THE ANALYSIS OF APPLICATION OF SALAM & ISTISNA'A IN ISLAMIC FINANCIAL INDUSTRY

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ABSTRACT

The modes of Salam and Istisna'a are the exceptional sales that help Islamic Financial Institutions (IFIs) to cater the needs of those customers who require working capital financing to produce or manufacture something.

Keeping in view the conditions and guidelines for execution of Salam and Istisna'a transactions; this article is based upon the evaluation of different ways and possibilities to find the best possible way, upon which the product might be structured by Islamic Financial Institutions to meet the financial requirements of the customer with the special consideration of coverage of unique risks in these transactions.

INTRODUCTION

Islamic Financial Institutions (IFIs) enter into Salam & Istisna'a transactions with the customers who require finance facilities to produce or manufacture something. Since in these cases; the subject matter is not available at the moment, which is the condition of a valid sale or rental transaction in Islam, the general practicing modes like Murabaha, Ijarah, and Diminishing Musharaka etc. cannot be used for this purpose. The permissible modes, in this respect, are Salam and Istisna'a which are being practiced in Islamic Financial Industry, in accordance with the guidelines as given by Shariah. These transactions are being executed at very small scale and with very reliable customers due to the high intensity of risk inherent in these transactions.

EVALUATION OF THE FINANCIAL NEEDS & POSSIBLE SOLUTIONS

For the purpose of production or manufacturing something, generally the customers require financing from financial institutions for two purposes:

1. The customer needs financing to produce or manufacture something for their personal use or expansion of business etc.

2. The customer needs financing to produce or manufacture something in order to sell in the market or meet the delivery orders and earns profit.

<u>POSSIBILITY NO. 1</u>

The Islamic banks may enter into an arrangement of Parallel Salam/ Istisna'a contract in which the Islamic bank would be the seller in the first contract and become the buyer in the second contract. The Islamic bank may buy the commodity or asset from the one party and then sell it to the other party at the same date or period. The two contracts would be executed in a separate capacity and cannot be linked with each other. The difference in prices would be determined as income of the Islamic bank.

The analysis, in this context, is as under:

a. It is a fact that Islamic banks deal only with their customers and provide financing facilities to their customers after consideration and proper credit analysis of their customers. The Islamic bank would not like to enter into any party other than the Islamic bank's customer because Islamic bank is not the trader in actual and performs as financier in the market like conventional banks. Likewise, any third party other than the customer would also not like to execute an agreement with the bank. This is the general behavior of working of banks and corporate world in the present business scenario.

b. Apart from the above-mentioned hindrance of parallel contract aspect, if the parallel transaction would be executed, **there is a delivery risk** might be faced by Islamic bank at the time of delivery. If the seller would not be able to deliver certain commodity or asset, the Islamic bank would be liable to deliver the certain commodity or asset to the customer. In this certain case, the Islamic bank might face difficulty.

c. The general phenomena regarding financing for banks is that banks **disburse** financing to their customers, to fulfill the certain need, and **receive** repayment as principal plus profit i.e. the amount over and above the principal. Therefore, it is an understood fact that banks disburse lower amount and receive higher amount. In Parallel Salam/Istisna'a arrangement, the Islamic bank would have the capacity of seller with the customer and having the capacity of buyer with the third party who is producing or manufacturing the certain item for the bank's customer. **In case of Salam**, it is impossible for Islamic bank to choose parallel arrangement due to the condition of full payment in advance. In this way, the Islamic bank would make payment to the producer or simultaneously receive payment from the customer. Why the customer would make higher payment to the bank as he would have already the requirement of capital? If he has the capital, he may directly go to the producer. ***While in Istisna'a, parallel istisna'a transaction might be executed in case of certain manufacturing or construction where the bank would make full or partial payments to the constructor or manufacturer and receive repayment, in installments (partial payments), from the customer higher than the disbursed amount and in this way, it may earn profit according to the pre-agreed benchmark.***

d. In parallel arrangement, one problem may also be arisen at the part of the customer that if the customer requires prompt or immediate financing for any purpose like salaries payment, utility bills payment etc. while production or manufacturing something, the parallel salam/istisna'a contract would not be suitable.

<u>POSSIBILITY NO. 2</u>

The Islamic Bank may enter into Salam/Istisna'a contract with the customer and sell the item in the market at the time of delivery. In this case; Promise to Purchase may be taken from the third party at the time of execution of salam/istisna'a agreement to sell the item at the time of delivery, without any delay.

The analysis, in this context is as under:

In both the above-mentioned general financial requirements of the customers, this option cannot work because as per salam/istisna'a agreement, the customer has to return the item to the bank which is not the desire of the customer in both the cases.

This option may be considered in those cases where the actual trading is being done for which the banks generally do not go.

<u>POSSIBILITY NO. 3</u>

The Islamic banks may execute Salam/Istisna'a agreement with the customer and at the time of delivery, the customer becomes an agent of the bank to sell the commodities or asset on behalf of the bank.

The analysis, in this context, is as under:

This option might be considered when the customer needs financing to produce or manufacture certain items for further selling in the market to make profit thereon.

The bank will buy certain items from the customer either on Salam/Istisna'a basis. ***At the time of execution of salam/istisna'a agreement, the bank must ensure that the customer have certain delivery orders from the market.***

At the time of delivery, the bank will execute **Agency Agreement** with the customer after taking constructive possession of certain goods/commodities. The ***Agency Fee or the formula of Agency Fee*** must be decided and mentioned in this agreement.

If the customer would sell the certain quantity of commodity in the market above than the certain price, the profit above than the certain value would be considered as **Agency Fee** of the customer but if the customer would sell the commodity equal or below the certain price, the agent would not be entitled for any Agency Fee. The agency fee or formula of agency fee might be determined on the basis of consideration of profit that the bank would have to earn on disbursed amount according to the certain benchmark.

The bank purchases a certain quantity of commodity/asset on discount keeping in view the expected market price at the time of delivery OR keeping in view the selling price upon which the customer has the commitment to sell the certain item to the buyer. At the time of completion or production of goods/commodity, the customer would sell the same to the third party being an agent of Islamic bank. The customer would make payment of principal (disbursed amount) and profit to the bank and get the remaining amount as an agency fee according to pre-agreed arrangement as per agency agreement. This remaining amount of selling price would be the profit for the customer that is intended by the customer while doing business.

This option is used widely by Islamic banks while executing salam/istisna'a transactions to meet the working capital needs of the corporate customers either to produce or manufacture something for further sale in the market.

THE UNIQUE RISKS

It is a fact that Salam and Istisna'a transactions are very risky in nature as the customer has not any direct obligation of repayment in monetary terms but has an obligation to deliver certain commodity or asset at the specified time. Due to this reason, Islamic banks face some unique risks, not faced in other modes of Islamic banking, which are as under

1. To cover the **risk of non-deliverance or non-performance** by the producer or manufacturer, Islamic banks may obtain appropriate security in the form of guarantee, mortgage or hypothecation.

2. Islamic banks may face **commodity or asset risk** as between the period of delivery of the certain commodity or asset by the customer and selling the same to the final buyer, in case of any mishappening with the certain commodity or asset, the risk will be borne by the Islamic bank. To avoid the occurrence of any mishappening, the Islamic bank must obtain takaful coverage and the expense has to be borne by the Islamic bank in this respect.

   While executing Istisna'a, the bank must avoid to make financing very specialized items, *for example: specialized software for a certain firm*, as in case of refusal to buy such item from the final buyer, the bank might face very much difficulty to sell in the open market.

3. If the expected **price of the commodity** in the market decreases at the time of delivery, the bank may suffer loss or earn profit less than the expected profit. **To mitigate price risk**, bank must execute transactions with the customers having agreed delivery orders (as mentioned above in the option of agency arrangement) or in any other case like parallel salam/istisna'a, the selling price must be ensured at the time of disbursement. But, in case, where the situation arises where the bank receives the delivery and it has to sell the goods in the market due to refusal to purchase from the other party or for any other reason, it might face the risk of devaluation of certain commodity or asset in the market. To cover this risk, the Islamic bank must buy the asset or commodity at the considerable discount rate to face such type of risk, if arises.

CONCLUSION

The customers require financing either to produce or manufacture something for their personal use or expansion of business etc. OR to produce or manufacture something in order to sell in the market or meet the delivery orders and earns profit. From the above-mentioned evaluation of different possible options, it is clear that the option of Parallel Istisna'a might be chosen for construction or manufacturing purposes where the customer needs financing to make expansion of the business or for personal use while in the second case where the customer needs financing to meet the delivery orders, the option of Salam/Istisna'a agreement along with agency agreement (at the time of delivery either physical or constructive) might be chosen.

Due to unique risks, Islamic banks do not make these transactions on a very large scale and execute only in case of immense need where the execution of other modes are impossible. Furthermore, Islamic banks only execute these transactions with their very selective customers who have good creditworthy track record.

It is a fact that in the present scenario, the Islamic banks are not interested in trading of assets and commodities but to provide monetary facility to their customers. The transactions based upon the modes of Salam and Istisna'a might be increased if the Islamic Financial Institutions would start thinking beyond the boundaries and take out themselves from the conventional thinking structure. If IFIs come to actual trading and become ready to make hybrid arrangements with more than one party who needs financing, the Salam and Istisna'a transactions might be enhanced or developed. But, it is also a fact that the society and corporate world must show a healthy response as IFIs could not do this as a sole activist in this respect.

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