivery in the parallel contract can be the same as that of the original Salam. This does not come under prohibition in any way. Similarly, the seller can enter into a parallel contract to enable him to deliver the agreed commodity at the agreed time.

If the seller in the first Salam contract breaches his obligation, the buyer (the injured party) has no right to relate this breach/default to the party with whom he concluded a Parallel Salam. The two contracts cannot be tied up and performance of one must not be made contingent on the other. The delivery date in the parallel contract can be the same as in the original Salam contract, but not earlier than that, as this would mean sale of goods which one does not possess. There must be two separate and independent contracts, one where the bank acts as buyer and another in which it is a seller.

Getting Promise for Purchase

A Salam purchaser may like to get a promise from any third party whereby the latter will buy the commodities of specified quality and quantity at a mutually agreed price. The delivery date of the Salam goods can be the delivery date in the promise. The bank (as promisee) may take earnest money (Hamish Jiddiyah) from the promisor and if the latter backs out, the bank will have the right to cover the actual loss from the earnest money. In the case of promise, prepayment of price by the promisor would not be necessary, and this is the edge of the promise option over the option of Parallel Salam for disposing of goods purchased on the basis of Salam.

SALAM – POST EXECUTION SCENARIOS

After execution of the Salam contract, a number of situations could arise.

Supply of Goods as Per Contract

The seller delivers the commodity with the stipulated features at the due time and place of delivery. The bank (buyer) takes delivery and the transaction culminates smoothly; the bank will dispose of the commodity as per its plan.

Failure in Supply of Goods

The seller defaults and does not deliver the goods, saying, for example, that he was un able to produce goods of the agreed quality or the required quantity. The Salam buyer shall have the following options:

- to wait until the commodity is available;
- to cancel the contract and recover the paid price;
- to agree to a replacement with mutual consent and subject to the relevant rules.

The bank will ask the client to acquire the goods, or part thereof, from the market for supply to it as per the contract, and if the customer is unable to do so, the bank will sell the pledge/collateral given by the client in the market, purchase the commodity (the subject of Salam) from the market with the proceeds and give the remainder amount, if any, to the customer. If the proceeds are not sufficient to procure the goods as per the contract, the bank has the right to ask the customer to make good the deficit.

It is pertinent to observe here that the bank has the right to take the goods that it is purchasing from the proceeds of the security, but if it decides to get cash from the customer, it has the right to get only the price given in advance at the time of the contract. The price paid in advance by the bank amounts to a debt in the hands of the seller for the entire period until the goods are delivered. If the contract stands rescinded, the amount of debt will have to be refunded without any increase or decrease. The same amount of money will be returned without any consideration to the increase or decrease in its relative value.

Supply of Inferior Goods

Another situation may be that the seller supplies goods inferior to what had been agreed upon and thus forces the bank to either accept those inferior goods or to rescind the contract. This will put the bank in an embarrassing situation. Disputes regarding quality of the goods can be adjudicated by any institution having expertise in the area. A clause to this effect can be inserted in the Salam agreement at the time of the contract. The bank would not be obliged to accept the goods if their quality is judged to be inferior. It may, however, agree to acceptance, may be even at a discounted price. It may also make adjustment for superior quality or additional quantity. There may be a number of solutions to this problem, and some of these are as follows:

1. The bank may refuse to accept the goods and insist on the supply of the agreed goods according to the procedure given in Section 10.7.2, or get the price paid at the time of contract back.

2. If the seller is not able to supply the agreed item, and the item is absolutely out of stock in the accessible market, the bank may ask the seller to supply any other goods.

3. If the seller can only partly supply the agreed goods, the bank may accept the same and revise the purchase order to the extent of the remaining quantity, or it may claim a refund of the balance.

Solution 1 above will be permissible provided it does not involve the return of a price that is different from what the bank had paid. As to solution 2, the substitution is allowed with some conditions. The rules applicable for substitution are that the new commodity must also be fungible and not non fungible – every unit of which is different in quality and price than the other units – and its value should not be more than the value of the Salam commodity. The new commodity should not be of the same genus as that of the original

Salam commodity; for example, if the subject of the Salam was wheat, it can be substituted by cotton but not by corn or other animals owned by the customer. Both parties will mutually decide the present market price of the original Salam goods and enter into a sale agreement for the new commodity.

This will be done only when the agreed item is absolutely out of stock in the accessible market. If the item is available, the seller is obliged to buy it for delivering the same to the bank, whatever the market price may be. It is possible that the seller may require additional finance for purchasing the item to deliver it to the bank. He may approach the same bank for a facility to discharge the liability, but the new facility or advance so made by the bank will have to be treated as a separate transaction. Under no circumstances may the two contracts be tied up.

As regards solution 3 involving part delivery of the item, the bank may resort to any of the solutions given above for the remainder amount of the goods. It has to accept the available quantity of the contracted item; for the remaining amount, it can get back the part of the price it has paid. If the seller becomes insolvent and absolutely incapable of honouring the commitment at any time in the near future, he will be treated like an insolvent debtor.

SALAM-BASED SECURITIZATION – SALAMCERTIFICATES/SUKSUK

Salam certificates representing a sort of forward contract can be issued against the future delivery of a commodity, product or service. In countries with large public sectors or where the governments have substantial deposits of natural resources, such as petroleum, copper, iron, etc., they can issue certificates for the future delivery of such products, which are fully paid for on the spot by investors, who receive certificates of purchase in return. For example, a country that produces oil may want to expand its refining facilities. It may sell oil products through Salam instead of borrowing on the basis of interest and use the price received in advance.

The Salam purchaser can choose to hold onto the Salam contract and receive the shipment on the designated date, or he may elect to sell the goods involved in the contract through

Parallel Salam before the date of delivery, at whatever possible market price, to an other investor. He could also issue Salam SukSuk or certificates (SC) against the price paid for future delivery of the oil products. An SC may change hands between the beginning of the contract and its date of maturity. Actual delivery and receipt, and not just paper settlement, are binding on the SC issuer or the final holder of the certificate. The essential feature of Salam certificates is the fact that the issuer's obligation towards the investor is not different from what the market in the real sector pays on the due date of payment.

Salam certificates are geared to a specific commodity or project. People who purchase SCs share income from those commodity/projects, and as such their income is not guaranteed, although it can be quasi-fixed. Since the Salam certificates tie finance, production and sale of the items involved into one contract, the risk of changing prices of the subject of Salam belongs to those who invest in them, i.e. the Salam purchasers.

The investors in Sukuk have to bear counterparty as well as market risks. The counter party risk would arise with regard to the possibility of the seller being unable to deliver the goods.

The market risk would result from the buyer being unable to market the goods at the time of delivery, or selling them at a sale price lower than the cost to him. These risks can be mitigated by the structure of the deal.

In Bahrain, for example, aluminium has been designated the underlying asset for issuing

Salam Sukuk. The Bahrain government sells aluminium to the buyer in the future market.

The Bahrain Islamic Bank (BIB) purchases the aluminium and it has been nominated to represent the other banks wishing to participate in the Salam transaction. As consideration for this advance payment, the government of Bahrain issues Salam certificates and under takes to supply a specified amount of aluminium at a specified date.

ISTISNA‘A (ORDER TO MANUFACTURE)

Definition and Concept

Istisna‘a, like Salam, is a special kind of Bai‘ where the sale of a commodity is transacted before the commodity comes into existence. The legality of Istisna‘a is accepted by the Sh’ri'a scholars because it does not contain any prohibition, it has always been a common practice in the world and also because of ease for human beings. Renowned contemporary jurist Zuhayli writes:

"Istisna'a evolved into Islamic jurisprudence historically due to specific needs in the areas of manual work, leather products, shoes, carpentry, etc. However, it has grown in the modern eraas one of the contracts that make it possible to meet major infrastructure and industrial projects such as the building of ships, airplanes and other large machinery. Accordingly, the prominence of the commission to manufacture contract has increased with the scope of the financed projects."

Istisna'a is a valid contract and a normal business practice. As a financing mode it has been legalized on the basis of the principle of Istihsan (public interest). Istisna'a is an agreement culminating in a sale at an agreed price whereby the purchaser places an order to manufacture, assemble or construct (or cause so to do) anything to be delivered at a future date. It becomes an obligation of the manufacturer or the builder to deliver the asset with agreed specifications at the agreed period of time.

As the sale is executed at the time of entering into the Istisna'a contract, the contracting parties need not renew an exchange of offer and acceptance after the subject matter is prepared. This is different from the promise in a contract of Murabaha to Purchase Orderer, which requires formal offer and acceptance by the parties when possession of the items to be sold is taken by the bank. Istisna'a can be used for providing the facility of financing the manufacture/construction of houses, plant, projects, building of bridges, roads and highways, etc. The price must be fixed with the consent of the parties involved.

In Istisna'a, the manufacturer arranges both the raw material and the labour. If material is supplied by the purchaser and the manufacturer is required to use his labour and skill only, this is the contract of Ujrah (doing any job against an agreed wage/remuneration)and not of Istisna'a. In the following sections we discuss elements of Istisna'a in detail.

An Istisna'a contract is binding on the contracting parties; the manufacturer is obliged to supply the subject matter with the agreed specifications and the orderer or buyer is obliged to accept the asset of stipulated type, quality and quantity and make the agreed payment. The parties may agree to a period during which the manufacturer will be responsible for any defects or the maintenance of the subject matter.

Subject Matter of Istisna'a

Istisna'a is a sale contract applicable to items to be manufactured that are identified by specification not by designation. This contract is valid only for those objects that have to be manufactured or constructed. But it is not necessary that the seller himself manufactures the item, unless stated in the contract. The subject of Istisna'a (the thing to be manufactured or constructed) must be known and specified to the extent of removing any ignorance or lack of knowledge of its kind, type, quality and quantity.

The sellers agree to provide the subject matter transformed from raw materials through manufacturing or goods manufactured by human hands. It is invalid for natural things or products like animals, corn, fruit, etc. Both unique and homogeneous types of assets are covered under Istisna'a provided their specifications are agreed at the time of the contract.

For example, items of unique description that have no regular market, have no substitute in the market and where the value of each unit of that type of goods may be different, are covered by Istisna'a.

Istisna'a is not confined to what the manufacturer himself makes after the contract.

The specifications demanded by the buyer and agreed between the parties are important.

The seller/manufacturer will be fulfilling his obligation if he brings in an asset conforming to all agreed specifications, unless otherwise agreed in the contract that the seller will himself manufacture the asset. In other words, the contract is binding according to specifications.

It is not permissible that the subject matter of an Istisna'a contract be an existing and identified asset. For example, it is invalid for an Islamic bank to conclude a contract tosell a particular designated car from a factory on the basis of Istisna'a. But an asset that has already been produced by the seller or by another can become the subject matter of Istisna'a provided that it is not identified in the contract and the contract identifies speciation only.

An Istisna'a contract may be drawn for real estate developments on designated land owned either by the purchaser or the contractor, or on land in which either of them owns the usufruct. It is allowed because the contract involves the construction of specified buildings that will be built and sold according to specification and, in this case, the contract of Istisna'a does not specify a particular identified place.

An Istisna'a contract must definitely state, in clear terms, the type, dimensions, period and place of delivery of the asset. The asset can be manufactured or produced by any or a specific manufacturer, or manufactured from specific materials or any materials available in the market, as may be agreed between the two parties.

The manufacturer (seller) may enter into a contract with a manufacturer to provide the subject matter of Istisna'a. On this basis, the banks may undertake financing based on Istisna'a by getting the subject of Istisna'a manufactured through another such contract.

Thus, Islamic banks can serve both as manufacturers (sellers) and purchasers in Istisna'a.

Price in Istisna'a

The price in Istisna'a can be in the form of cash, any tangible goods or usufruct of identified assets. Usufruct as consideration for an Istisna'a contract is relevant to situations where government institutions offer usufruct of the asset being built for an agreed time period, commonly known as "build, operate and transfer" (BOT).

The price should be known in advance to the extent of removing ignorance or lack of knowledge and dispute. It is permissible that the price of Istisna'a transactions varies in accordance with variations in delivery date. There is also no objection to a number of offers being subject to negotiation, provided that eventually only one offer is chosen for concluding the Istisna'a contract. This is to avoid uncertainty and lack of knowledge that may lead to dispute.

The price, once settled, cannot be unilaterally increased or decreased. However, as manufacturing of huge assets may involve more time, sometimes necessitating many changes, the price can be readjusted by the mutual consent of the contracting parties because of making material modifications to the item to be manufactured or due to unforeseen contingencies or changes in prices of the inputs.

It is not necessary in Istisnaʻa that the price is paid in advance (unlike Salam, in which spot payment of price is necessary). The price can be paid in instalments within the agreed time period and can also be linked with the completion stages. Against the general rule set out for Salam, contemporary scholars have legalized it on the basis of analogy and Istihsanas it involves personal labour, effort and commitment of the seller, which makes the contract similar to a leasing contract, in which it is permissible to defer the payment of the rental without that being considered a sale of debt for debt. Further, the construction of huge plants may require a long gestation period and also payment through instalments, according to the pace of implementation of such projects.

A contract of Istisnaʻa cannot be drawn up on the basis of a Murabaha sale, for example, by determining the price of Istisnaʻa on a cost-plus basis. This is because the subject matter of Murabaha should be something already in existence, its cost should be known and it should be owned by the seller before conclusion of Murabaha, so that a profit margin maybe added to that. None of these is a requirement of Istisnaʻa.

The bank may be acting either in the capacity of the manufacturer or of the purchaser, and may give or demand a security deposit (ʻArb¯un), which may be considered as part of the price if the contract is completed, and can be forfeited if the contract is rescinded. However, the amount forfeited may be restricted to the amount of actual damage suffered and the remaining amount may preferably be returned to the customer.

Penalty Clause: Delay in Fulfilling the Obligations

An Istisnaʻa contract may also contain a penalty clause stipulating an agreed amount of money for compensating the purchaser adequately if the manufacturer is late in delivering the asset. Such compensation is permissible only if the delay is not caused by intervening contingencies (*force majeure*). Further, it is not permitted to stipulate a penalty clause against the purchaser for default in any payment because this would be Riba. A voluntary rebate for prepayment is permissible, provided it is not agreed in the contract.

It can be agreed, in other words, between the parties that in the case of delay in delivery, the price shall be reduced by a specified amount. The scholars have contended this on the basis of analogy. The classical jurists allowed such a condition in Ijarah, e.g. if a person hires the services of a tailor, he may tell him that the wage will be 10 dirhams if he prepares the clothes within a week and 12 if within two days. By analogy, experts allow a penalty clause in the Istisnaʻa agreement in the case of a delay in delivery, supply or construction of the subject of Istisnaʻa.

In Fiqh, this principle is termed Shart-e-Jaz¯ai (penalty condition), or the condition ofdecreasing the price on account of a delay in delivery of the subject matter of Istisnaʻa.

This reduction will enhance the income of the orderer (purchaser) and it will not go to charity, as in the case of all other modes. This special permission is on account of the fact that, in Istisna'a, timely completion of the work depends on labour and commitment of the manufacturer (seller). If he does not devote full time to completion of the job of a particular contract and engages in other contracts in his quest for more and more orders and maximum earnings, he can be fined. This benefit would go to the purchaser, who might suffer in the case of non delivery at the stipulated time. Any such undertaking by the manufacturer would be binding on him.

Contrary to this, in Salam, any penalty taken for late delivery by the Salam seller will goto charity, because in Salam, the price paid in advance creates a debt liability on the seller which has to be paid without any increase. Even this penalty is permissible only if the delayis not caused by intervening contingencies (*force majeure*). However, it is not permitted to stipulate a penalty clause against the purchaser (from the bank, for example) for default on payment.

The Binding Nature of an Istisna'a Contract

Istisna'a is nonbinding as long as the manufacturer does not start work on the subject matter of the contract. Therefore, before the manufacturer starts the work, any one of the parties may cancel the contract by giving notice to the other. However, after the manufacturer has started the work, the contract cannot be cancelled by the buyer unilaterally. The majority of contemporary Shar¯ı´ah scholars, Civil Law in some Muslim countries like Jordan and Sudan, the "Unified Arab Law" proposed by the League of Arab Countries and the Fiqh Council of the OIC treat Istisna'a as a "binding contract" provided that certain conditions are fulfilled. If the asset conforms to the specifications agreed at the time of the Istisna'a contract, the purchaser is bound to accept the asset and he cannot exercise the option of inspection (Khiyar al Ro'yat). He, however, has the "option of defect" (Khiyar al 'Aib) and the option of specified quality, meaning that if the asset has any proven defect or lacks the agreed specifications; the purchaser has the right to be indemnified.

Guarantees

The bank, acting either in the capacity of the manufacturer or of the ultimate purchaser, can give or demand security, collateral or a performance bond to ensure that the work is performed within the agreed time and as per specifications. It can also get 'Arb¯un, which will either be part of the price if the contract is fulfilled, or forfeited if the contract is rescinded. However, it is preferable that the amount forfeited be limited to an amount equivalent to the actual damage suffered.

Parallel Contract – Subcontracting

Istisna'a is not confined to what the manufacturer himself makes, and if the contract is silent or it expressly allows such, the seller/supplier can get it manufactured as per the specifications given in the contract from anyone else. Financial institutions, as sellers, would contract with someone else to manufacture the same. This could be a case of a Parallel

Istisna‘a contract.

An Istisna‘a contract shall be entered into, on the one hand, between the bank and a customer, while on the other hand, the bank may enter into a Parallel Istisna‘a with a third party (contractor) for preparation of the subject matter of the first Istisna‘a. The delivery date of the parallel contract must not precede the date of the original Istisna‘a contract.

In one contract, the bank will be the buyer and in the second, the seller. Ownership related risks of the two contracts will remain separate and will have to be borne by the respective parties so long as the asset is not transferred to the other. Each of the two contracts shall be independent of the other. They cannot be tied up in a manner whereby the rights and obligations of one contract are dependent on the rights and obligations of the other contract. Further, Parallel Istisna‘a is allowed with a third party only.

It is permissible for the bank to buy items on the basis of a clear and unambiguous specification and to pay, with the aim of providing liquidity to the manufacturer, the price in cash when the contract is concluded. Subsequently, the bank may enter into a contract with another party in order to sell, in the capacity of manufacturer or supplier, items whose specifications conform to the wishes of that other party, on the basis of Parallel Istisna‘a, and fulfil its contractual obligation accordingly.

Istisna‘a and Agency Contract

The bank, acting either as a seller or as a buyer in Istisna‘a, can appoint any agent, with the consent of the other party, to supervise the manufacturing process or to sell the asset when received. It can ask the client/manufacturer to act as an agent to sell the subject matter. The agency agreement should be separate and independent from the Istisna‘a agreement. Banks that are using Istisna‘a normally appoint an agent for sale of the asset in the local or foreign markets.

An agency contract can also be used if there is a delay on the part of the purchaser in taking delivery of the subject matter within a particular period of time. The seller can sell that asset in the market and pay the amount over and above his dues, if any, to the purchaser.

The bank can also engage any consultant firms to supervise the construction work and to determine whether the subject matter conforms to the stipulated specifications or for other advisory services. The parties may mutually decide who will bear the related supervision expenses.

Post Execution Scenario

Work in Progress

Before the manufacturer starts work on the subject matter of Istisna‘a, both of the parties have the right to rescind the contract. Once the seller/manufacturer initiates the work, the contract becomes binding and any change is possible only with mutual consent. The parties to the contract are inevitably bound by all obligations and consequences flowing from their agreement. The purchaser will make the payment as per the agreed schedule and the manufacturer/seller will supply the asset as per the specifications agreed. If the subject matter does not conform to the specifications agreed upon, the customer has the option to accept or to refuse the subject matter. The purchaser shall not be regarded as the owner of the materials in the possession of the manufacturer for the purpose of producing the asset.

If the actual cost incurred by the bank (as seller) on an asset sold on Istisna'a is less than the forecast cost, or the bank gets a discount from the subcontractor on a Parallel Istisna'a basis, the bank is not obliged to give a discount to the purchaser and any additional profit, or loss if any, pertains to the bank. The same rule adversely applies when the actual costs of production are greater than the forecast costs.

If so desired by a customer, the Islamic bank (as purchaser) may replace an existing contractor to complete a project which has already been commenced by the previous contractor. For this purpose, the existing status of the project needs to be assessed, whereby the cost of such assessment and all liabilities as of that date shall remain the responsibility of the customer.

The bank, working as a manufacturer (seller), must assume liability for ownership risk, maintenance and Takaful expenses prior to delivering the subject matter to the purchaser as well as the risk of theft or any abnormal damage. The manufacturer cannot stipulate in the contract of Istisna'a that he is not liable for defects. Therefore, if the bank is the manufacturer for the purpose of an Istisna'a contract, it cannot absolve itself from loss on this account. The orderer (purchaser) has the right to obtain collateral from the manufacturer for the amount he has paid and as regards delivery of the commodity with specifications and time of delivery. A voluntary rebate for prepayment is permissible, provided it is not agreed in the contract.

Delivery and Disposal of the Subject Matter

1. Before delivery of the asset to the purchaser, it will remain at the risk of the seller; any loss to the raw material or to the item in the process of manufacturing will be borne by him.
2. After delivery, risk will be transferred to the purchaser.
3. Possession of goods can be physical or constructive, depending upon the nature of the asset and transfer of ownership/risk. Transferring risk and delegating authority of use and utilization/consumption are the basic ingredients of constructive possession. For this, there should be a demarcation line between handing over and taking over of possession.
4. If a manufactured asset is delivered before the agreed date, the purchaser should accept it if the asset meets the stipulated specifications. He can refuse to accept the goods if these are not as per the agreed specifications or there is some other genuine justification for not accepting before the agreed date (Istisna'a Standard, clauses 6/1 to 6/3).
5. If the condition of the subject matter does not conform to the contractual specifications at the date of delivery, the ultimate purchaser has the right to reject the subject matter or to accept it in its present condition, in which case the acceptance constitutes satisfactory performance of the contract.

The Potential of Istisna'a

Islamic banks can use Istisna‘a for manufacturing of high technology goods like aircrafts, ships, buildings, dams, highways, etc. It can also be used for housing and export financing, meeting working capital requirements in industries where sale orders are received in advance. Potential areas are given below:

- financing the construction industry – apartment buildings, hospitals, schools and universities;
- development of residential/commercial areas and housing finance schemes;
- financing high technology industries such as the aircraft industry, locomotive and ship building industries.

Risk Management in Istisna‘a

Banks could face the following risks in Istisna‘a-based financing:

- settlement risk;
- price risk;
- delivery risk;
- possession risk;
- market risk.

As a whole, risks in Istisna‘a would be mitigated by taking proper collateral, performance bonds, technical expertise in the relevant areas for timely and effective marketing and for ensuring cost effectiveness, by resorting to suitable Takaful policies, by choosing good client sand by adopting suitable capital budgeting and liquidity management policies.

Further Reading:

- ✓ ***Islamic Finance in a Nutshell: A Guide for Non-Specialists By Brian Kettell***
- ✓ ***Derivatives in Islamic Finance: Examining the Market Risk Management Framework By Sherif Ayoub***