Center for Islamic Finance

Ijara & its Application

www.bibf.com

The Instructor

Nedal El-Ghattis

Senior Lecturer

Tel: +973 17815525
Fax: +973 17729928
Mobile: +973 397 40416
Email: nedal@bibf.com
P.O. Box 20525
Manama, Kingdom of Bahrain
www.bibf.com

"Best Islamic Finance Training Institution 2008, 2009, 2010, 2011"
Global Islamic Business and Finance Awards

Day one

- Fundamentals of Islamic banking and finance, with special focus on Ijara including sources and authorities of interpretation of Islamic Commercial Jurisprudence.
- Participatory and Non-Participatory Islamic Financial Instruments: Basic principles and application of murabaha, tawarruq, salam istisna contract, musharaka, and mudarabah
- Comparison between conventional leasing and Ijara: key differences, mechanisms, types and rules of conventional leasing and Ijara financing.

Day two

- Key principles and rules of the Main Ijara Contracts: Ijara Muntahia Bittamleek and Ijara Wa Iqtina.
- perational Ijarah
- Al-Ijarah Thumma al-Bay’ or Muntahi Bittamleek
- Ijarah in Credit Cards
- Ijarah Mawsufa fii Al Dhimmah & Ijarah Securities
- Mechanisms for calculating the Ijara rentals.
- Risk management in Ijara Companies
- AAOIFI Standards for accounting Ijara transactions..

Introduction to Bahrain Institute of Banking and Finance

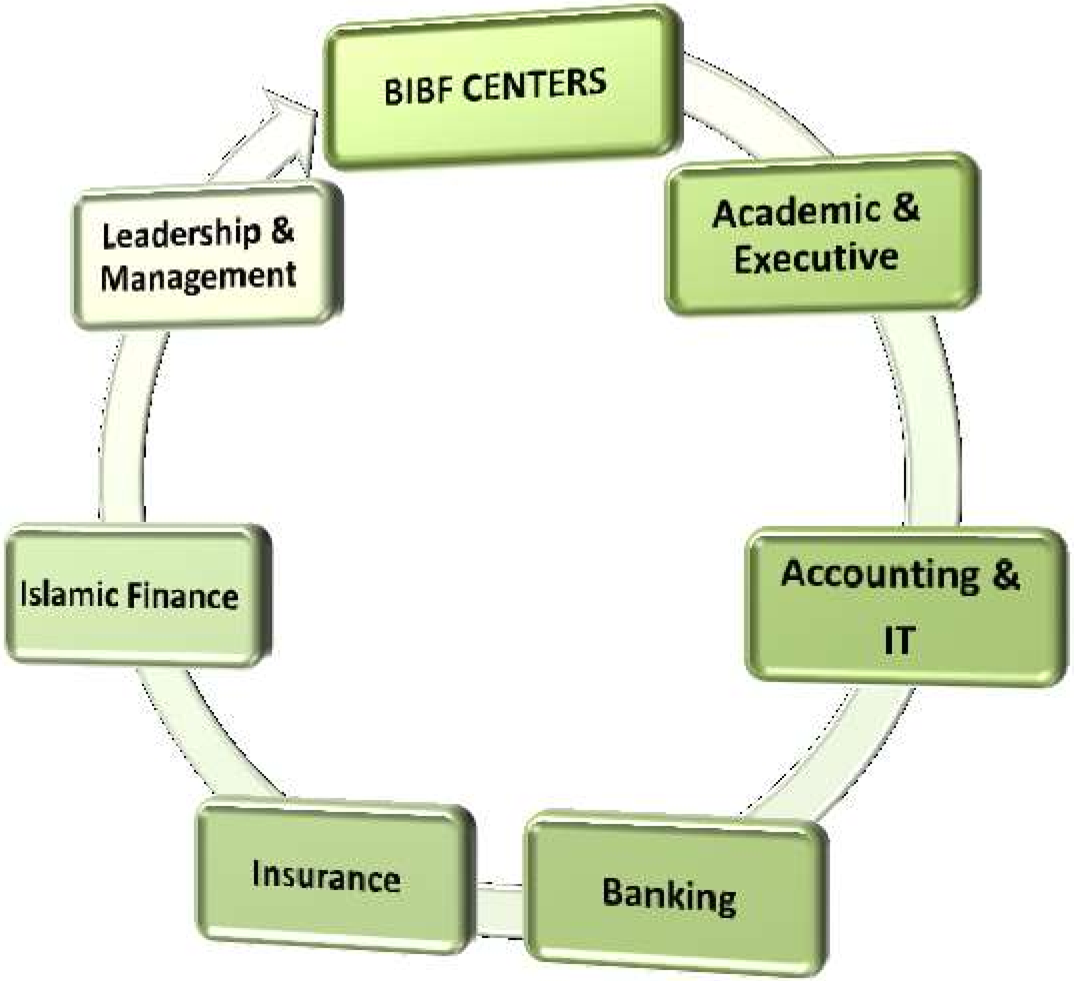
Purpose of Establishment and Set Up

- Inaugurated in 1981 as the training center for Banks in Bahrain
- Today is the leading provider of Training, Education and Professional Development programs to the financial industry in the Gulf and the Middle East
- Set Up
  - Amiri Decree 1975. High Council for Vocational Training
  - Ministerial Directive 1979. Specific Council for Vocational Training
  - BIBF inaugurated on March 28, 1981

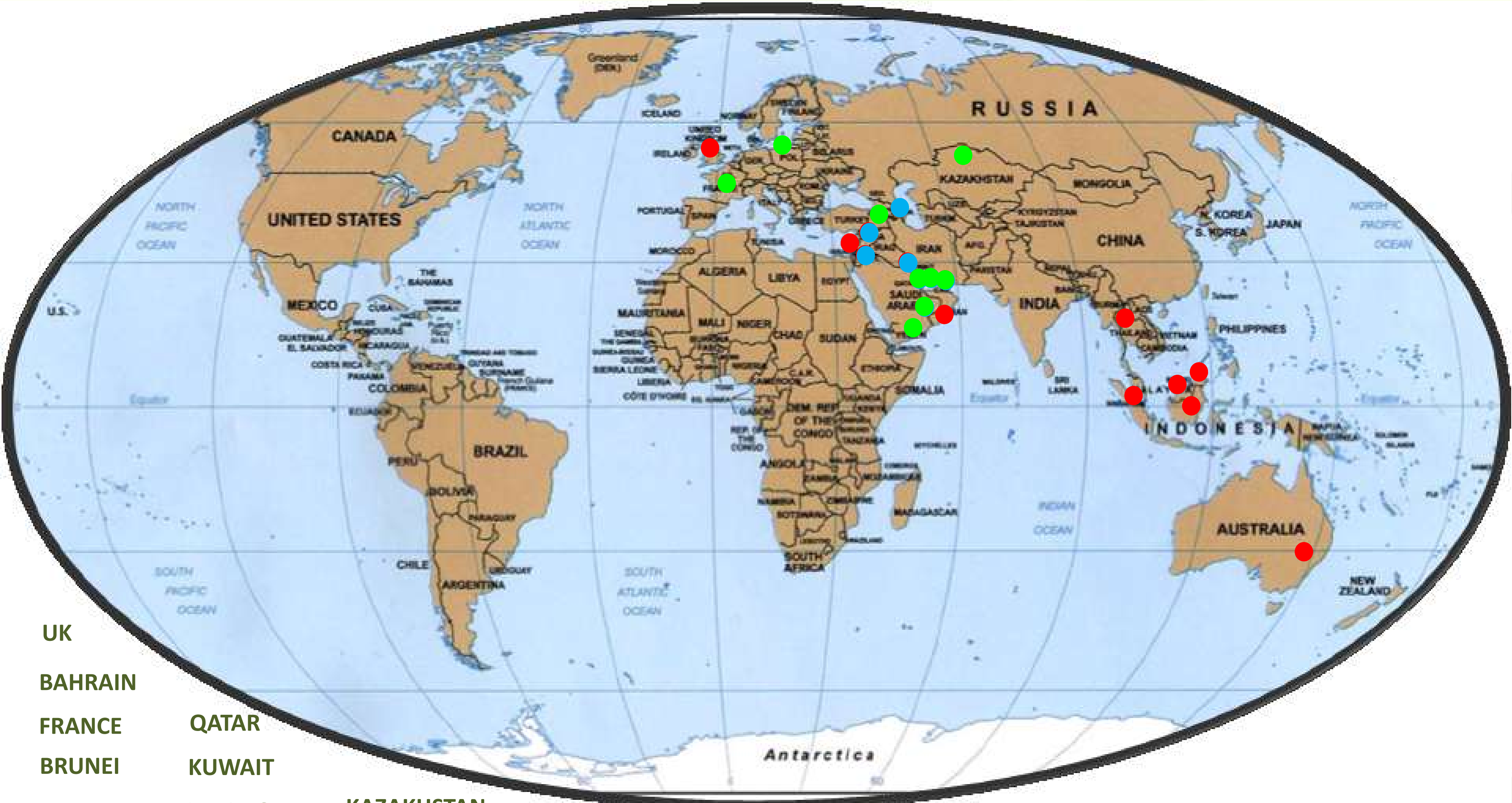
Vision, Mission, and Values

- Vision
  - BIBF is the Institute of choice for the development of business professionals.
- Mission
  - Leadership through providing ongoing education for business professionals
- Values
  - Principles
  - Respect builds success
  - Improve and Innovate
  - Deliver to win together
  - Expect the best

Center Structure



Islamic Finance - Our impact: 2008 to 2011



UK

BAHRAIN

FRANCE QATAR

BRUNEI KUWAIT

INDONESIA LEBANON KAZAKHSTAN

KUWAIT MALAYSIA SAUDI ARABIA JORDAN UAE YEMEN AZERBAIJAN

POLAND OMAN SINGAPORE SYRIA TURKEY THAILAND AUSTRALIA

Center for Islamic Finance

Center for Islamic Finance *continued*

Short Courses

- Public Offerings by BIBF Faculty
- External Offerings by Industry Practitioners
- Special Offerings Customized Programs

Center for Islamic Finance *continued*

Professional and Academic

- BIBF Advanced Diploma in Islamic Finance
- CIMA Islamic Finance Qualifications and IFQ of the CISI
- BIBF Advanced Diploma in Islamic Commercial Jurisprudence
- ICMA TR BIBF Islamic Capital Markets Certificate

Center for Islamic Finance *continued*

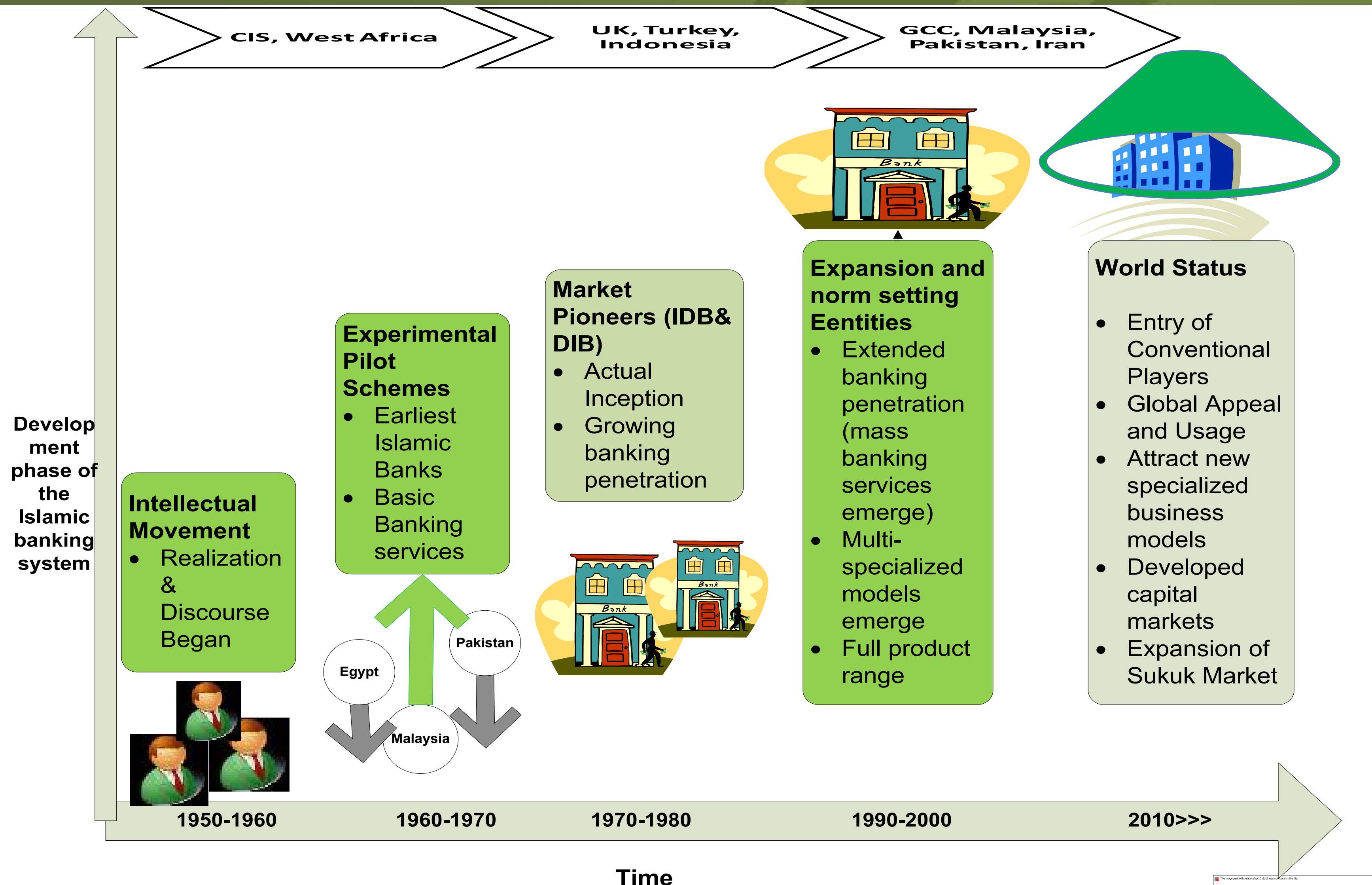
Research and Consulting Services

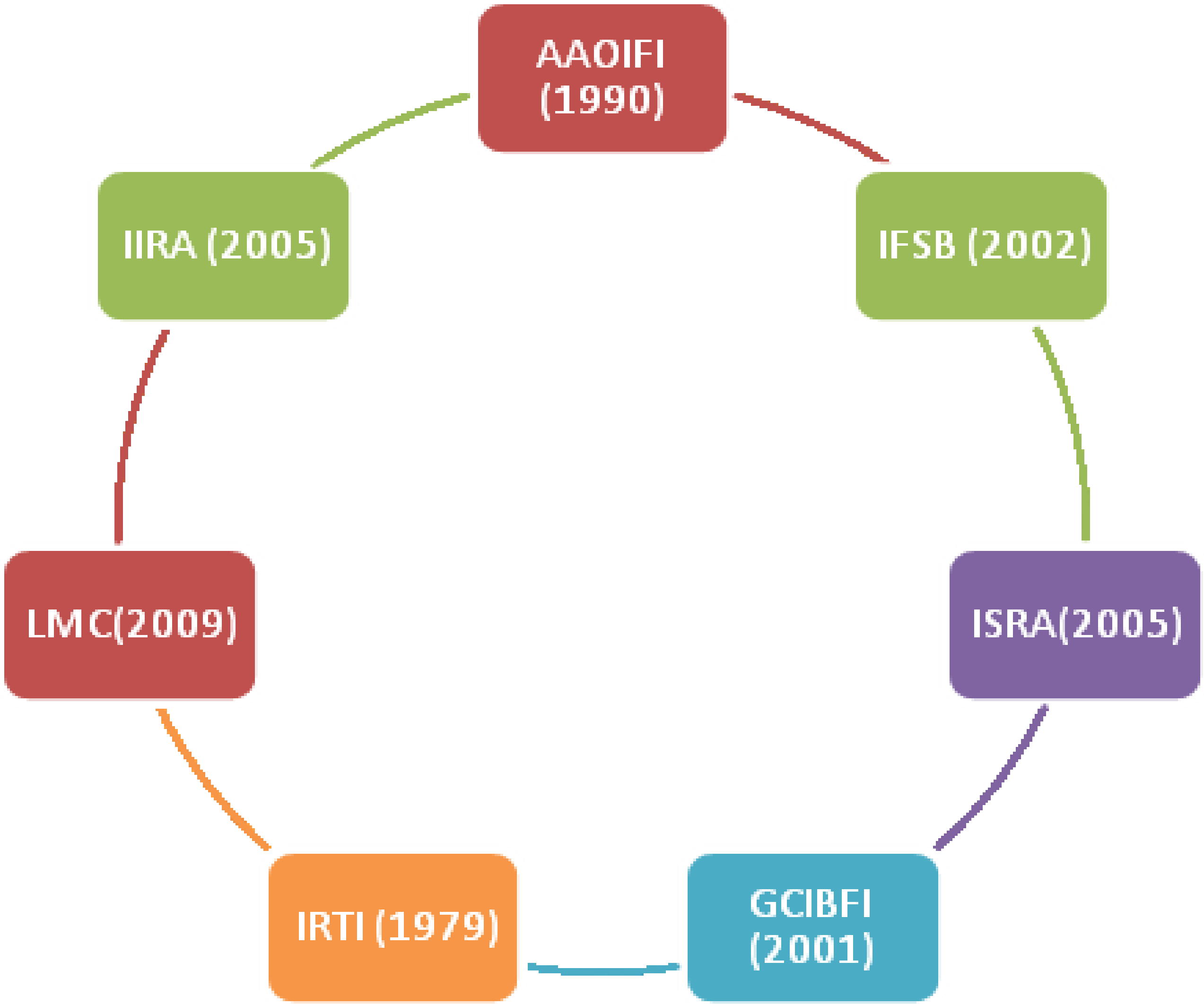
- Publication of High Level Policy Research and Database
- Islamic Finance Advisory Services
- Sector Development and Research Conferences

Qualifications in the pipeline

- Islamic Real Estate Professional Certificate
- Shari’a Audit Diploma in Arabic
- Zamala/Fellowship in Fiqh Al Muamalat (Commercial Jurisprudence)
- Online Diploma Program in Islamic Finance
- Advanced Diploma in Islamic Finance - Arabic
- PhD Program in Islamic Finance
- Diploma in Islamic Finance Law
- Islamic Economics Research Conference
- Islamic Business Ethics for Bankers

An Recap on the History of Islamic Banking and Islamic Infrastructure Institutions


CIS, West Africa
UK, Turkey, Indonesia
GCC, Malaysia, Pakistan, Iran
Development phase of the Islamic banking system
Intellectual Movement
• Realization & Discourse Began
Experimental Pilot Schemes
• Earliest Islamic Banks
• Basic Banking services
Egypt
Pakistan
Malaysia
Market Pioneers (IDB& DIB)
• Actual Inception
• Growing banking penetration
Expansion and norm setting Eentities
• Extended banking penetration (mass banking services emerge)
• Multi-specialized models emerge
• Full product range
World Status
• Entry of Conventional Players
• Global Appeal and Usage
• Attract new specialized business models
• Developed capital markets
• Expansion of Sukuk Market
1950-1960
1960-1970
1970-1980
1990-2000
2010>>>
Time

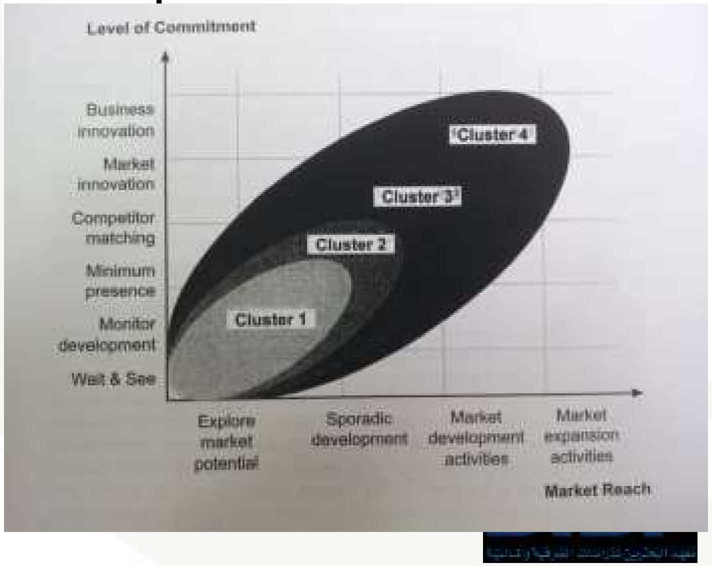

AAOIFI
(1990)
IFSB (2002)
ISRA(2005)
GCIBFI
(2001)
IRTI (1979)
LMC(2009)
IIRA (2005)

Islamic Banking - Past, Present & Future

- Early History
- The first Islamic Financial Institutions
  - Tabung Haji Bahrain - Malaysia, 1963
  - Mit Ghamr Savings Bank - Egypt,1963
  - Islamic Development Bank - Saudi Arabia, 1973
  - Dubai Islamic Bank - UAE, 1975
  - Bahrain Islamic Bank - Baharain, 1978

- Dar Al Baraka & Dar Al Mal - Early dominance
- Father of modern Islamic Banking - Dr. Ahmad Al Najjar
- Citi Bank as the first ever conventional bank to set up an Islamic Subsidiary

- Present Islamic Banking
  - Approximately a 1 trillion dollar industry (?)
  - Rapid growth in the market
  - Existing in many countries, not just Islamic
  - The establishment of many Islamic Financial supporting infrastructures
  - The 4 clusters of Islamic Banking Development



The evolution of Islamic Banking

1960s	1970s	1980s	1990s	Since 2000
Mit Ghamr Rural Bank (Egypt) Tabung Hajji (Malaysia)	Dubai Islamic Bank (UAE) Islamic Development Bank (Saudi Arabia) Kuwait Finance House (Kuwait) Bahrain Islamic Bank (Bahrain) Faisal Islamic Banks (Sudan and Egypt)	Bank Islam Malaysia Berhad (Malaysia) Bank Islami Bangladesh Limited (Bangladesh) Al-Rajhi brand (Saudi Arabia) Dar al-Maal al-Islami Trust Dalla Al Baraka Group	Emergence of Centres of Excellence like Bahrain and Malaysia Establishment of Accounting & Auditing Organisation for Islamic Financial Institutions Islamic banking & finance in Europe Sharia screening methodologies for investing in equity A global phenomenon	Integration of Islamic financial services in the mainstream financial markets European and American conventional investment banks like UBS, Deutsche, ABN Amro, Credit Suisse, BNP Paribas etc. emerged as major players in Islamic finance Emergence of Islamic bonds or Sukuk market Establishment of Islamic Financial Services Board

Significance of Shari'ah in Islamic Banking
What is the difference between Islamic banking and conventional banking?

Significant

Superficial

Shair'ah is the all- encompassing jurisprudential code of conduct for Muslims as guidance in their daily affairs

Fiqh = Human Comprehension

- Some basic principles of Islamic Finance:
  - Risk Sharing
  - No Exploitation
  - The transaction should not finance sinful activities, as defined by the principles of Islam

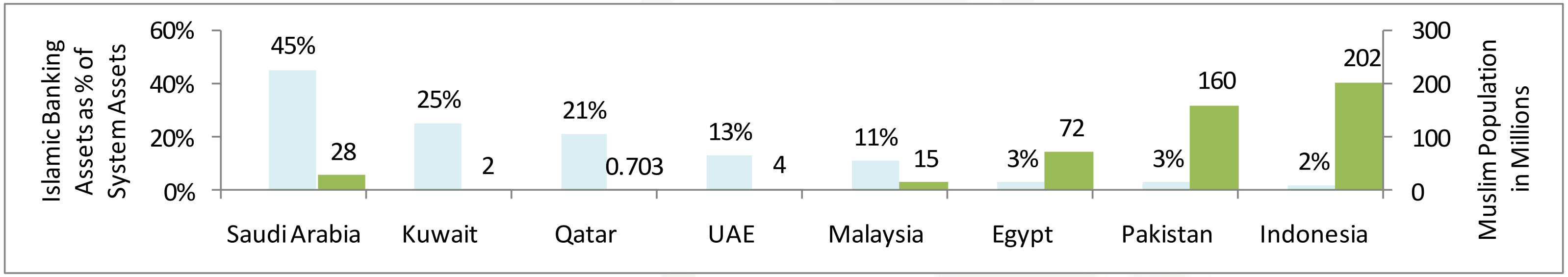
Key Growth drivers

1. Large, under-banked Muslim population globally

Asia and Africa – contain almost the entire Muslim population

	Muslim Population (Mn)	Total Population (Mn)	% of Muslim Population
Africa	442.9	923.2	48%
Asia	1,060.7	3,970.5	27%
Europe	50.7	731.7	7%
North America	7.1	331.7	2%
South America	3.1	566.05	1%
Oceania	0.6	33.54	2%
Total	1,565.0	6,556.7	24%

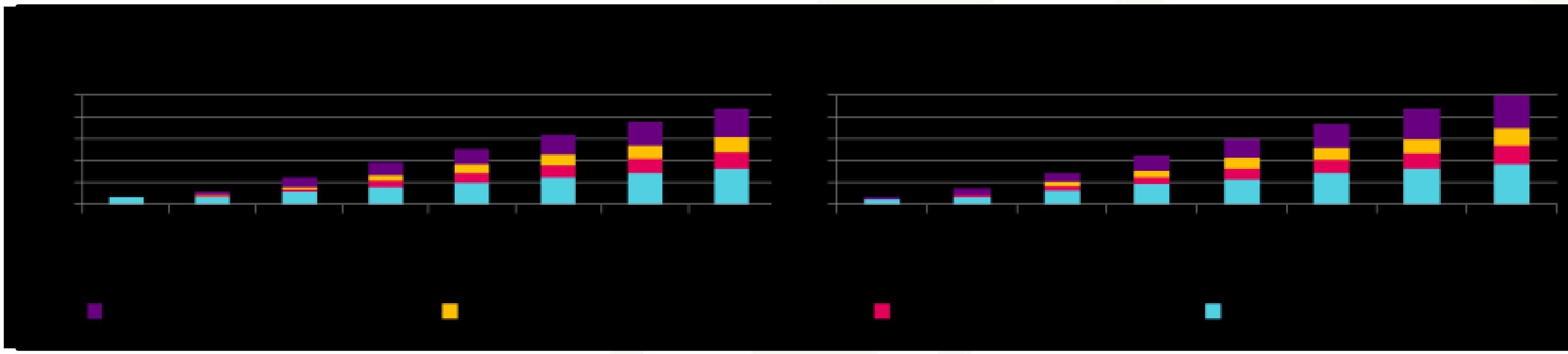
Islamic Banking Assets as % of System Assets (2006):
Lowest in Pakistan and Indonesia… Two countries with largest Muslim Populations



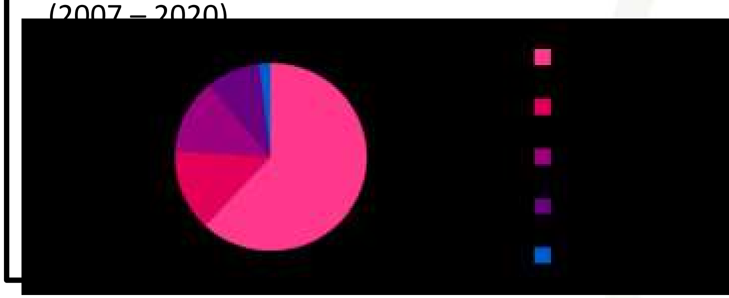
Source: Morgan Stanley Research

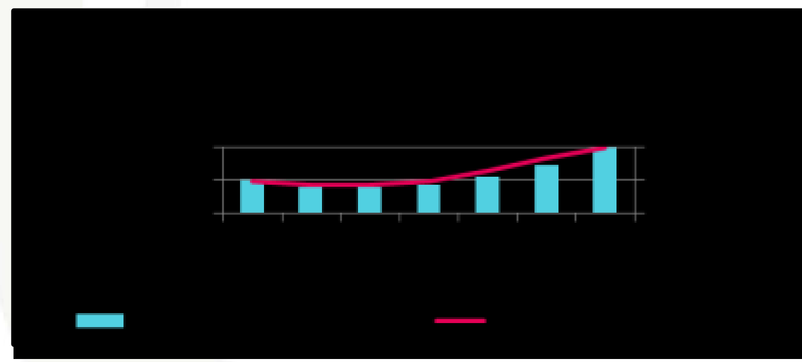
Key Growth drivers

2. Rising wealth of Islamic nations, super-charged by oil prices



GCC States' Share of Cumulative Oil Rev. (2007 – 2020)





Key Growth drivers

3. Government and regulatory support for the development and promotion of Islamic banking

Governments of Bahrain, Pakistan, and Bahrain have been supportive of the development of a strong Islamic financial sector alongside the conventional banking system

Bahrain – standout example in this respect

4. Participation of conventional banks in Islamic banking

Conventional banks in many Muslim-majority countries have also begun to offer Islamic banking

to cross-sell a new range of Islamic finance products to their existing customers

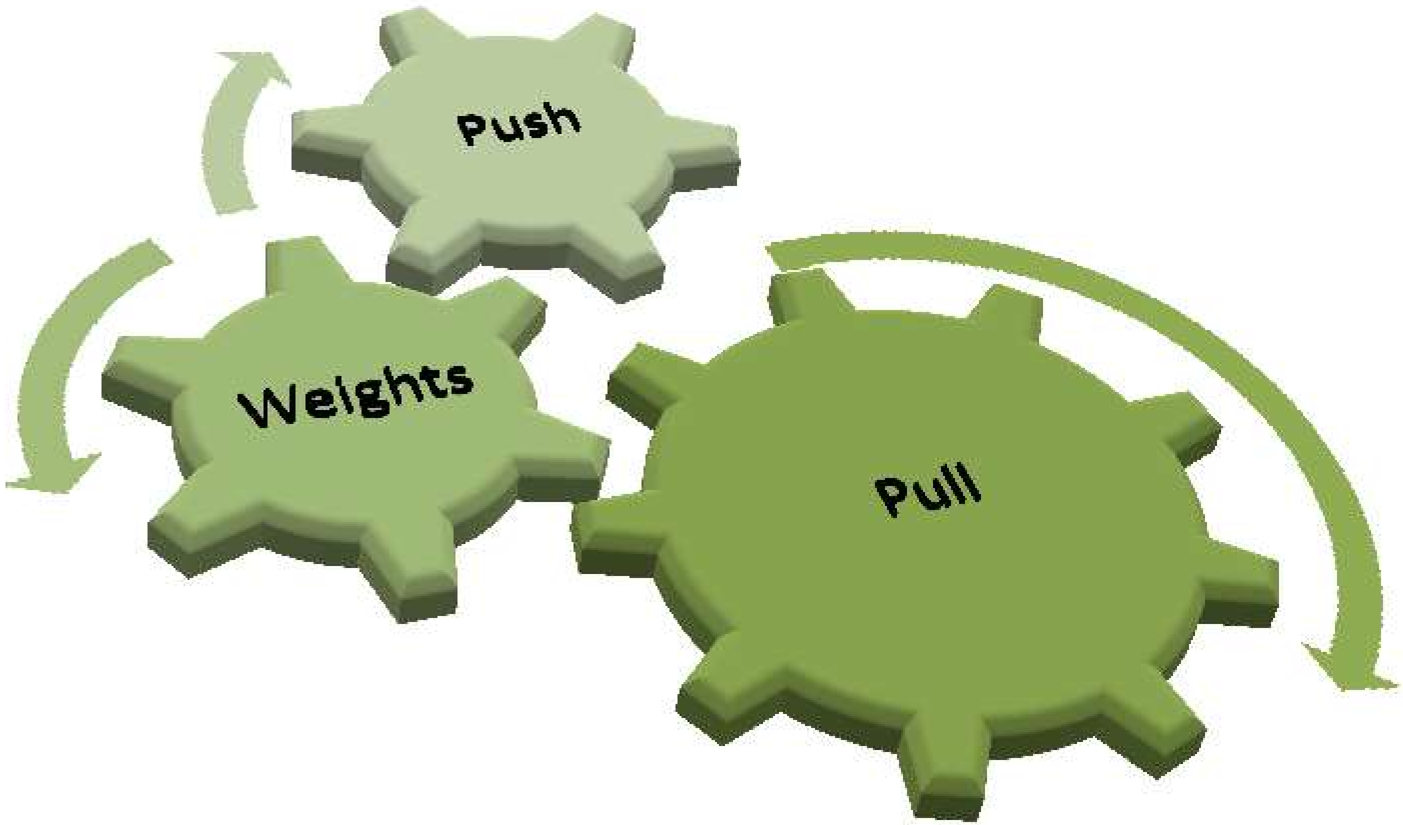
to reach out to a new clientele

5. Wider acceptance of Islamic banking products

Bahrain - good example of Islamic banking products being widely accepted by non-Muslims, at both the retail and corporate ends

Islamic Banking: What the future holds through Futurology

- Futurology or Futures studies is the study of foreseeing and postulating possible, probable, and preferable futures.
- Sohail Inayatullah’s triangular method of future studies consisting of 3 key element
  - Push
  - Pull
  - Weig



Futurology Triangular Method towards Islamic Banking Future

Pull

- Monotheism
- Fulfillment of role as vicegerent
- Achievement of supreme religious objectives
- Purification

Push

- Population composition
- Rising wealth of Islamic nations
- Wider acceptance of Islamic banking
- Rise of Islamic intellectual movement / Islamic renaissance

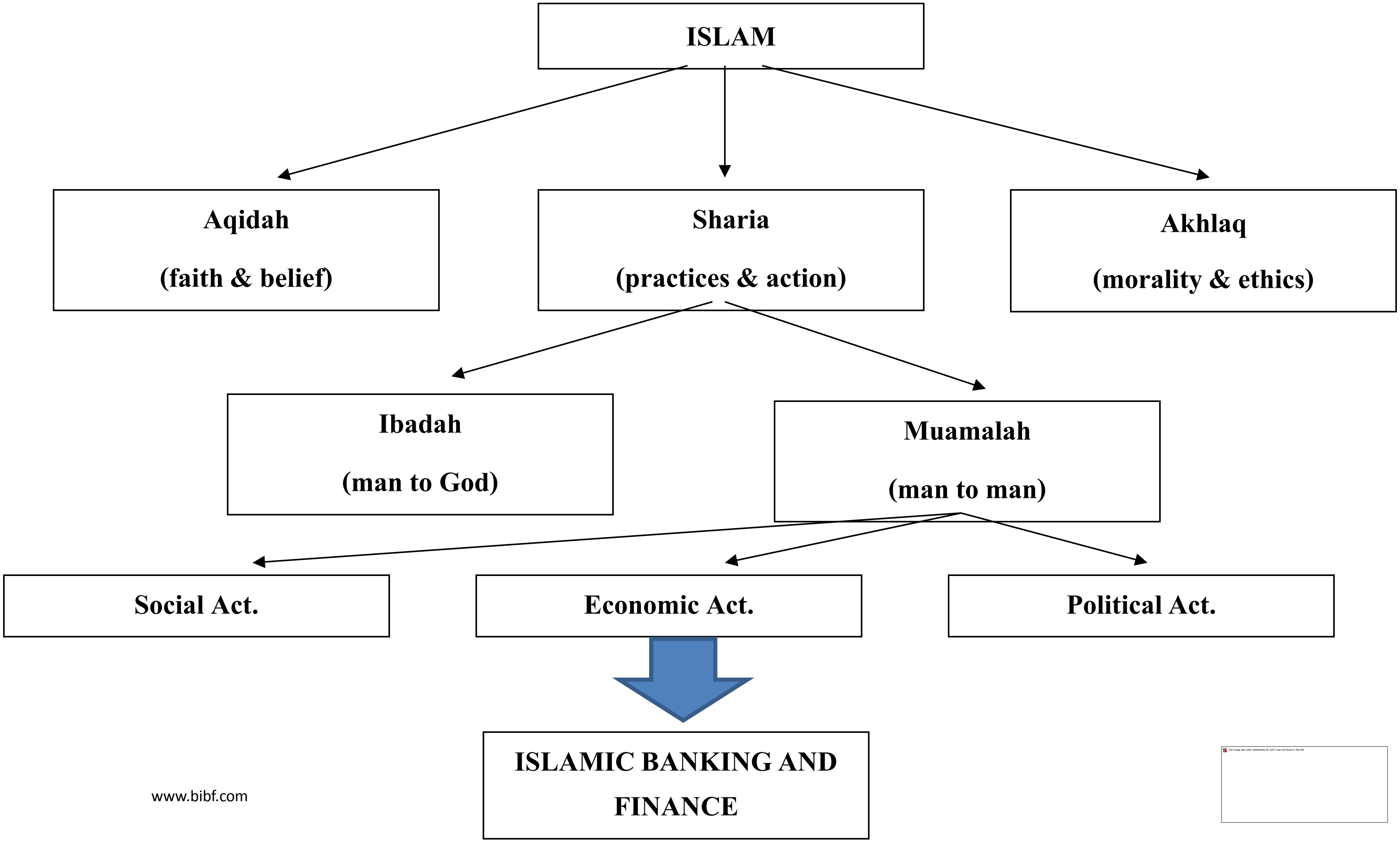
Futurology Triangular Method towards Islamic Banking Future

Weights

- Shariah Harmonization
- Product Development and Innovation
- Building Credibility and Confidence
- Competition and Cost Efficiency
- Human Resources - Skill and Expertise
- Marketing
- Corporate Governance Issues
- Risk Management and Regulatory Issues

Authorities of Interpretation and the Islamic Finance Infrastructure

The position of Islamic Banking and Finance



Authorities of Interpretation: Traditional

1. **Schools of thought**
   - *Hanafi* (Turkey, Balkans, Central Asia, Indian Subcontinent, China and Egypt)
   - *Maliki* (North Africa, West Africa and several of the Arab Gulf States)
   - *Hanbali* (Arabia)
   - *Shaafi'i* (Indonesia, Malaysia, Egypt, East Africa, Yemen and southern parts of India)
   - *Jaafari* (Iran, Iraq, Azerbaijan, Lebanon, Bahrain, Pakistan and parts of Afghanistan and Saudi Arabia)
   - *Zaidi* (Yemen)
   - *Abadi* (Oman)
   - *Zahiri* (North Africa)

Authorities of Interpretation: Global

2. Islamic Fiqh Academy

- Created in Jeddah in 1981.
- Scholar representatives from all Islamic countries (OIC) come together
- All main schools are represented
- Focus on pressing issues medical, scientific, technological & institutional innovations.
- Close collaboration with institutions & organizations
- Issues numerous verdicts on areas of Islamic Finance

Authorities of Interpretation: Industry

3. Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)

- Compiles and provides determinative guidance (Standards) on Islamic laws related to finance
- Based in Bahrain
- Subject to significant due process

4. Al Baraka Deliberations

- Prominent Shari'a scholars engaged in Islamic finance come together on a yearly basis to discuss most important issues affecting the industry.
- Issues discussed recently: Tawarruq and its validity
- Board Members: Shaikh Dr. Abdul Sattar Abu Ghuddah, Shaikh Abdullah Mannea, Shaikh Dr. Abdulatif Al Mahmood Al Mahmood, Shaikh Dr. Abdulaziz Alfawzan, Dr. Ahmed Mohyedeen Ahmed, Dr. AlSadiq Hammad

Authorities of Interpretation: Institutional

5. Shari'a Supervisory Boards (SSB)

- Comprises more than 3 scholars
- Reviews all processes within the Islamic bank
- Reviews documentation and contracts used by Islamic banks
- Interacts with product development team to develop new products
- Intensely involved in structured transactions
- Responsibility for ensuring that overall operations of Islamic banks to ensure compliance with *Shari'a* (Shari'a Audit)
- Signs annual report for Shari'a compliance

Islamic Nominate Contracts - The building blocks of Islamic transactions

Classification of Contract

UNILATERAL

- Gift (hibah)
- Endowment (Waqf)
- Off-set of Debt (Ibra')
- Loan (Qard)
- Will (Wasiyyah)

BILATERAL

`Uqud Muawadat (Contract of Exchange)

- Cash Sale
- Deferred payment sale
- Deferred Delivery sale
- Sale on order
- Sale of debt
- Sale of currency
- Auction sale

`Uqud Ishtiraq (Partnerships)

- Mudarabah (Profit sharing)
- Musharakah (Profit-loss sharing
- Muzara`ah (in farming)
- Musaqat (in fruit trees)

`Uqud Manfaah (Utilization of usufruct)

- *Ijarah* (Hire/lease)
- *`Ariyah* (Loan of tangible asset)
- *Waqf* (Endowment)

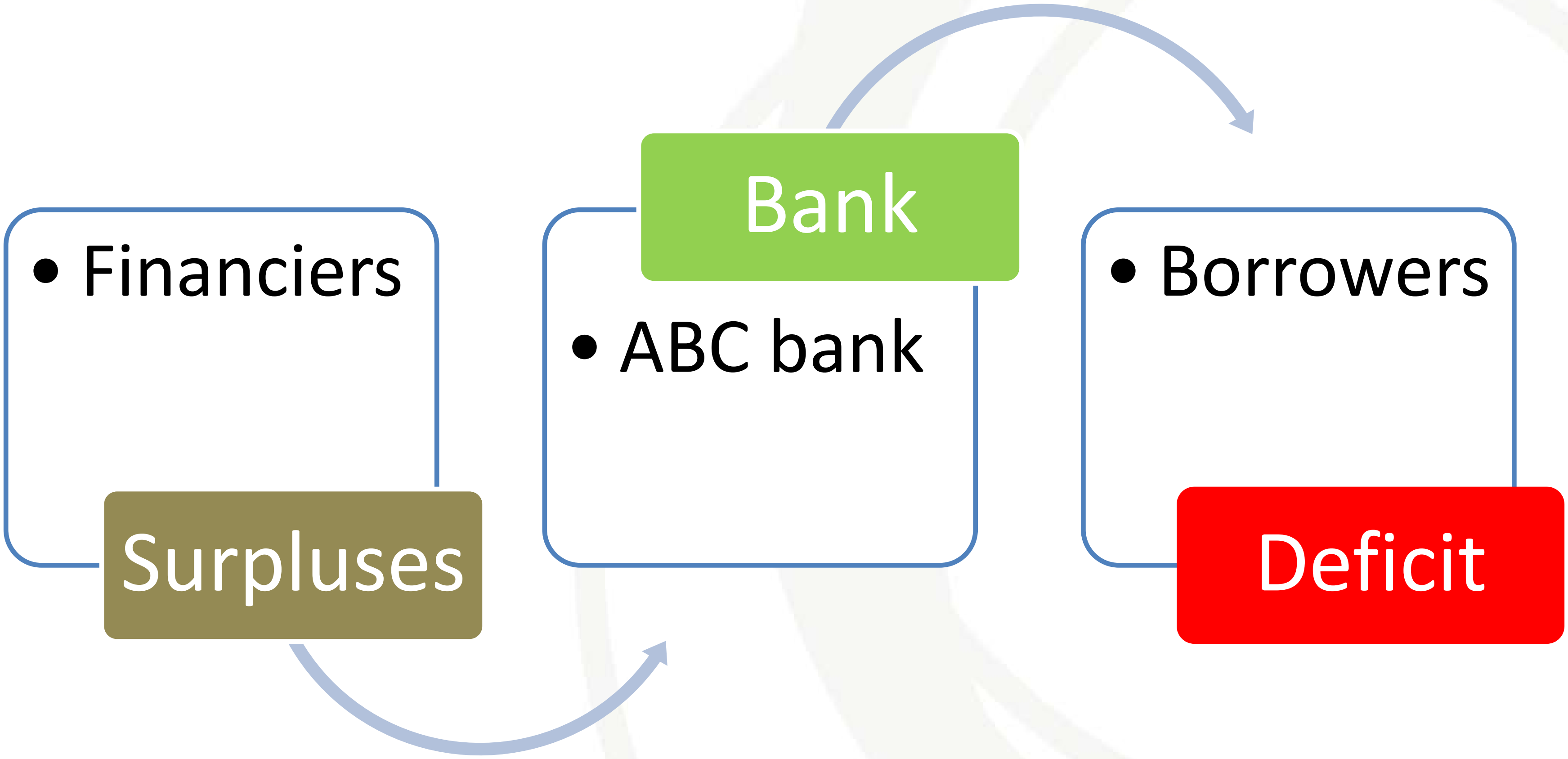
`Uqud Tawthiqat (Security)

- Pledge (*Rahn*)
- Guarantee (*Kafalah*)
- Transfer of Debt (*Hiwalah*)

`Uqud Wadi`ah (Safe custody)

`Uqud Wakalah/Joalah (Agency)

Transferring financial resources



Islamic vs. Conventional Banks
Profit Sharing vs. Browing & Lending

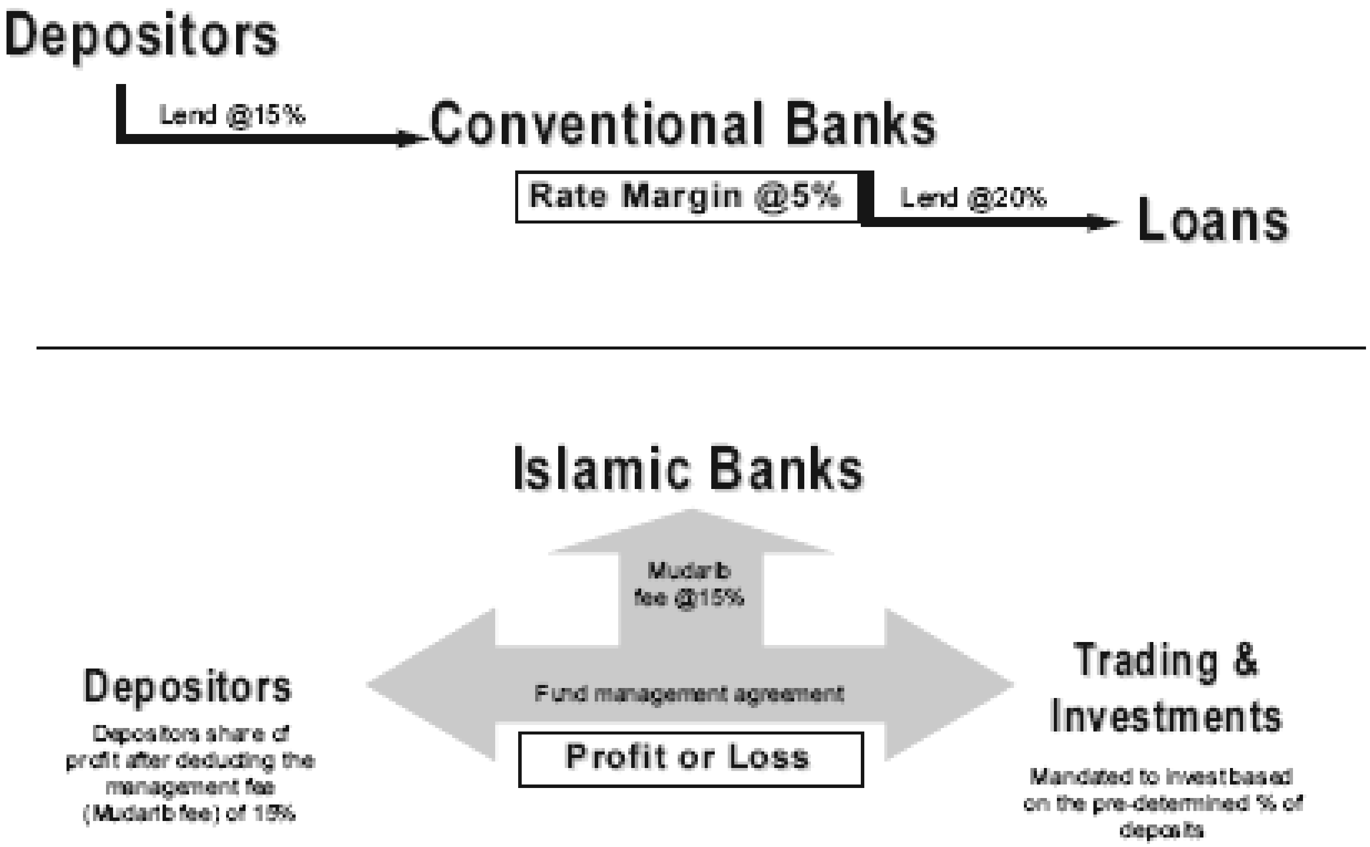


Figure 1: Traditional versus Islamic financial intermediation
(Source: M.Ikram Thowfeek)

Participatory Modes Vs Nor-participatory

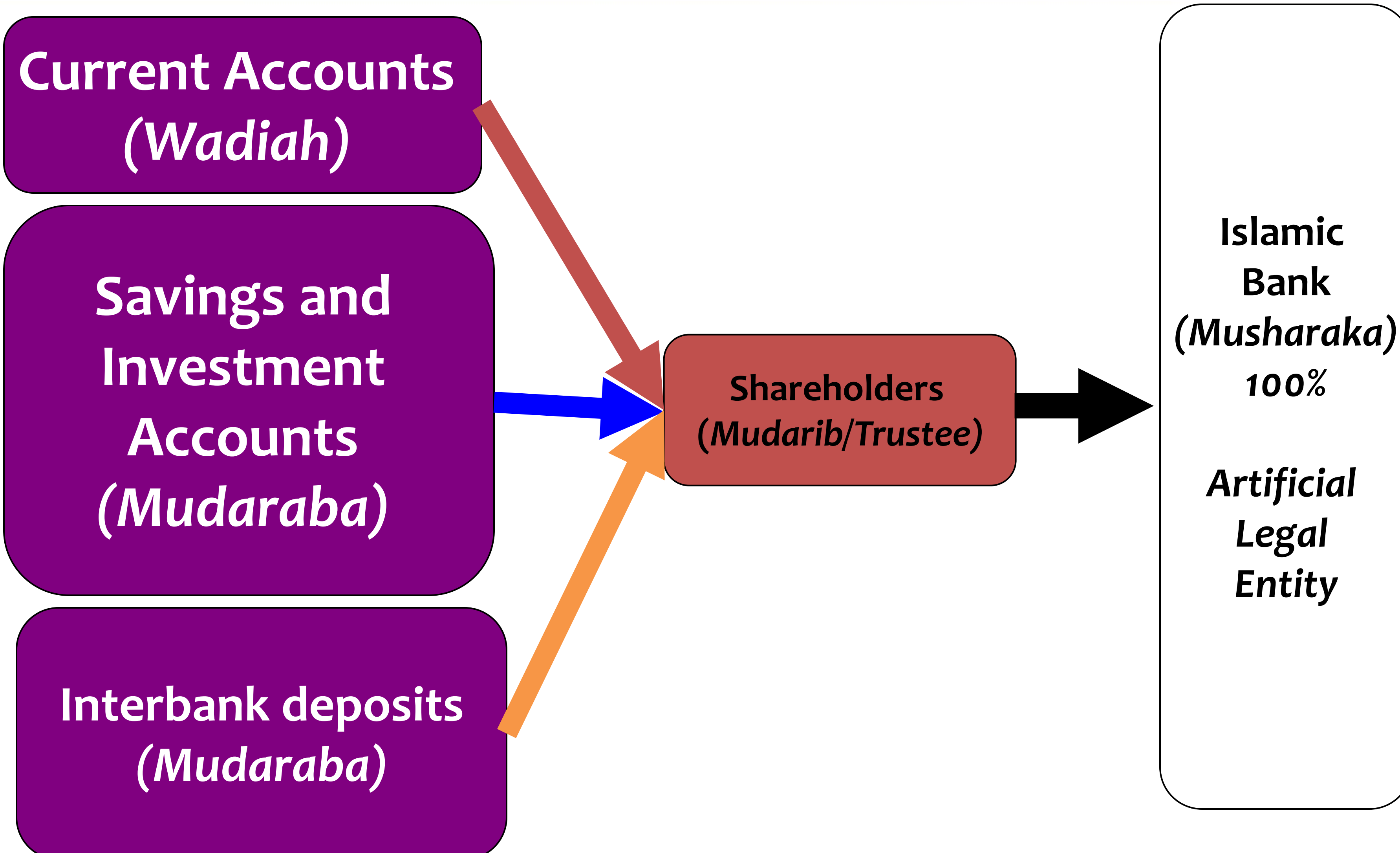
Equity

- Mudaraba
- Musharaka

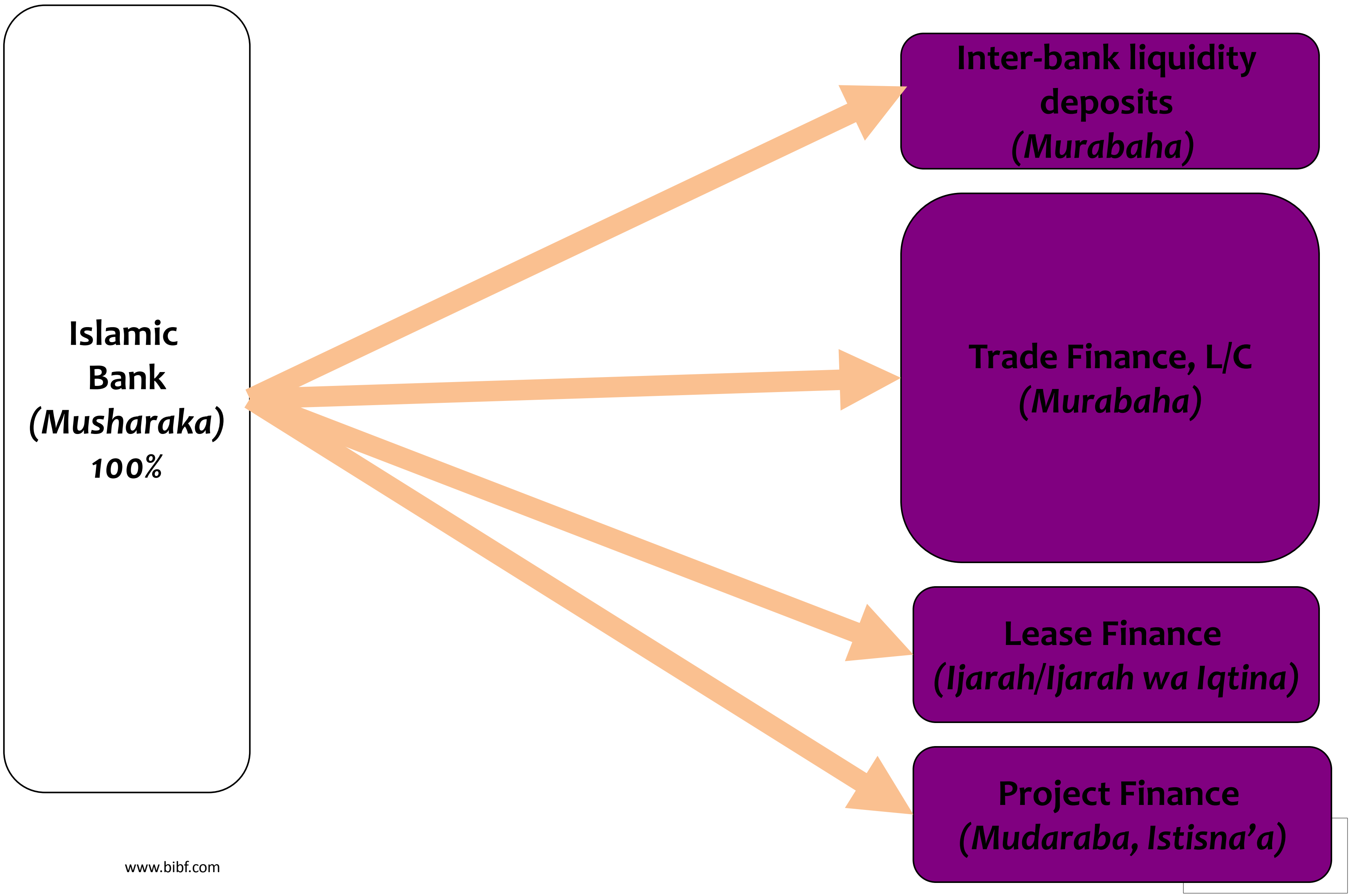
Debt

- Murabaha
- Salam
- Istisna’a
- Ijarah
- Tqwqrruq

How does an Islamic Bank source its funding?



How does an Islamic Bank mobilize its funds?



A Review of the Negative Elements of Transactions in Islamic Finance

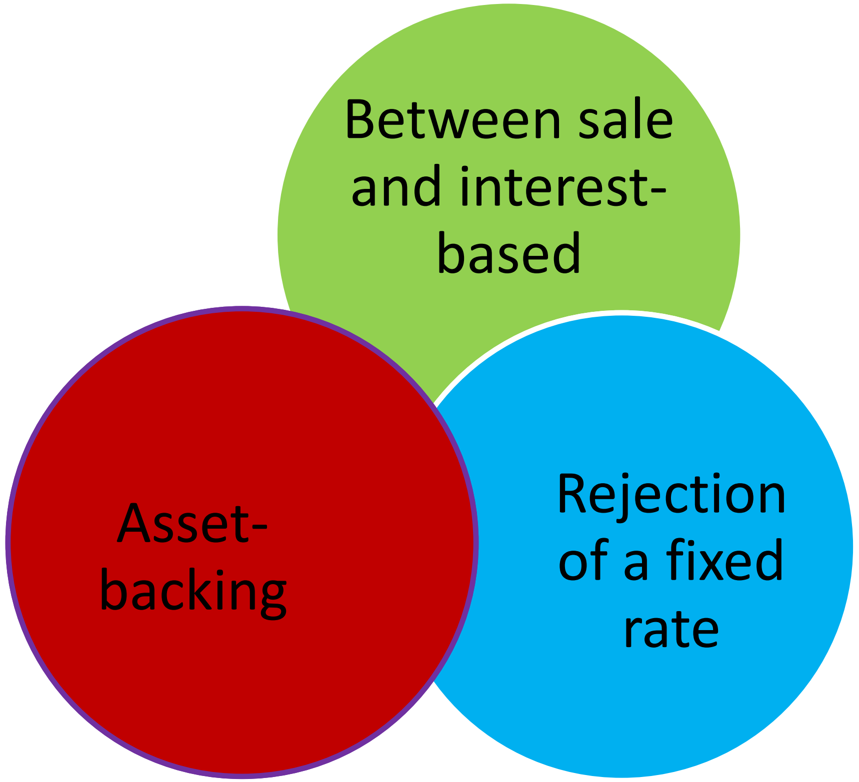
Categories Unlawfulness of a transaction

- Unlawful for its own sake
- Unlawful due to an external reason
- Unlawful due to unfulfillment of contract

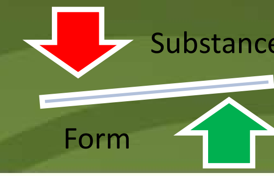
Roots of Financial Engineering in Islam

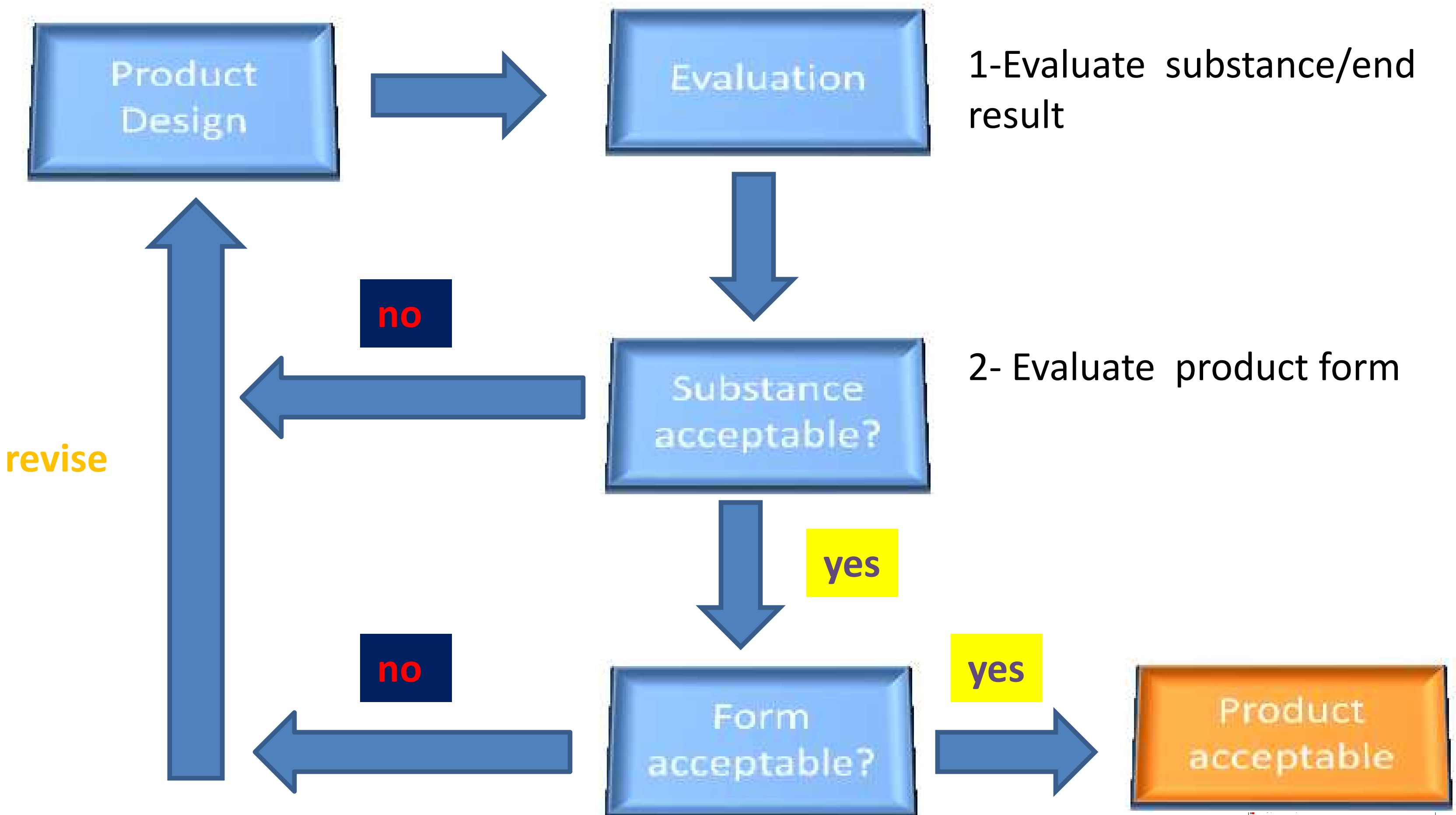
- Constraints V Creativity
- Islamic Finance -> uncomplicated contracts
- Books of Fiqh contain prohibited transactions
- The Doctrine of Original Permissibility

- Does not only replace Halal with Haram but also provides for Maqased Al Shari’a



Process of Product Evaluation

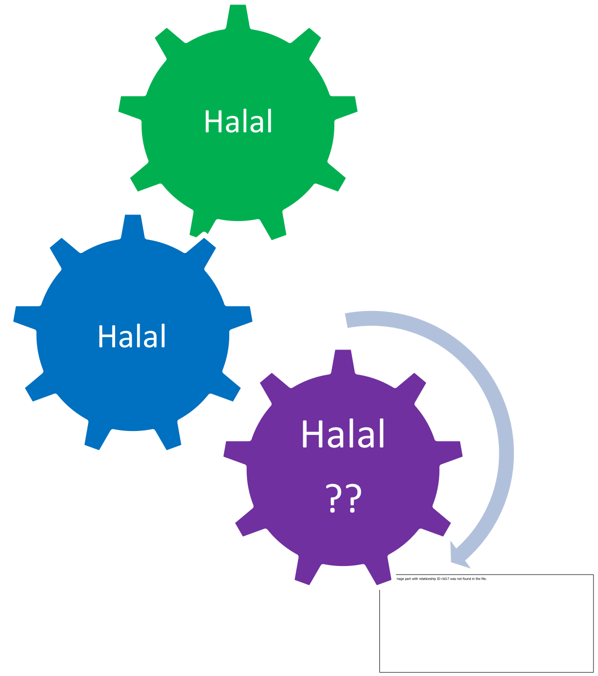




Cont…

- Importance of activating Ijtihad
- Any product is a result of the entire ideology
- Combined contracts
- Eg : Murabaha through Musharakah

Stratagems (Hiyal)

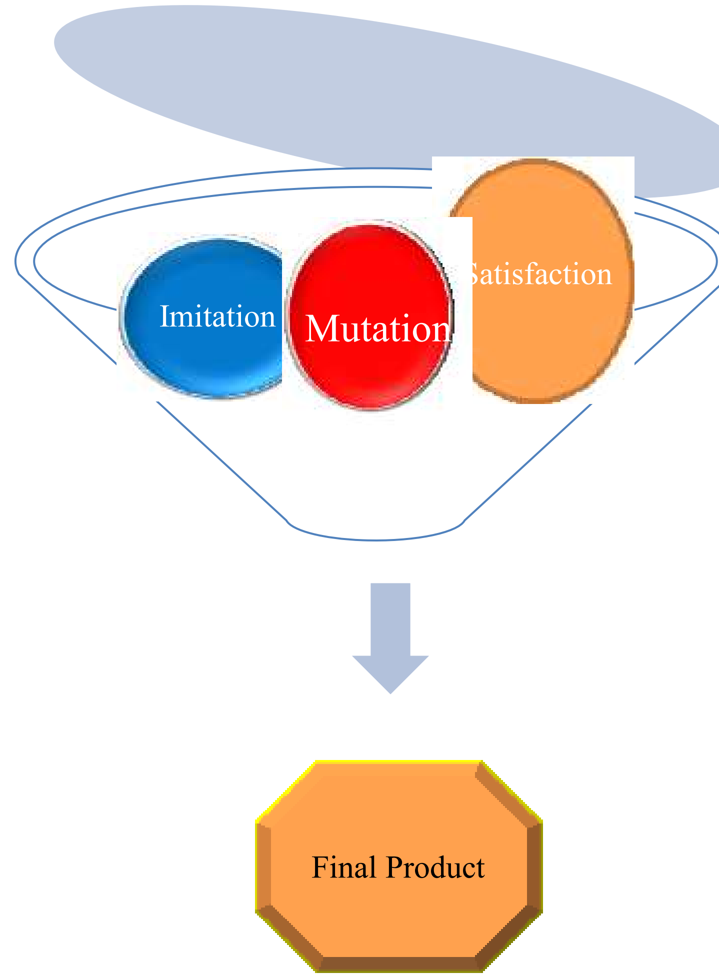


Strategies For Product Development

Satisfaction
- Actual needs of customers
- Customers determine the direction

Mutation
- Start from acceptable product
- Continuous improvement

Imitation
- Conventional as a reference
- Reverse engineering



Shariah Compliant

Islamic Finance Foundation

Prohibitions

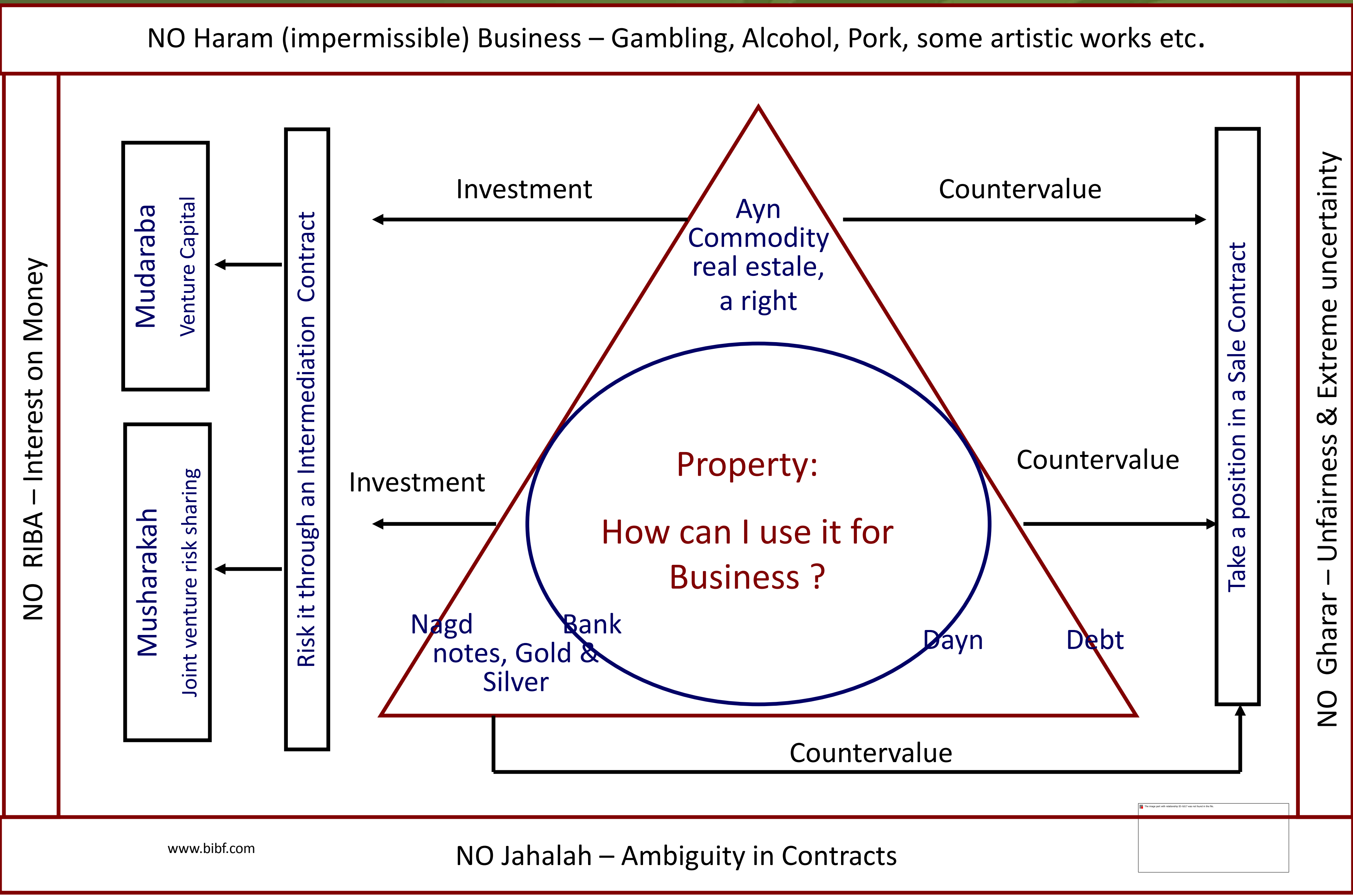
- Riba
- Gharar
- Jahala
- Maysir
- Haram

Contracts

- Uqud Al Muawadat
- Uqud Al-Wasatah
- Uqud Al-Tabbaru
- W'ad

Islamic Finance

Islamic Finance Constraints



Islamic Nominate Contracts:
The building blocks of Islamic transactions

- ‘Uqud Al-Muawadat (Mutually Onerous Compensatory Contracts) - Sale contracts, Sarf, Ijarah.

- ‘Uqud Al-Tabarru (Gratuitous Contracts) - Qard Hassan, Waqf, Wassiyah.

- ‘Uqud Al-Wasatah (Intermediation Contracts): Mudaraba Musharaka and Wakalah (include both agency and partnership contracts).

- Ancillary Contracts: Rahan,Hawala

Current accounts/demand deposits

- offered by conventional banks and Qard Hasan/Wadia accounts offered by Islamic banks have the following similarities:
  - Used for safekeeping and convenience in payments
  - Do not offer return or profit
  - Checkable
  - Face value of the deposit is guaranteed by the bank

Profit-bearing Savings accounts

- offered by conventional banks and profit-sharing savings accounts offered by Islamic banks have the following similarities:
  - Checkable
  - Do not have a fixed term to maturity

Profit-bearing investment accounts

- offered by conventional banks and profit sharing term accounts offered by Islamic banks have the following similarities:
  - Investors are committed for a certain time period
  - Usually not checkable
  - Early withdrawal may be denied by the bank, but usually allowed as per industry practice
  - Usually there is a minimum period before which the withdrawal would result in denial of all profits
  - For the withdrawals made after the minimum period, the weightage is reduced accordingly

Sources of Funds

- Paid-up capital and reserves (Equity)
- Islamic debt instruments
- Inter-bank borrowings
- Deposits/Investment Accounts

Islamic Finance Infrastructure

AAOIFI

IIFM

IIRA

LMC

ISLAMIC CAPITAL MARKETS

Sukuk based offerings

Islamic Mutual Funds

REITS

Hedge Funds

SHARI'A COMPLIANT MARKETS

DJIM

Bursa Bahrain Shari'a Index

ISLAMIC FINANCIAL INSTITUTIONS

FULL FLEDGED

Islamic Commercial Banks

Islamic Investment Banks

Multilateral Financial Institutions

QUASI-ISLAMIC

Islamic Windows

Islamic Subsidiaries

IFSB

IRTI / ISRA / BIBF

GCIBFI

IILM

Islamic Development Bank

- The purpose of the IDB is to foster economic development and social progress of its member countries and Muslim communities in non-member countries individually as well as jointly in accordance with the principles of Shari’a.

Objectives

- Promoting Islamic financial industry and institutions
- Poverty alleviation
- Providing various forms of development assistance, targeting different sectors of the member countries’ economies

Activities

- IDB extends financing to its member countries for infrastructural and agricultural projects such as roads, canals, dams, schools, hospitals, housing, rural development, etc. both in public and private sectors, which have an impact on the economic and social development of the member countries concerned and are accorded priority by the governments concerned.

AAOIFI

- As an international standards setter, AAOIFI develops, prepares and issues Financial Accounting Standards, Shari’a Standards and their relevant exposure drafts.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

Objectives

- Developing accounting and auditing thoughts relevant to Islamic financial institutions
- Disseminating accounting and auditing thoughts relevant to Islamic financial institutions and its application through training, seminars, publication of periodical newsletters, carrying out and commissioning of research and other means
- Preparing, promulgating and interpreting accounting and auditing standards for Islamic financial institutions
- Reviewing and amending accounting and auditing standards for Islamic financial institutions

Islamic Financial Services Board (IFSB)

- IFSB promotes the development of prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with Islamic Shari’a principles, and recommend them for adoption. To this end, the work of the IFSB complements that of the Basel Committee on Banking Supervision, International Organization of Securities Commissions and the International Association of Insurance Supervisors.

IFSB - Objectives

- Promoting development of a prudent and transparent Islamic financial services industry
- Providing guidance on the effective supervision and regulation of institutions offering Islamic financial products
- Developing the criteria for identifying, measuring, managing and disclosing risks, for the Islamic financial services industry, taking into account international standards for valuation, income and expense calculation, and disclosure
- Coordinating and cooperating with relevant organizations currently setting standards for the stability and the soundness of the international monetary and financial systems and those of the member countries

IFSB - Objectives

- Enhancing and coordinating initiatives to develop instruments and procedures for efficient operations and risk management
- Encouraging cooperation amongst member countries in developing the Islamic financial services industry
- Facilitating training and personnel development in areas relevant to the effective regulation of the Islamic financial services industry and related markets
- Undertaking research and publishing studies and surveys on Islamic financial services industry
- Establishing a database of Islamic banks, financial institutions and industry experts

The International Islamic Financial Market (IIFM)

- IIFM is an infrastructure institution with the mandate to take part in the establishment, development and promotion of Islamic capital and money markets. IIFM's primary focus lies on the advancement and standardization of Islamic financial instrument structures, contracts, products and infrastructure development and the issuance of guidelines and recommendations for the improvement of Islamic capital and money markets globally. Furthermore, development of global primary and secondary Islamic capital markets, short term financial markets and creation of a market for Islamic financial instruments are also key focus areas for IIFM.

(IIFM) - Objectives

- Encouraging self-regulation for the development and promotion of the Islamic capital and money market segment
- Promoting issuance and trading guidelines, best practice procedures, product innovation, market recommendations and infrastructure development
- Acting as a market body in the development and maintenance of uniformity, assisting with standards benchmarking for transparency and robustness of Islamic financial markets

Islamic International Rating Agency

- IIRA is the sole rating agency established to provide capital markets and the banking sector in predominantly Islamic countries with a rating spectrum with full array of capital instruments and specialty Islamic financial products.

Objectives

- Developing methodologies and benchmarks for issue/issuer ratings
- Providing independent assessment and opinion on the likelihood of timely payment of financial obligations by sovereigns, corporate, banks and financial institutions and securities issued by governments, corporate, banks and financial institutions
- Providing independent opinion on the level of compliance with the principles of Shari'a
- Assessing the governance system of corporate, banks, and other financial institutions
- Disseminating information and data relating to business enterprises for development of sound and efficient capital markets
- Offering research, analysis and evaluation of sectors, industries and entities
- Encouraging the introduction of standards for greater disclosure and transparency

General Council for Islamic Banks and Financial Institutions

- CIBAFI performs the task of enhancing awareness and visibility of Islamic financial industry in major international financial markets. The objective is to help integration of Islamic banking in the global financial markets. It focuses on developing strategic alliances and holds seminars and conferences to educate various stakeholders.

CIBAFI - Objectives

- Promoting Islamic financial industry in theory and practice
- Improving multilateral understanding between Islamic banks, their customers and the public at large
- Serving the long term objectives of the Islamic financial institutions by enhancing their image and improving their ability to serve customers around the world
- Promoting adherence to the three-part commitment of Islamic banking practices: ethical investment, professionalism and transparency

Islamic Research and Training Institute

- IRTI envisions becoming a centre of excellence in Islamic economics, banking and finance. It aims to contribute to building institutional infrastructure for promoting human development and enhancing economic cooperation among member countries in collaboration with the IDB group members and other partner organizations.

  – IRTI is presently composed of four divisions and three support units. These are:
  – Islamic Economics, Cooperation and Development Division (IECD)
  – Islamic Banking and Finance Division (IBFD)
  – Training Division (TD)
  – Information Centre (IRTIC).

Objectives

- Providing financial and socio-economic statistics about member countries
- Promoting strategic dialogue among member countries on key issues of common interest
- Facilitating practical application of Islamic economics and finance
- Developing Islamic economics and finance as scientific disciplines
- Business and endowment development for strengthening financial position of IRTI

Liquidity Management Centre

The Liquidity Management Centre (LMC) was established for the purpose of facilitating the investment of the surplus funds of Islamic banks and financial institutions into quality short
and medium term financial instruments structured in accordance with the Shari'a principles.

Short-term secured Investment Sukuk

The opened ended Short Term Sukuk Program (STS) was initially launched by LMC in January 2004 and has grown steadily to a size of approximately US$100MM as at September 2005. The program possesses a number of key attributes which include: Monthly investment entry and exit points for investors

- Payment on monthly investment returns to investors
- Reputed liquidity providers for the program
- Underlying asset security/collateral coverage in the form of a performing portfolio of various Sukuks
- LMC provides each and every one of our clients with Sukuk structures and documentation is tailored to meet their requirements.

These may include, but not be limited, to the following: Sukuks of Murabaha and post dated sales

- Salam and Istisna'a Sukuk Developement
- Mudaraba and Musharaka and investment certificates
- Ijara and leased Ayan Sukuk
- Istisna’a into Ijara Sukuk
- Investment Agency Sukuk

Secondary Sukuk market activities

- Secondary Sukuk market activities
  As per its founding mandate LMC aims to develop an active secondary market for all transferable Islamic investment instruments. LMC's activities in this area revolve around assisting prospective buyers and sellers of Sukuk. This area of our business is evolving in line with the underlying expansion in the primary Sukuk issuance market. Please use our Bid/Offer registration and Display Service which can be accessed from the **"Secondary Market"** menu.

Shari'a Board

- It is the source of expert knowledge on Islamic Principles (Including Fatwas)
- It oversees the development of all products to ensure no Shari'a repugnant feature arises
- It analyses unprecedented situations not covered by fatwa, in the Bank's transactions to ensure Shari'a compliance
- It analyses contracts and agreements concerning the Bank's transactions to ensure Shari'a compliance
- It ensures the immediate correction of breaches (if any) in compliance to Shari'a
- It supervises Shari'a training programmes for the Bank's staff
- It prepares an annual report on the Bank's balance sheet with respect to its Shari'a compliance

Profit equalization reserve (PER) and investment risk reserve (IRR)

- A PER is an appropriation of income attributable to shareholders prior to distribution. It is meant to maintain a certain level of Return on Investment Account Holder (ROIAH) for IAHs.
- A PER is the amount appropriated by an IFI out of its **gross income, before allocating the Mudarib share**, in order to maintain a certain level of return on investment for IAH and increase the owners' equity. The basis for computing the amounts to be appropriated should be pre-defined and applied
- in accordance with the contractual conditions accepted by the IAH and after formal review and approval by the IFIs' **Board of Directors** (BOD). In certain jurisdictions, such as Bahrain the supervisory authority lays down requirements relating to the maintenance of the PER in accordance to the rate of return framework. This provides assurance to IAHs that **a reasonable rate of return is determined as disclosure of the PER indicates the stability of profit distributed to IAH as dividends**.

Investment risk reserve (IRR)

- An investment risk reserve is appropriated out of **the investment account holders' income after allocating the IFI's Mudarib share**. It is meant to m**itigate against future losses for investment account holders**. Both reserves require the approval of the investment account holders.
- An Investment Risk Reserve (IRR) is the amount appropriated by the IFI out of the income of the IAH,
- after allocating the Mudarib share, in order to cushion the effect of the risk of future investment losses on the IAH. The terms and conditions whereby IRR can be set aside and utilised should be determined and approved by the IFI's BOD. The IRR **provides a form of buffer or protection against IAH loss of capital**. The reserve is used to absorb adverse performance of IFI financing or investments affecting Investment accounts. Hence the IAH is assured that their capital is maintained before profits are distributed or after loss is experienced.

The Contract of Murabaha

Pointers on Murabah

- From the word ‘*ribh*’ which means profit or gain.
- Part of *Bay’ al-Amanah*.
  - Bay Al Tawliyyah
  - Bay Al Wadhiyyah
- It is a sale with a profit, either lump sum or based on a percentage, but the cost price is informed to the seller.
- The payment may be on the spot or on the subsequent date agreed upon by the parties.
- It does not necessarily imply the concept of deferred payment.
- Difference with Musawamah at least on two points
  - Parties and disclosure

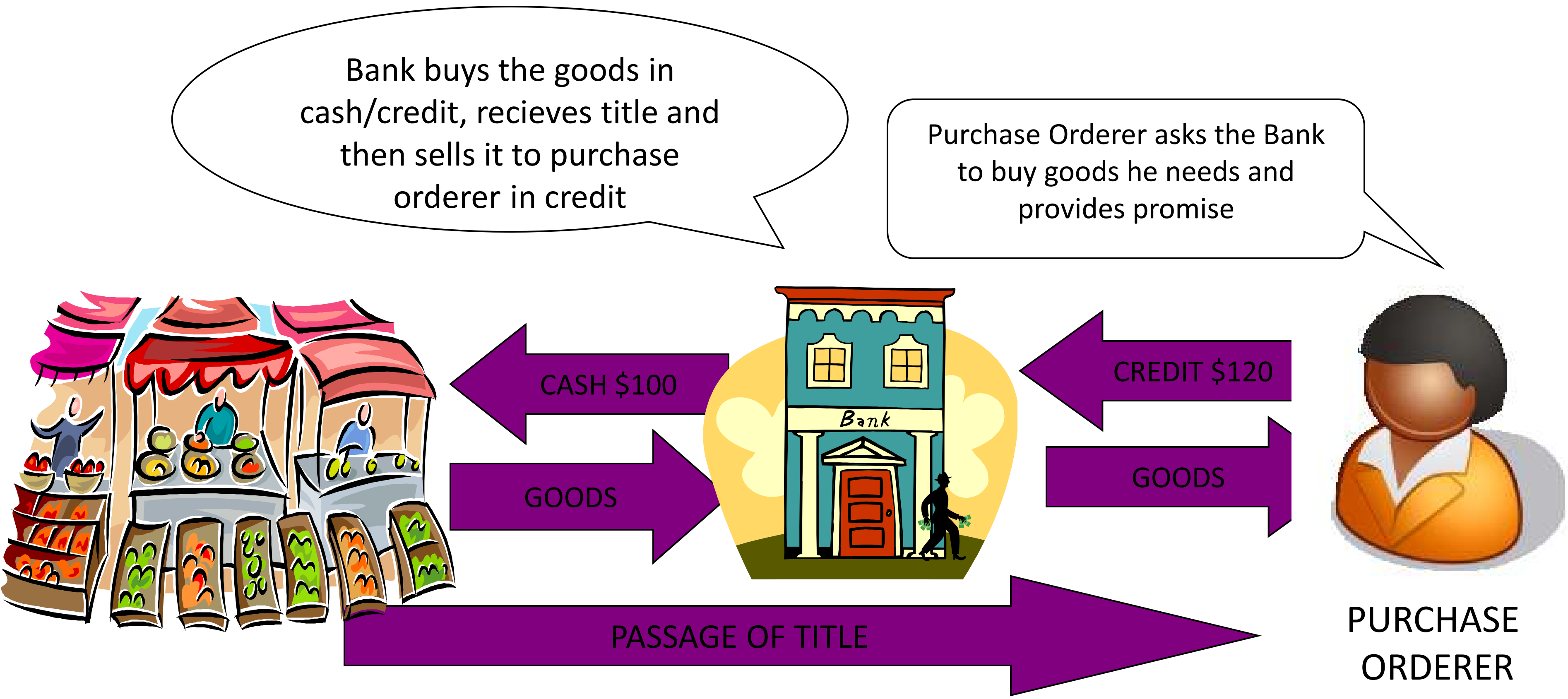
Legal Basis of Murabaha

- From the word '*ribh*' which means profit or gain.
- No dispute among the jurists on the validity of *bay' al-murabah*
- This is a form of sale (bay')
- Comes under the purview of "Allah has permitted **sale** and prohibited riba" (al-Baqarah:275)
- It is no sin for you that ye seek the bounty of your Lord (by trading). (al-Baqarah: 198)

The original purpose Murabaha compared to the current Murabaha

- To help incapable person to acquire a commodity via the help of an experienced seller. The seeker of a commodity will then approach a person who is an expert (as well as trustworthy) to purchase the defined commodity and then resell it to the seeker with additional profit agreed upon. The risk of the seeker is reduced
- Most of Islamic banks are using Murabaha as a mode of financing, and most of their financing operations are based on Murabaha, while the original concept of Murabaha is different from this model.
- Fiqh Murabaha and Financial Murabaha

Murabaha to the Purchase Orderer Process



The Difference between *Fiqhi Murabaha* and Financial *Murabaha*

- *Fiqhi Murabahah*: To sell or resell a commodity which is already possessed / owned by the seller.
- Financial *Murabahah* is known as the *murabahah* with an order to purchase (*Al-Murabahah lil-Amir bi al-Shira')*
- Three parties are involved: The customer, the financier (Islamic Bank), and the supplier.
- The customer asks the bank to purchase a commodity from the supplier, and the bank sells it to the customer.

Similarity to Conventional Loan?

- Question: How does it differ from a simple loan on interest to a customer who then buys the goods himself?
- Answer: Economically there might be no significant difference, but legally, especially from the *fiqhi* point of view, there are substantial differences.

Differences with its Conventional Counterpart

- Legally, for the interval between the two sales, the bank owns the goods so the bank bears the risk of goods being destroyed, harmed, or defective, and that the supplier may default. Bank also faces the risk that the buyer will reject the goods as unsatisfactory and defective. (concept of khiyar). Theoretically, the bank bears the risk
- In financial *murabaha* there is a meaningful connection between the credit service and the unique transfer of goods from a third party to a customer, where the time value of money is recognized. A conventional loan, by way of contrast, need have no connection with any economic or legal event beyond the customer's undertaking to pay.

Murabaha in practice:

- The bank and its customer agree in advance that the second sale occurs at the same instant as the bank gains title under the first sale.
- The customer may even contract to purchase goods from the supplier before the *murabaha* is signed.
- The bank assigns the customer as its agent to purchase and obtain the goods.
- Islamic banks often employ various ways to reduce their risks in *murabaha* almost to zero.
- All in all, the bank's connection with the goods becomes merely theoretical.

Simplified Steps Undertake in Murabaha

1. The client and the bank sign an overall agreement whereby the bank promises to sell and the customer promises to buy the commodities on an agreed ratio profit added to the cost.
2. When a specific commodity is required by a customer, the bank appoints the client as his agent for purchasing the commodity on its behalf, and an agreement of agency is signed by both parties.

Cont'd…

3. The client purchases the commodity on behalf of the bank and takes its possession as an agent of the bank.
4. The client informs the bank that he has purchased the commodity on its behalf, and at the same time, makes an offer to purchase it from the institution.
5. The bank accepts the offer and the sale is concluded whereby the ownership as well as the risk of the commodity is transferred to the client.

Cont'd…

- The most essential element of the transaction is that the commodity must remain in the risk of the institution during the period between the third and the fifth stage.

Customer as the Agent (*wakil*)

- "The best method of *murabaha*, according to *Shari'ah*, is that the financier himself purchases the commodity and keeps it in his own possession, or purchases the commodity through a third person appointed by him as agent, before he sells it to the customer. However, in exceptional cases, where direct purchase from the supplier is not practicable for some reasons, it is also allowed that he makes the customer himself his agent to buy the commodity on his behalf"

Purchase Order Murabaha without Obligation

1. Request by customer is considered willingness to buy not an offer
2. If bank accepts, it acquires the asset via valid contract
3. Bank offers asset to customer
4. Customer has option to accept or decline offer
5. If he accepts contract is concluded
6. If he declines offer asset remains in possession of bank
7. If an advance payment is required it should be made after acceptance of offer & is part of price

Purchase Order Murabaha with Obligation

1. Request by customer to bank (Bank can ask customer to pay "Hamish-Jedyah" when request is made).
2. If bank accepts request, bank is bound to purchase asset from vendor via valid sale contract.
3. Bank offers asset to customer who is bound to accept it and should establish a sale contract.
4. If Murabaha contract is concluded "Hamish-Jedyah" can become part of price.
5. If customer reneges on his promise, bank recourse to "Hamesh-Jedyah" for amount of damage
6. If not enough, bank may recourse to customer for further compensation.

Hamish-Jedyah VS. Urboun

- Some banks use Urboun instead of Hamish-Jedyah
- Both are part of price if Murabaha contract is concluded.
- Hamish-Jedyah is used to pay for actual damage if Murabaha contract is not concluded.
- Urboon is taken in full-whether it is more or less than damage-if Murabaha contract is not concluded.

Risks in Murabaha

- Customer may reject the goods or break his promise.
- Interim ownership/Commodity price.
- Warranties on the merchandize.
- Pricing (Fixed rate of profit 2mnths to 7 years)
- Seller may default on repayment (No penalty for late payment).
- Delivery risk/Loss from damaged goods.

Risks in Murabaha

Stage 1

Stage 2

Stage 3

Stage 4

Stage 5

Customer identifies a product which they wish to purchase from a specific vendor

Customer gives preliminary undertaking to Islamic bank to buy the same product from Islamic bank

Islamic bank purchases the product from the vendor at disclosed cost

Islamic bank enters into another agreement with customer to sell this product at a mark-up with either deferred or lump sum payment

Customer makes payments periodically or lump sum

Risk
s

Settlement
Risk

Market Risk +
Operational Risk

Credit Risk +
Re-pricing Risk
+ Liquidity Risk

Relationshi
ps

Promisor/promi
see

Buyer/seller

Debtor/
Creditor

Tawarruq

- *Simplest Definition?* Murabaha (deferred credit sale) with an additional cash sale.
- Alternative to Bai Al ‘inah or buy-back sale.
- *Why do we use it?* To raise cash/silver (wariq)
- ***How do we do it?***

  1. Buy goods from the market on credit

  2. Sell the goods for cash
- ***Why do we offer it?***

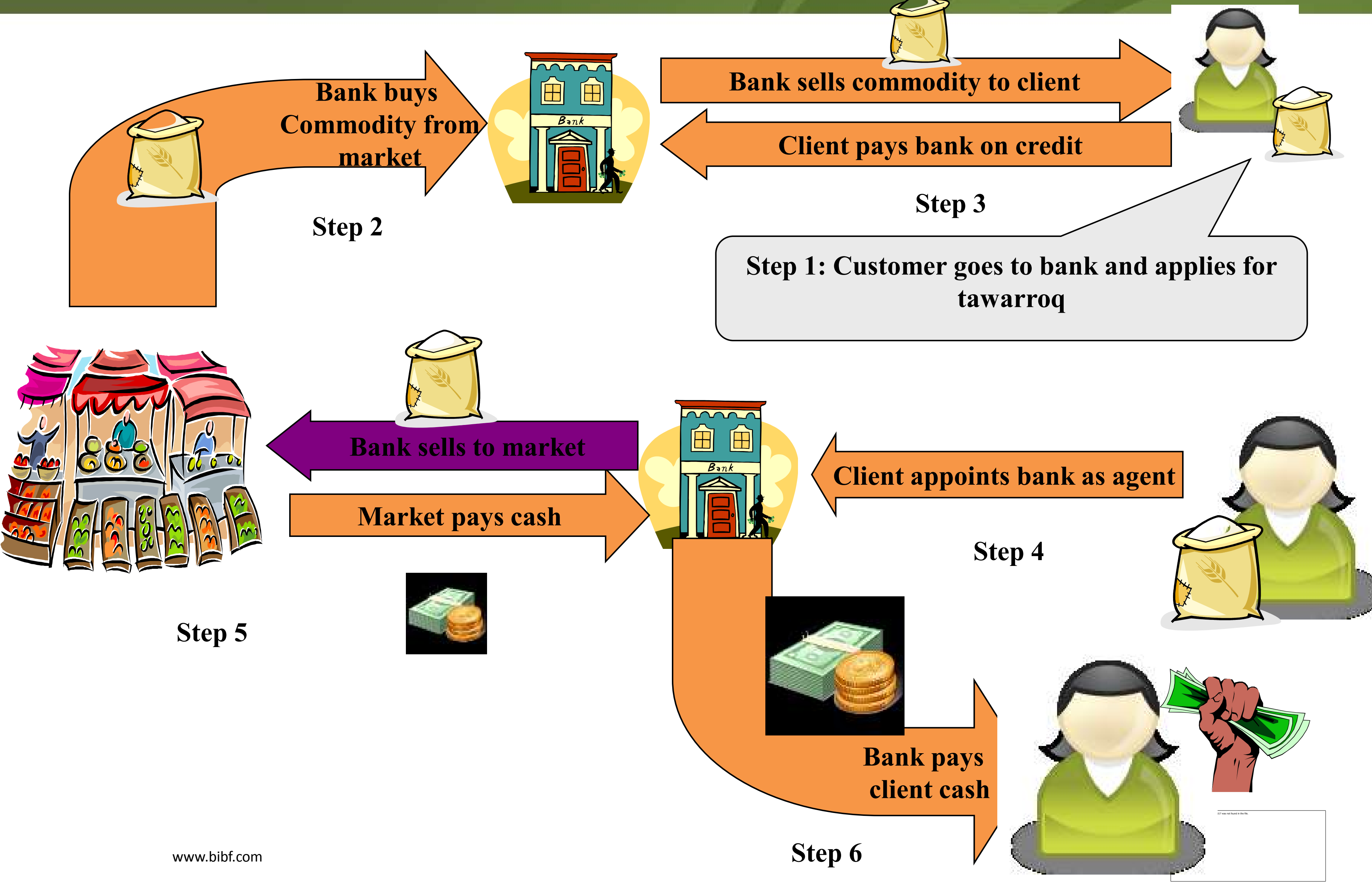
  Growing need amongst customers for cash without committing Riba

  No other Islamic nominate contracts can purely raise cash

  Fixed rate of return (but could be a disadvantage)

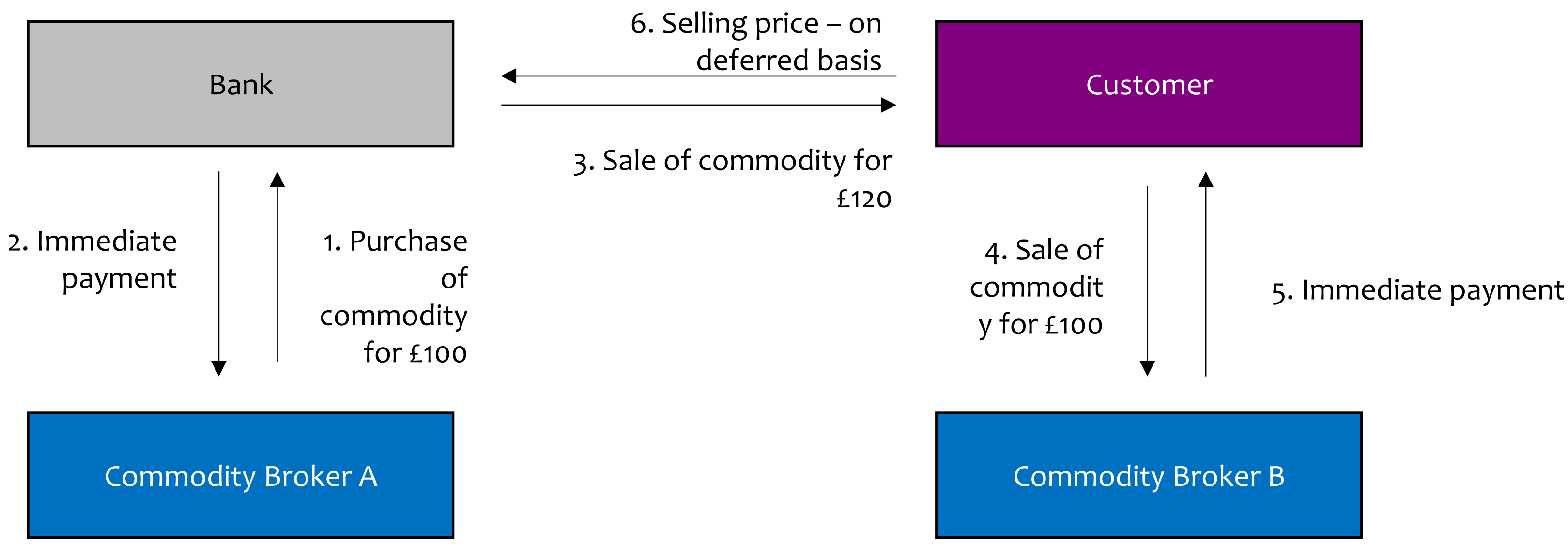
  Secured transaction

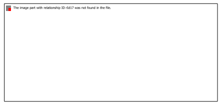
Tawarruq Process



Commodity Murabaha

- Murabaha is also be used for generating finance for short and medium term (also known as reverse Murabaha or Tawarruk).
- Murabaha financing typically involves purchase and sale of a commodity.
- An illustrative structure is set out below:





Step 1 Application
Receive the application from the customer. Obtain all necessary documents.
Prepare the contracts and other documents. Send the application to the Treasury Department.

Step 2: Buy the commodity
Treasury Department gets a request to buy the commodity (platinum, paper, gold….. etc). Client signs Sale & Agency Contracts. Bank makes sure of the kind, quantity, and final price of the commodity needed.

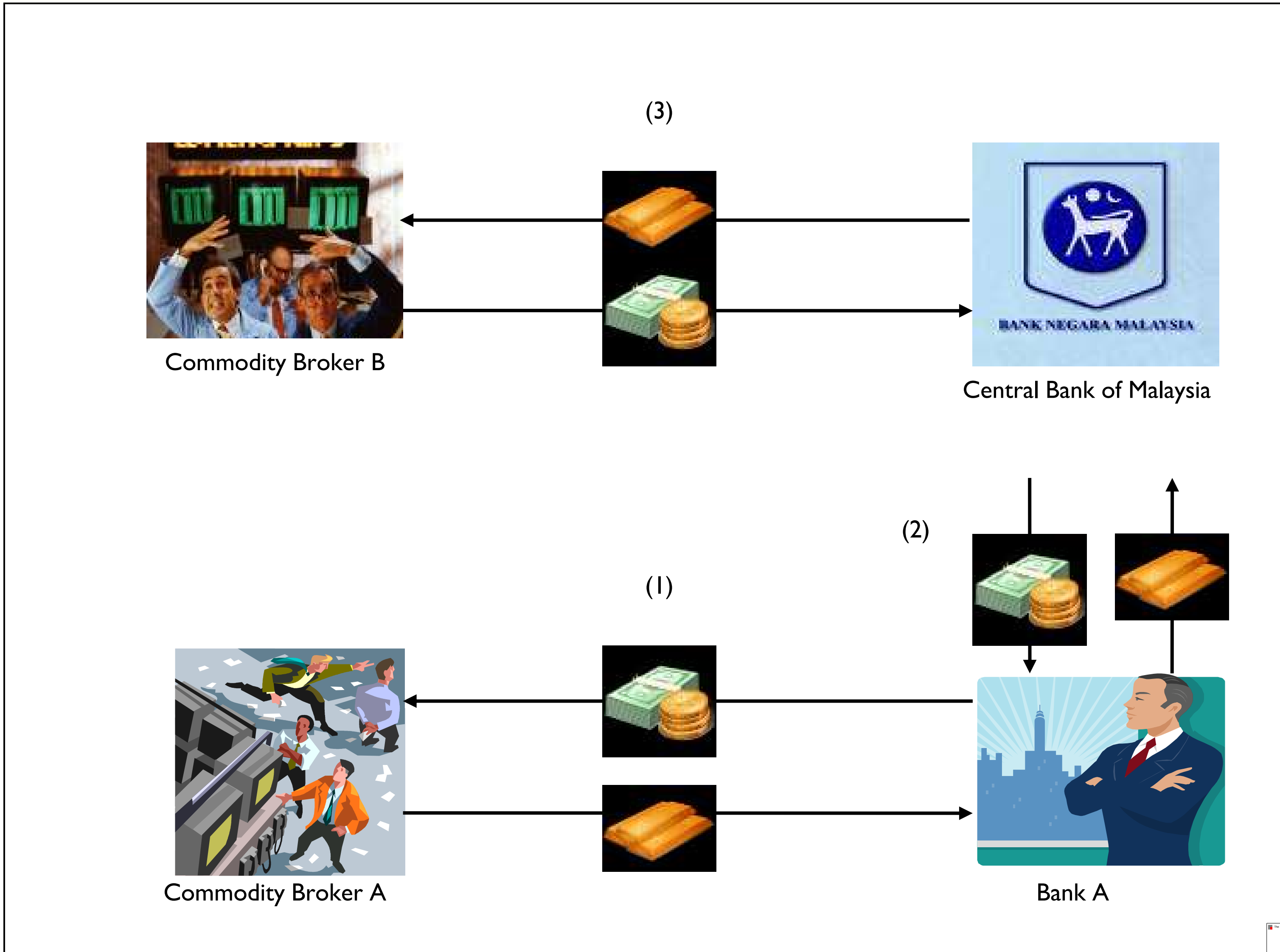
Step 3: Sell the commodity to the client
Marketing Department calls the client and informs him/her about the kind, quantity, and price of the commodity bought. The bank will sell goods to the customer as per sale contract on a deferred payment basis.

Step 4: Agency Contract with bank gets activated
Customer asks to sell the goods in the market for market price

Step 5: Bank sells the commodity on his behalf
The commodity must be sold to third party in the open market by the bank (as an appointed agent).
The bank will receive the proceeds of the sale.

Step 6: Bank gives the client proceeds
The bank will pass the same proceeds to the client's account with the bank. The operations department will call the client and send a bill with the kind, quantity, and price of the commodity sold.

Commodity Murabaha Program for Liquidity Absorption

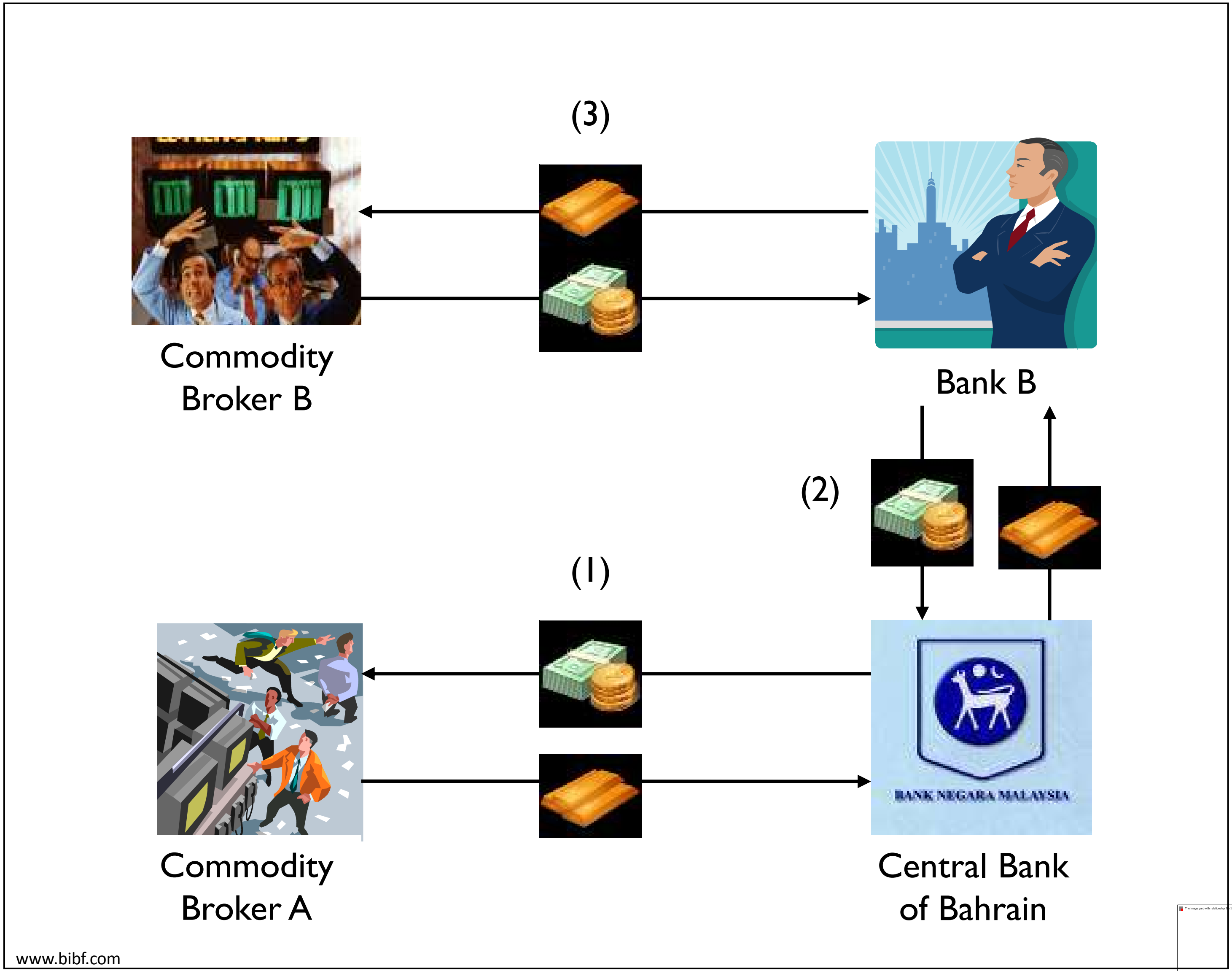


Commodity Murabaha Program for Liquidity Absorption

Several mechanism of commodity murabahah for absorbing liquidity can be further illustrated as follows:

- Bank A that faces excess liquidity can manage their liquidity by purchasing commodities from Broker A on cash basis. For example, BD 1 million.
- Thereafter, the bank sells the commodities to Central Bank of Bahrain on deferred price (cost price plus profit margin). For example, BD 1 million (cost) plus 7.5 profit margin for a duration of six months (7.5% x 6/12 x BD1 million = BD 1,037,500).
- Central Bank of Bahrain sells the commodity to Broker B in on spot at the original price to net off the commodity position that it holds when it purchased from Bank A. The Central Bank of Bahrain may appoint the bank as his agent to sell the commodities in the commodity market.

Commodity Murabahah Program for Liquidity Injection



Commodity Murabaha Program for Liquidity Injection

The details of the steps are described below:

- ☐ Central Bank of Bahrain purchases the commodities from Broker A on cash basis. For example, BD 1 million. Alternatively, the Central Bank of Bahrain can appoint Bank B (that faces temporary liquidity problem) as its agent to buy the commodities from commodity market. Bank B will receive the funds for the purchase of commodities on spot basis. The ownership of the commodities is then transferred to the Central Bank of Bahrain.
- ☐ Thereafter, the Central Bank of Bahrain sells the commodities to Bank B on deferred price (cost price plus profit margin). Hence, the ownership of the commodities is now transferred to Bank B.
- ☐ Bank B sells the commodities to Broker B in on the spot at the original cost price to net off the commodity position that it holds when it purchased from Central Bank.

Essential Points on Murabaha

1. Different Pricing for Cash and Credit sale

- If a commodity is sold in exchange of money, the seller, when fixing the price, may take into consideration different factors, including the time of payment.
- If either of the two prices is not determined in specific terms, the sale will not be valid.
- Positive time value of money is not applicable in the contract of loan or exchange money for money of the same currency.

2. The Use of The Interest-Rate as a Benchmark

- Using KLIBOR (Kuala Lumpur Inter Bank Offered Rate) to determine the profit or mark-up on the basis its current interest rate.
- If a *murabahah* transaction fulfills all the conditions, merely using the interest rate as a benchmark for determining the profit does not render the transaction as invalid, *haram*, or prohibited.
- The interest rate has been used only as an indicator or as a benchmark.

3. Promise to Purchase

- Fulfilling a promise is obligatory.
- Whether or not a promise is enforceable in courts depends on the nature of the promise.
- The promise on commercial dealing is binding on the promisor with the following conditions:
  1. It should be one-sided promise (to be different from bilateral forward contract)
  2. The promise causes liabilities to the promisee
  3. Promise should not be considered as sale
  4. If the promise is broken, the court may force the promisor to purchase the commodity or pay actual damages to the seller.

4. Securities Against *Murabahah* Price

- *Murabaha* price is payable at a later date.
- To make sure that the price will be paid at the due date, the bank will turn the object of sale in the form of mortgage (*rahn*).
- Rulings:
  1. The security can be claimed rightfully where the transaction has created a liability or a debt. However, it is also permissible that the client furnishes a security at earlier stage, but after the *murabaha* price is determined.
  2. It is also permissible that the sold commodity itself is given to the seller as a security.

5. Guaranteeing the *Murabahah*

- The seller in a *murabaha* financing can ask the purchaser / client to furnish a guarantee from a third party.
- Using the principle of suretyship (*kafalah*)
- No guarantee fee should be charged. Instead it can charge or pay a fee to cover expenses incurred in the process of issuing a guarantee.

6. Penalty of Default

- If the client defaults in payment of the price on the due date, the price cannot be increased.
- The government or central bank, however, may develop a system where such defaulters may be penalized by debarring them from obtaining any facility from any financial institution.
- Penalty of paying a specified amount to a charitable fund maintained by the bank. No part of this amount shall form part of the income of the bank.

7. Rebate on Earlier Payment

- If the earlier payment is conditioned with discount, it is not permissible.
- If the rebate is not taken to be a condition for earlier payment, and the creditor gives a discount voluntarily on his own, it is permissible.
- Rebate cannot be stipulated in the agreement, nor can the client claim it as his right.

8. Rescheduling of Payments

- If the installments are rescheduled, no additional amount can be charged for rescheduling.
- The amount of the *murabaha* price will remain the same.

9. Securitization of *Murabahah*

- *Murabahah* is a transaction which cannot be securitized for creating a negotiable instrument to be sold and purchased in secondary market.
- If the client in a *murabahah* transaction signs a paper to evidence his indebtedness toward the seller, the paper will represent a monetary debt receivable from him. So, if the paper is sold to other party, it must be at par value.

Murabaha VS. Term Loan

Murabaha	Term Loan
Sell Tangible asset	*Advance money*
Profit margin (mark-up on cost of comm.)	*Interest rate on balance outstanding*
Receivables (debt) in bank books	Receivables (debt) on bank books
Collateral to secure payments	Collateral to secure payments
Penalty for delay or default not acceptable	*Penalty acceptable*
Risks: • *Customer reneges his promise.* • Credit risk. •Interest Rate risk • *Commodity risk.*	Risks: • Credit risk. • Interest rate risk.

The key economic difference is that Murabaha links between the supplier and the buyer while a conventional loan may not provide any connection of legal event beyond the customers undertaking.

The Contract of Salam

Recap on the Basic Conditions of Sale

- The commodity must be existing, therefore if it doesnt exist at the time of sale it is invalid
- Seller shoud have the ownership of the commodity, if he doesnt own it, its invalid
- Mere ownership not enough. He must own it phisically.

Definition

- Salam is an Arabic word which means credit
- Also known as **salaf** which means lending due to deferred delivery of the counter value
- A sale of specific commodity delivered at a future date for an advanced payment fully paid on the spot.
- Salam is one of the most important tools for short-term liquidity management
- Liability on the seller
- The opposite of deferred sale.

Terms

- Buyer = rabbus salam
- Seller = muslam Ilaih
- Salam commodity = muslam fih
- Cash price = ra’sul mal

Original Purpose of Salam

- Small farmers
- Export traders

Pre Islamic

- In the pre Islamic days whenever a buyer does a salam transaction, the quantity and date of delivery was not pre-determined
- This means it is *gharar*

Legitimacy

- Under the strict rules of contract in the Shari`ah, this kind of sale would be unlawful, because the seller sells goods which is not yet in existence or not in the seller's possession.
- **Hadith**: "Do not sell what you do not possess"
- During the reign of Abu Bakar and Umar r.a. Ibn Abbas narrated that when the Prophet s.a.w. arrived at Madinah, he found that its inhabitants practiced forward (salam) transactions in fruits for one, two and three years. The Prophet s.a.w. then said the following:

  "Whoever enters into a forward contract let him specify a known volume or weight, and a known term of deferment."

Legitimacy

- "O you who believe! When you deal with each other in transactions involving future obligations in a fixed period of time, put them in writing." (Al-Baqarah, 2:282) = **Al Quran**
  - Ibn Abbas also referred to this verse when explaining the salam contract.
- Hadith: “Whoever wishes to enter a contract of salam, he must effect the salam according to a specified measure, and a specified weight, and a specified date of delivery.” (Bukhari, Muslim, Abu Daud, Tirmizi, Nasa’I, Ibn Majah)
- **Ijma’** (the consensus of the jurists)

Advantages of Salam

- Financing Aspect: Beneficial to the seller, because he receives the price in advance
- Hedging Aspect: Beneficial to the buyer (provider of capital) as a protection against the possible future rise in price
- Lower than the spot market price

Exceptions from Ordinary sale

- Non-existence of the commodity
- Payment must be spot and full (no installment) – except for Malikis: allowing for 2-3 days late.

Subject Matter of Salam

- Normally agricultural and natural product.
- Only for commodity which can be specified exactly in quantity and quality. Precious stone cannot be sold by salam.
- Measurable and weighable items (fungibles)
- Generally available in the market
- Cannot be effected on a particular product or commodity or on a specific source

Payment and Price

- Money and non-monetized object (barter)
- In barter, it must not be the subject of *ribawi* items of the same *'illah* (legal reasoning), eg. Wheat for barley cannot be delayed; gold for silver cannot be delayed. Hence, they cannot be subject to Salam.

Delivery

- The exact date of delivery must be specified in the contract.
- There is a minimum date of delivery, long enough to affect prices
- It is better to specify the place of delivery, according to Malikis.

Hanafi’s opinion

- The Hanafis argue that the commodity should be present in the market from the time the contract is concluded until the delivery is made. This is to make sure that the seller is capable of delivery if his own crops are destroyed by causes beyond his control. The majority of the schools are of the opinion that it is sufficient that the commodity is available in the market during the time of the delivery.

Issue in Salam

- Can the buyer dispose of the commodity sold to him by reselling it to a third person before it was actually handed over to him from the original seller? The Schools are all of the opinion that this action is not acceptable from the Shari’ah point of view.
- “Whoever buys foodstuff (or anything), he should not sell it (to others) before he receives it, or possess it.” Hadith

Salam as a Mode of Financing

- The price in salam may be fixed at a lower rate than the price of commodities that are delivered on the spot. The difference between the two prices is the profit
- The issue is that banks are conversant in dealing with money only. Keeping commodity would be cumbersome.

Alternatives of using Salam as a Mode of Financing

1. Banks should establish a special cell for dealing in commodities
2. After purchasing a commodity through salam, the bank can sell it again but through a parallel salam for the same date of delivery. Because the 2nd salam has a shorter delivery time the price may be a little higher

Alternatives of using Salam as a Mode of Financing

3. If a parallel salam is unattainable, a promise to purchase from another buyer is possible. Because it is a promise, the buyer doesnt have to pay the price in advance.
4. Selling the salam commodity back to the seller at the date of delivery at a higher price. This is Bay Al ’ina, it is prohibited.

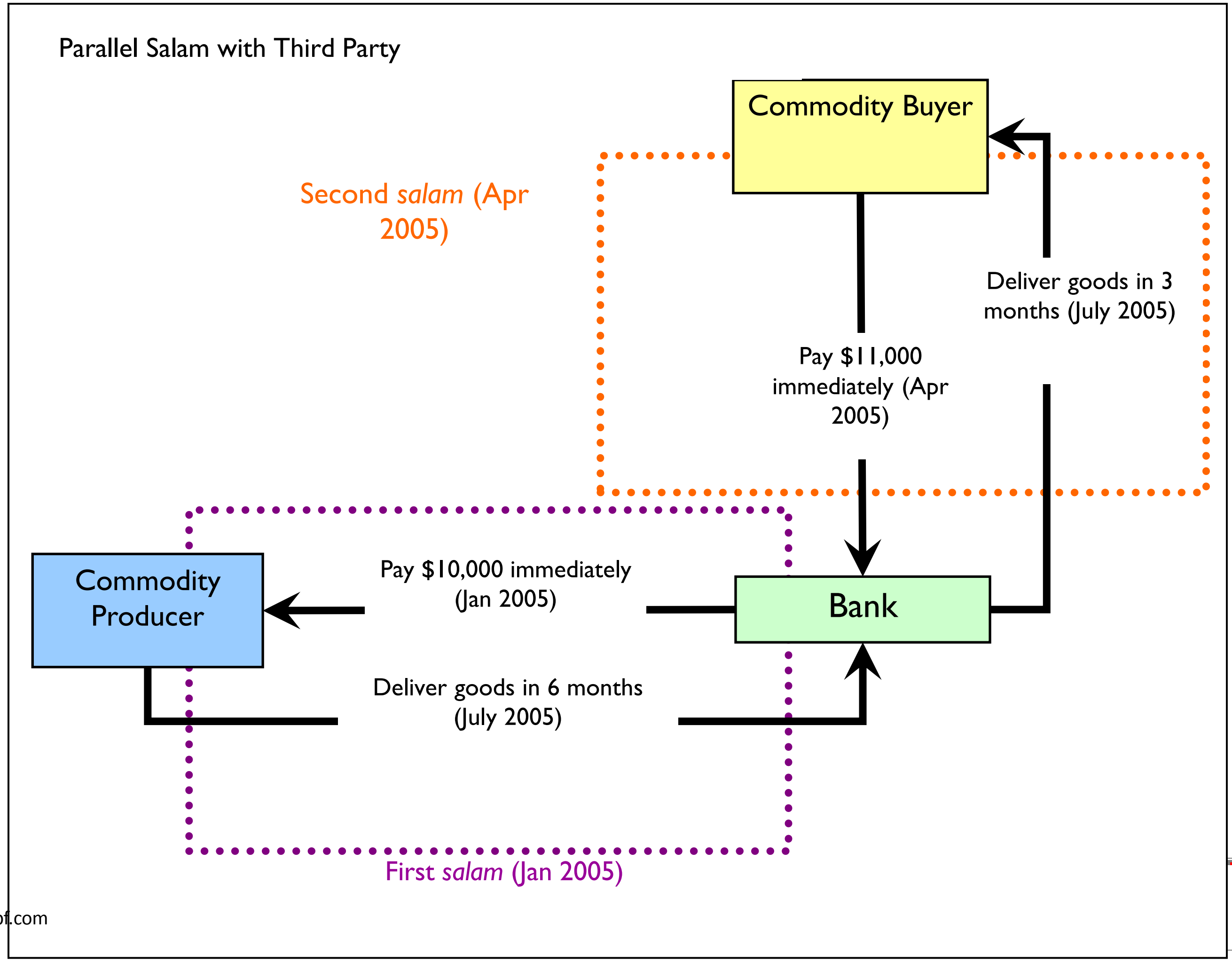
Salam as a Mode of Financing

- The price in salam may be fixed at a lower rate than the price of commodities that are delivered on the spot. The difference between the two prices is the profit
- The issue is that banks are conversant in dealing with money only. Keeping commodity would be cumbersome.

Modus Operandi of Salam Financing

- Parallel Salam: after purchasing a commodity by way of salam, the bank may sell to a third party through another contract of salam for the same date of delivery. The period of the second salam is shorter, so the price is higher. Therefore, the difference is the profit for the bank.
- Should be no “double sale” (‘inah) in Parallel salam.

Applications of Salam in Islamic Banking and Finance : **Parallel Salam with a Third Party**

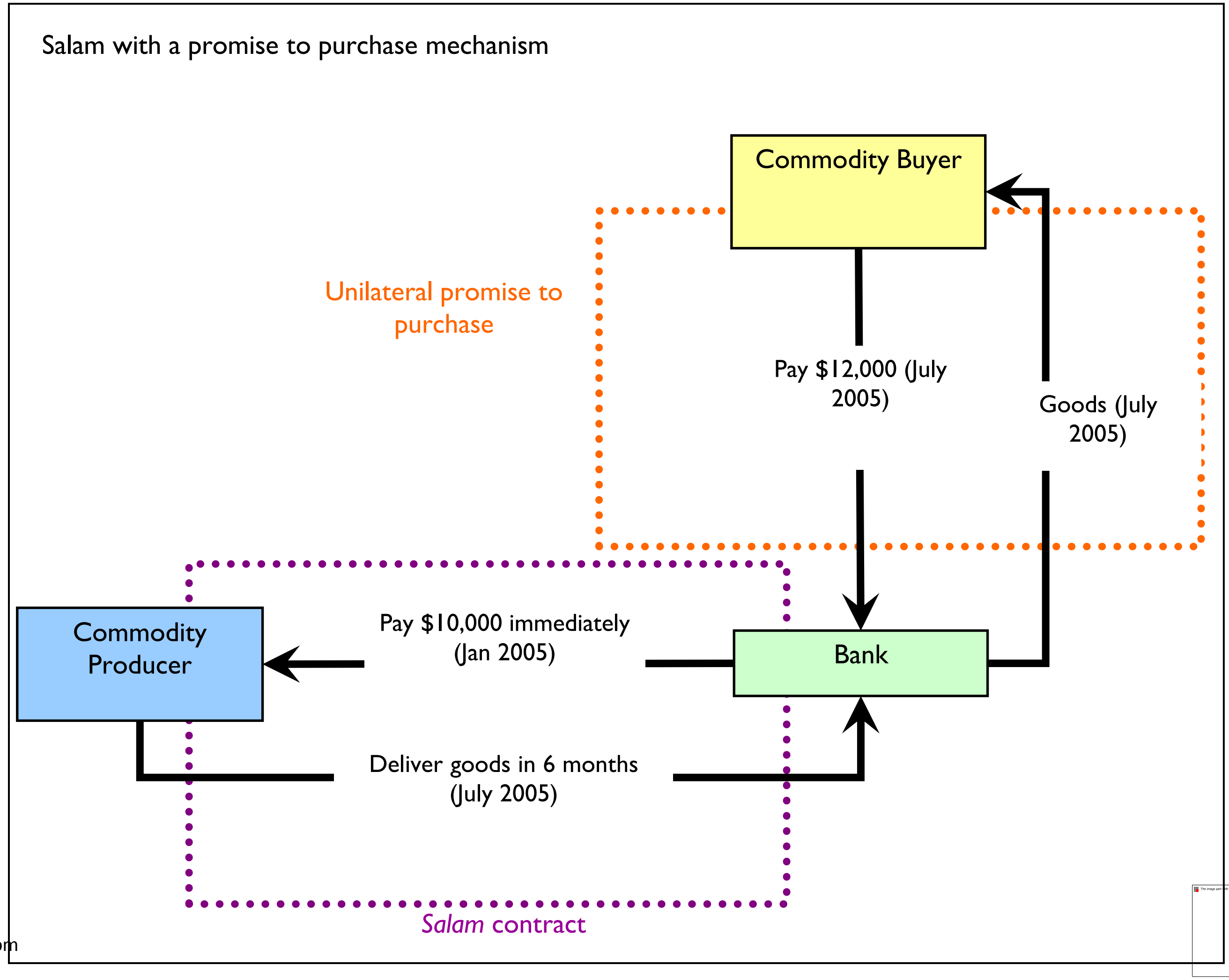


Applications of Salam in Islamic Banking and Finance : **Parallel Salam with a Third Party**

EXAMPLE

- Islamic bank (financier) enters into a first salam contract as the purchaser (muslam) and pays US$10,000 in advance to the seller (muslam ilayhi) on January 2005. The commodities are to be delivered in six months later (July 2005).
- Then, Islamic bank enters into a second salam contract as the seller (muslam ilayhi) on April 2005 (3 months before the delivery date) with the commodity buyer (bank's customer) who pays US$11,000 on spot basis. The commodities are to be delivered three months later (July 2005).
- In the final analysis, under the first salam contract, the commodities are delivered to Islamic banks, which are subsequently delivered to the salam buyer under the second salam contract, also known as parallel salam. The period of salam in the second (parallel) transaction being shorter, the price may be a little higher than the price of the first transaction. The shorter the period of salam, the higher the price, and the greater the profit. In this way the banks may manage their short term financing portfolio.

Applications of Salam in Islamic Banking and Finance : **Parallel Salam with a Promise**



Applications of Salam in Islamic Banking and Finance : **Parallel Salam with a Promise**

EXAMPLE

» Client approaches bank for financing a purchase of commodity, signs a letter of undertaking stating his promise to purchase the commodity on July 2005.

» Once obtaining the client's undertaking, bank enters into a salam contract as the purchaser (muslam) and pays US$10,000 cash immediately to the commodity seller (muslam ilayhi) on January 2005. The commodities are to be delivered in six months time (July 2005).

» On July 2005, upon receiving and taking possession of the commodity from the commodity producer, the bank enters into a sale contract with the commodity buyer. The price of the commodity can now be charged at a higher price than the salam price as long as both parties agreed to that condition or according to the terms of the promise.

The Contract of Istisna’

Bay’ al-Istisna’

- Derived from the root word sana’ which means to manufacture or to construct something
- Definition: A sale of manufactured commodity delivered at a future date for a flexible method of payment.
- Special feature: Delivery is at future, and the payment can be spot, deferred, or installment.
- Financing and Hedging facilities.

Legitimacy

- The majority of jurists (except Hanafi jurists) considered istisna' as part of salam
- Istisna' exists only in the Hanafi school on the basis of istihsan.
- In other schools, the manufacture goods is dealt with salam.
- "O you who believe! When you deal with each other in transactions involving future obligations in a fixed period of time, put them in writing." (Al-Baqarah, 2:282)

Legitimacy

- A tradition of the Prophet s.a.w. whereby it was reported by Bukhari and Muslim that the Prophet s.a.w. requested a ring and a mimbar (a platform for delivering sermons) to be manufactured for him
- Ijma'

Difference between Istisna' and Salam

☐Type of Goods

- Homogenous commodities with a ready market and does not require manufacturing or construction
- Assets requiring construction or tailor-made manufacturing

☐Motives

- Serves the need of the seller for liquidity
- Serves the need of the buyer to get the goods according to his specifications

☐ Payment of price

- The buyer needs to pay the full amount of the price at the time of the contract
- The buyer has the various options whether to pay on spot, deferred, instalment, progressive payment, or any other combinations as agreed by the seller.

Difference between Istisna' and Salam

- **Time of Delivery**
  - Goods to be delivered in the future & delivery date must be fixed upfront
  - Goods to be delivered in the future & however according to Hanafi, the time of delivery must not be fixed, otherwise it would be regarded as salam will all its requirements applied
- **Cancellation of Contract**
  - The contract of salam once concluded constitutes an irrevocable contract whereby no parties can cancel the contract without the consent of the other party.
  - Serves The contract of Istisna' allow parties to revoke the contract before the commencement of work.

Difference between Istisna’ and Ijarah

- All the materials are provided by the manufacturer in bay’ al-istisna’. The buyer pays for the ready made article.
- If the buyer provides the materials, then it is not istisna’; it is ijarah.
- Going to a tailor without clothing material is istisna’, but with clothing material from the buyer is ijarah (i.e. renting the service of the tailor).

Conditions on Price

- The price must be clearly defined and known in advance
- The price can be in the form of cash or usage of another property or the subject matter of istisna'. For example, in the case of build operate transfer (BOT).
- The payment may be made in advance, deferred or paid on instalments as per stages of completion. This makes istisna' more flexible than salam
- The price may vary according to variation in delivery dates

Conditions on Goods

- The goods in istisna' must be created by the process of transforming raw materials from their natural state to other forms of goods by a manufacturing or construction process involving labour
- The goods should be susceptible to specification
- The goods may be provided from any source unless the purchaser specified that the goods must be manufactured by the seller
- The parties may agree on a defect liability period or just leave it to customary practice

Conditions on Delivery

- The manufacturer may act as an agent to sell the good on behalf of the purchaser. The goods should be susceptible to specification
- The penalty clause is allowed in istisna' against the manufacturer or contractor

□ A penalty clause is not allowed once the goods are submitted and the purchaser is about to make payments. This is because the liability of the purchaser in this case is not tangible goods but rather receivables in which charging late payment amount will dilute the validity and acceptability of the transaction.

Istisna’ as a Mode of Financing

- Financier undertakes housing construction to be sold by istisna’ to the client looking for financing facility. The financier may hire the service of the developer or have parallel istisna’ with the latter.
- Government may deal with the contractor to build a highway by istisna’. The payment is the right to collect tolls for a specific period. The contractor may have a mudarabah contract with an Islamic bank to get the finance.

The Contract of Partnerships: Musharakah and Mudharabah

Pointers on Musharakah

- Musharakah is a new term that is not found in the book of Fiqh
- The word *Shirkah* is used in Fiqh, the mixing of two capital where each property can no longer be recognized seperately
- Musharakah is an ideal Islamic long term collective investment mechanism consistent with the core objectives of Islamic economic systems. It is used as investment in or financing of underlying assets

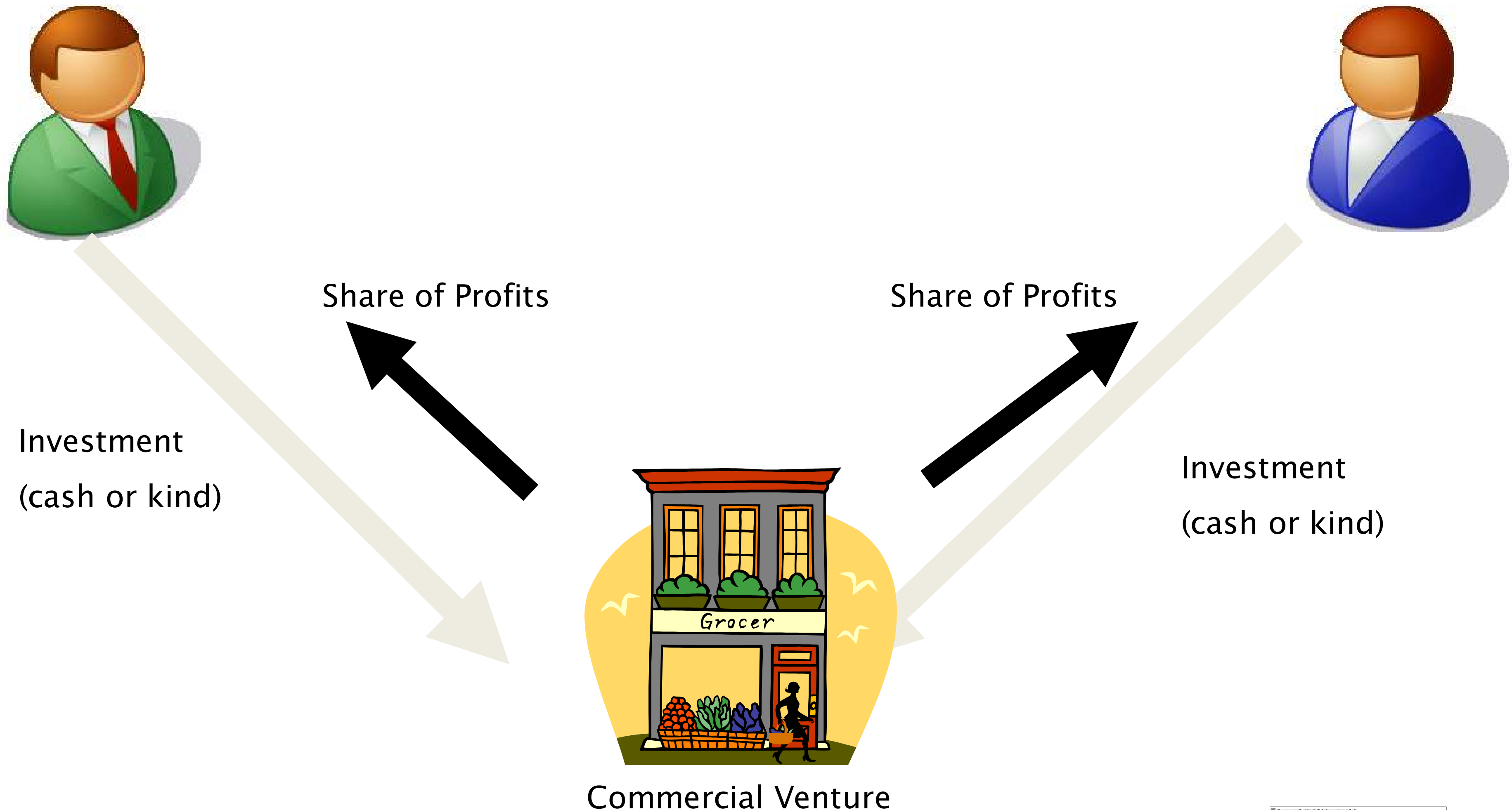
Legal Basis of Musharakah

- The Quran

  “O ye who believe! Profane not Allah's monuments nor the Sacred Month nor the offerings nor those garlands, nor those repairing to the Sacred House, seeking the grace and pleasure of their Lord. But when ye have left the sacred territory, then go hunting (if ye will). And let not your hatred of a folk who (once) stopped your going to the inviolable place of worship seduce you to transgress; but help ye one another unto righteousness and pious duty. Help not one another unto sin and transgression, but keep your duty to Allah. Lo! Allah is severe in punishment.” (Al-Maidah: 2)

- Hadith
  - "I am the third of every two partners as long as neither one betrays the other. However, if one betrays the other, I leave their partnership" (Narrated on the authority of Abu Hurayrah by Abu Dawud and Al-Hakim, who validated its chain of narration)
  - "Allah supports the partners as long as they do not betray one another", (Reported by Ibn Qudamah)
- Ijma’

Diagram of Musharakah



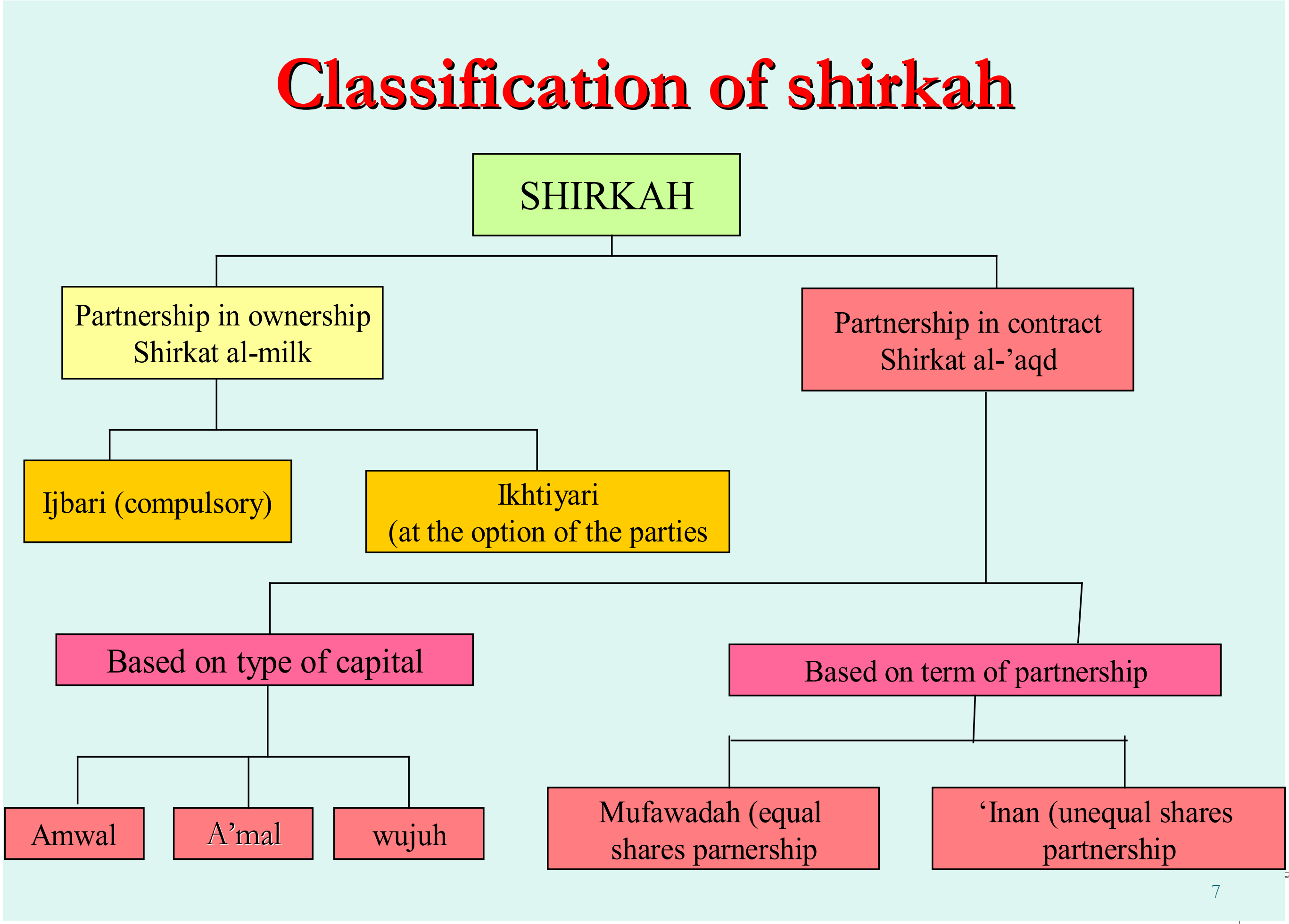
Types of Musharakah

1. Shirkat ul Milk: Partnership by joint ownership
   - Optional (ikhtiari)
   - Cumpulsory (ghair ikhtiar / jabr)

2. Shirkat ul Aqd – Partnership by contract
   - Shirkat ul Amwal (patnership in capital)
   - Shirkat ul Aamal (partnership in services)
   - Shirkat ul Wujooh (parnerhsip in goodwill)

- Shirkat Al Mufawada & Shirkat ul Ainan

Shirkah Diagram



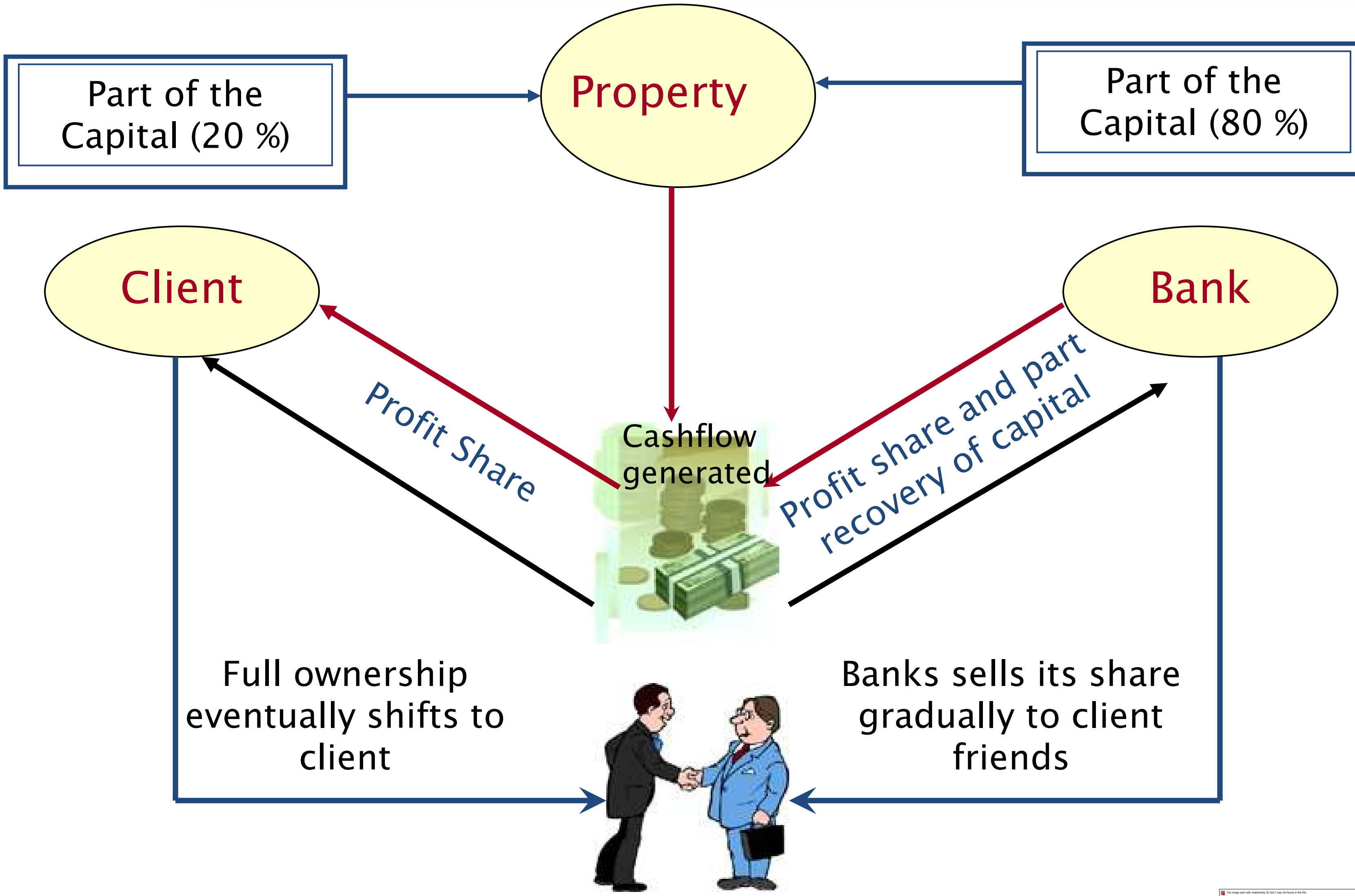
Necessary Conditions of Musharakah

- Quantification of profit sharing percentages (%) at inception of contract
- No predetermined amounts of principal (% of principal)
- Loss should be shared according to contributed capital
- Can be deferred to be covered by future profits (only in case of on - going Musharaka)
- But Guarantee against negligence & misconduct of partner is permissible.

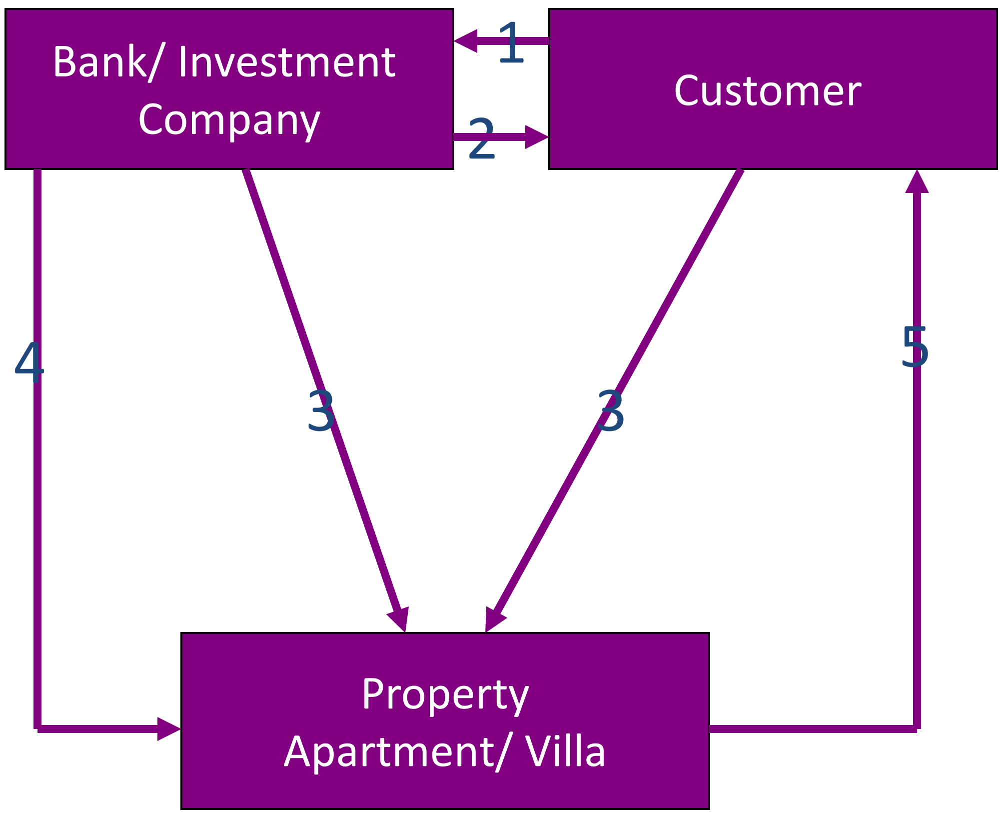
Diminishing Musharakah

- Islamic banks often use diminishing Musharakah in corporate finance-funding working capital and fixed assets.
- Diminishing Musharakah is the case wherein one party agrees to pay out his counterparty gradually.

Diminishing Musharaka Structure



Diminishing Musharaka Structure



1. Customer selects house and applies to financier.
2. Financier approves consumer and house.
3. Financier and consumer jointly buy house and obtain title in common tenancy.
4. Although both co-owners would have the right to occupy the property in this transaction, Bank gives the customer the exclusive right of the whole property. In exchange Bank will charge a **Rent** to be paid by the customer.
5. In addition Customer undertakes to buy the equity of the bank and ultimately becomes the sole owner of the asset.

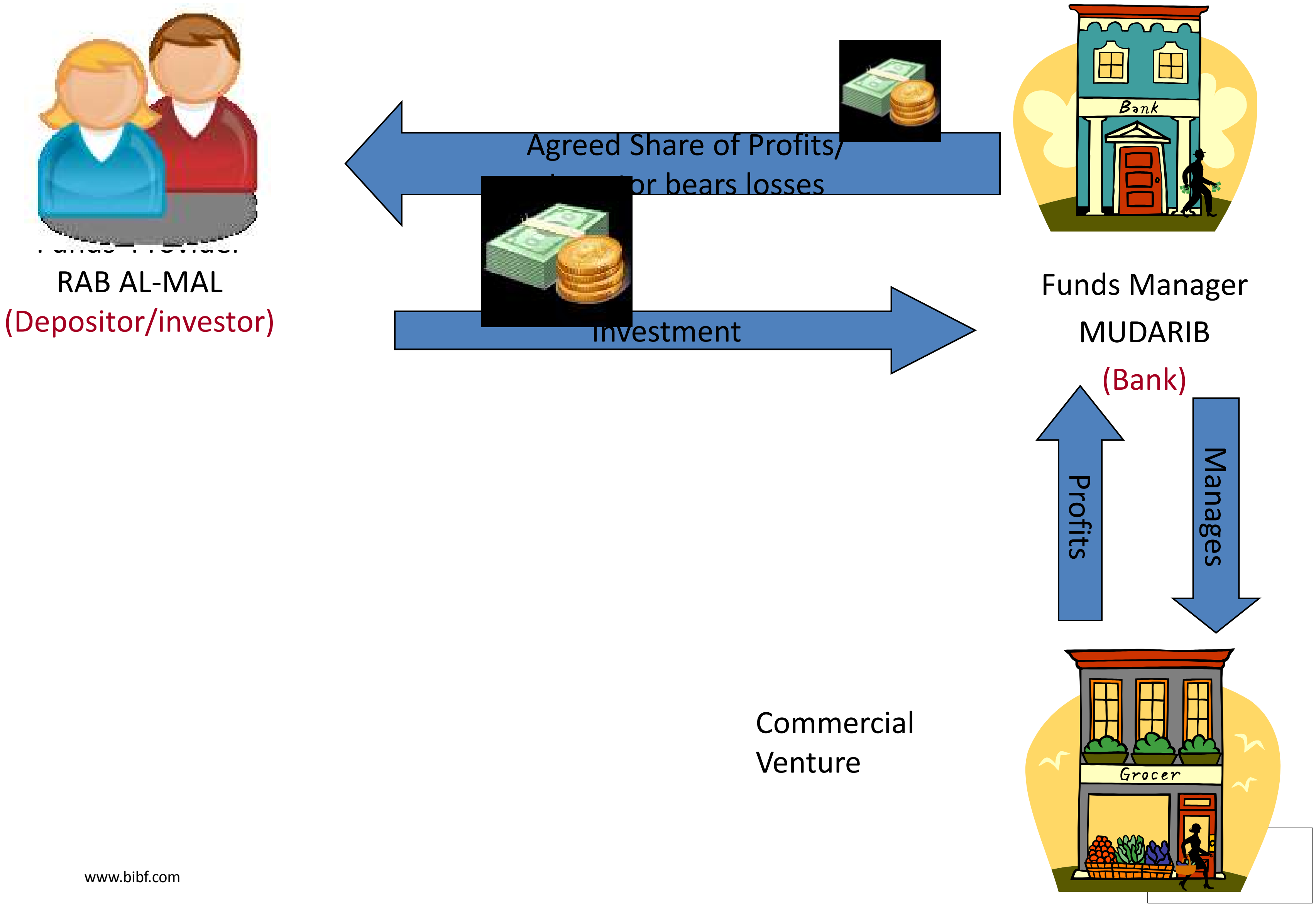
Pointers on Mudharaba

- The word is derived from surat Al Muzammil verse 20
- Other terms are ‘Qiradh’ or ‘Muqaradah’
- It is a profit sharing contract in which one party provides capital, and the other work and management

Legal Basis of Mudharabah

- The Qur’an - Al Muzammil 73:20
- The Sunnah - Ibnu Abbas & Ibnu Majah acknowledged on mudharib requirements
- The Practice of Muslim Society
- Affirmation of a pre-Islamic practice.

Diagram of Mudharabah



Types of Mudarabah

1. *Mudarabah Mutlaqah* (unrestricted / URIA)
   – No restriction on type, place, and time of business
   – It is up to the discretion of the entrepreneur to run the business according to his expertise and experience
   – Needs major degree of confidence and trust
   – Lower position of capital

2. *Mudarabah Muqayyadah* (Restricted / RIA)
   – To impose some terms and conditions in the business.
   – Violation of the terms would subject the entrepreneur liable for the loss
   – Needs less degree of confidence

Necessary Conditions of Mudarabah

- Capital must be in monetary form. Some agree that other asset is acceptable, if it is valued at the beginning of the contract.
- Capital not yet accepted is not allowed (exclusion of debt)
- Profit is shared according to ratio agreed upon. A fixed amount is not allowed.
- The loss is borne by the provider of the capital.
- The capital provider cannot intervene day-to-day business operation.
- *Sub-mudarabah* is not allowed without the permission of the first capital provider.
- *Mudarib* cannot claim any periodical salary or a fee or remuneration for the business.
- Guarantee is permissible but on the negligence of the Mudharib

Application in Islamic Banking and Financing

- Applicable in all investment accounts, i.e. general and special investment account
- Financing side: for single transaction such as day-to-day needs of small traders, or single export or import activity.
- Long term investment or Project Financing, such as building an airport, real estates, high way, etc.

Conventional Finance	Alternatives in Islamic Finance
Consumer Loan Finance	Murabaha Finance/Ijara
Personal Loans	Tawarroq Finance
Mortgage Loans	Ijara wa Tamleek
Corporate Loans	Murabaha, Ijara
Working Capital	Istisna, Salam/Murabaha
Supplier Finance	Salam/Istisna
Project Finance	Istisna/Ijara
Trade Finance	Murabaha/Salam
Secured Debt (provides claim on specific asset)	Ijara (provides security interest on specific asset)
Foreign Exchange	Sarf (forward contracts not acceptable)
Transfers (Local and cross-border)	Wakalah
Overdraft	Qard Hasan (Loan without any benefit or interest to the bank)/ Tawarroq (with profit markup)
Renting Safe Boxes	Ijarah
Draft cheques	Wakalah if cheque currency same as payment currency
Custody and keeping of belongings	Wadiah contract
Collections	Wakalah or Joa'la

The Contract of Ijarah

Definition

- Literally means compensation, reward, or consideration
- Juristic definitions lead to three signifcant aspects of Ijarah:
  - ijarah contract is well-understood as a contract to give the ownership of a particular usufruct
  - comprise three essential pillars of an ijarah contract, namely, consent of the contracting parties, a specific asset to be leased out and rental payments
  - the usufruct which is the subject of ijarah contract must be identified and capable of being legally and reasonably utilised

Definition & Basic Terms

- Ijarah is a contract in which the owner of a property transfers a legal right to use and derive profit from the property, to another person, for an agreed period, at an agreed consideration.
- The owner is called a lessor (mu'ajir); the person who uses the property is known as a lessee or hirer (musta'jir); the subject matter is the usufruct of the property (manfa'ah); and the consideration refers to a rent (ujrah).

Legitimacy

- The Quran
  - Al Qasas, 26-27: One of the two women said: O my father! Hire him! For the best (man) that thou canst hire is the strong, the trustworthy. He said: Lo! I fain would marry thee to one of these two daughters of mine on condition that thou hirest thyself to me for (the term of) eight pilgrimages. Then if thou completest ten it will be of thine own accord, for I would not make it hard for thee. Allah willing, thou wilt find me of the righteous
  - At-Talaq, 6: Then, if they give suck for you, give them their due payment and consult together in kindness; but if ye make difficulties for one another, then let some other woman give suck for him (the father of the child)

Legitimacy

- Sunnah
  - “Give a worker his fee before his sweat dries up”
  - “He who hires a person should inform him of his fee”
  - “We used to lease out land for some portion of the agricultural products and the Prophet s.a.w. prohibited us from such (practice). Instead, he asked us to lease it out for gold and money.”

- Ijma’

Types of Ijarah

- Operating lease - Al-ijarah ‘ain
  - In operating lease, the bank may already own a property which it wants to lease it out. In other words, operating lease is normaly not preceded by a promise to lease or the concept is not based on prior promise
- Financial lease - Ijarah Muntahia Bittamleek
  - It is necessary to clearly state the method of transfer of ownership in the agreement
    - Promise to transfer the ownership on the basis of ordinary or conditional gift
    - Promise to transfer the property through sale
- Other Classifications of Ijarah

Necessary Conditions of Ijarah

The Two Contracting Parties

The Lessor

- Lessor must have full possession & legal ownership of object before ijārah contract is made effective
- After conclusion of ijārah contract, he must give possession of the leased object to lessee, while still holding ownership title of the property
- He must deliver the property on time
- It is the duty of the lessor to maintain the leased property in order to retain its benefit which is to be used by the lessee.
- As an owner, he will bear all liabilities arising from the ownership

Note: Al-Rajhi Bank asserts that the lessor also bears most liabilities attached to the leased object such as damage to the object, cost of replacement of durable parts and other costs of basic maintenance. The lessor can authorise the lessee to undertake all the above liabilities, but the costs must still be borne by the lessor.

Necessary Conditions of Ijarah

The Two Contracting Parties

The Lessee

- He shall act as a trustee of the lessor in treating the leased property properly
- He must take reasonable care of the leased property and cannot use it in a harmful way
- In the event of negligence or misuse on part of the lessee, which may have damaged the leased object, he shall be liable to indemnify the lessor
- It is the lessee’s duty to bear any cost of ordinary routine maintenance

Necessary Conditions of Ijarah

Offer and Acceptance

- An offer and acceptance must be expressed clearly to show the party's intention
- A definite acceptance is made in response to a definite offer in the same session
- Acceptance must correspond exactly with the offer

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Necessary Conditions of Ijarah

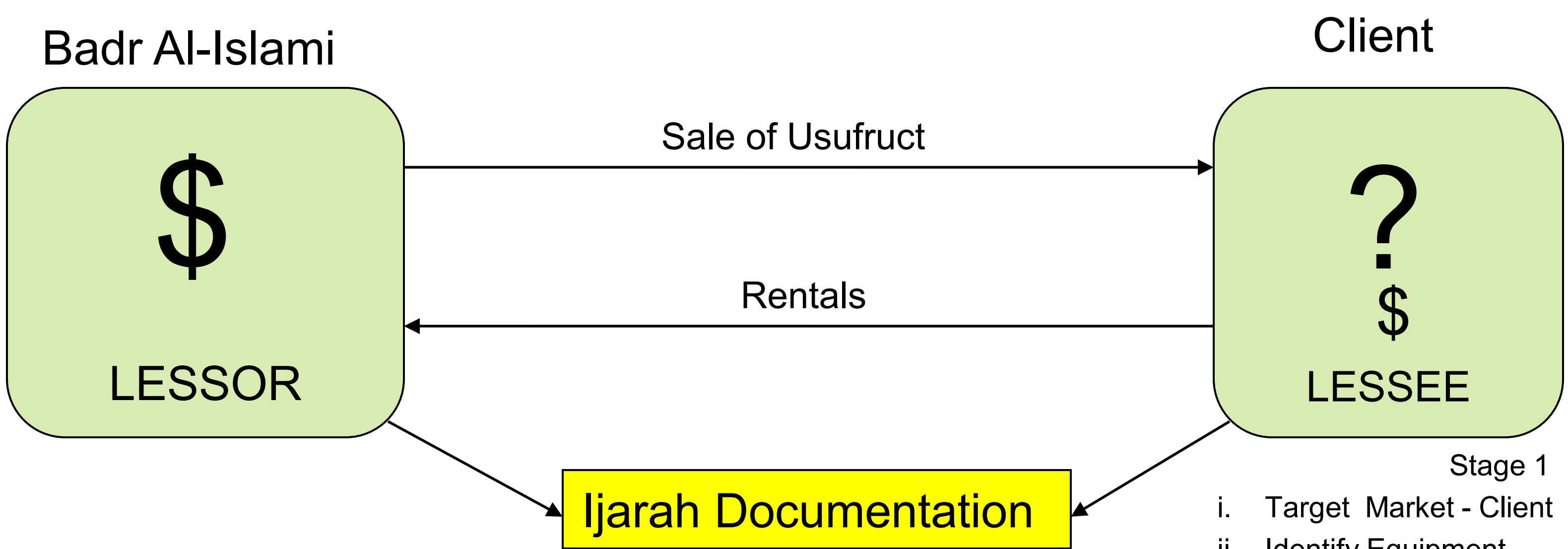
Subject

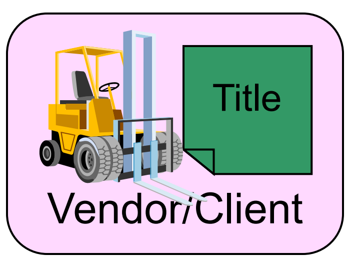
- It must have a valuable use, thus, a thing having no usufruct at all cannot be leased
- It must not be perishable for the whole period of lease
- It must be actually and legally attainable, thus, to lease something which cannot be delivered is not permitted
- It should be precisely specific
- It is necessary to make known the purpose for which the asset is rented. It must be free from ambiguity (jahala) and uncertainty (gharar)
- In commercial sectors, it is not permitted to lease a property to a company that will use it for Shari'a prohibited activities, such as to convert it into a gambling centre or bar
- The period for using it must be fixed and agreed upon by both parties. Renewal terms must also be stated clearly and should not be left to the lessor's discretion
- It is permissible to lease the property to those whose major activities are *Íalāl* or permissible even they involve some secondary prohibited activities

Apllications of Ijarah in Banking & Finance

1. Operational Ijarah
2. Al-Ijarah Thumma al-Bay’ or Muntahi Bittamleek
3. Ijarah in Credit Cards
4. Ijarah Mawsufa fii Al Dhimmah
5. Ijarah Securities

Operational Ijarah





Stage 1

i. Target Market - Client Selection.
ii. Identify Equipment .
iii. Client's Request for Ijara Facility.
iv. Bank's Approvals.

Stage 2

i. Complete Ijara Documentation.
ii. Client's contribution Margin.
iii. Bank's Contribution of Price.
iv. Bank Purchases Equipment.

Stage 3

i. Bank Leases Equipment to client.
ii. Client Pays Regular Rentals.

Stage 4

i. Payment of all rentals – Lease concluded.
ii. Equipment Transferred to Lessor.

Operational Ijarah – Target Market

Capital Intensive Industries:

- Oil exploration & transportation.
- Refineries & distribution.
- Construction and contracting Industry
- Transportation and infrastructure.
- Manufacturing and Industry.
- Marine and Off-shore.
- Tele communication.
- Service businesses.

Operational Ijarah – Equipments Leased

Nature of Assets for Equipment Leasing:

- Heavy equipment and machinery
- Construction equipment and machinery.
- Transportation equipment.
- Industrial Machinery and equipment.
- Power generation equipment.
- Marine equipment.
- Plants and manufacturing machinery.
- Telecommunication equipment.

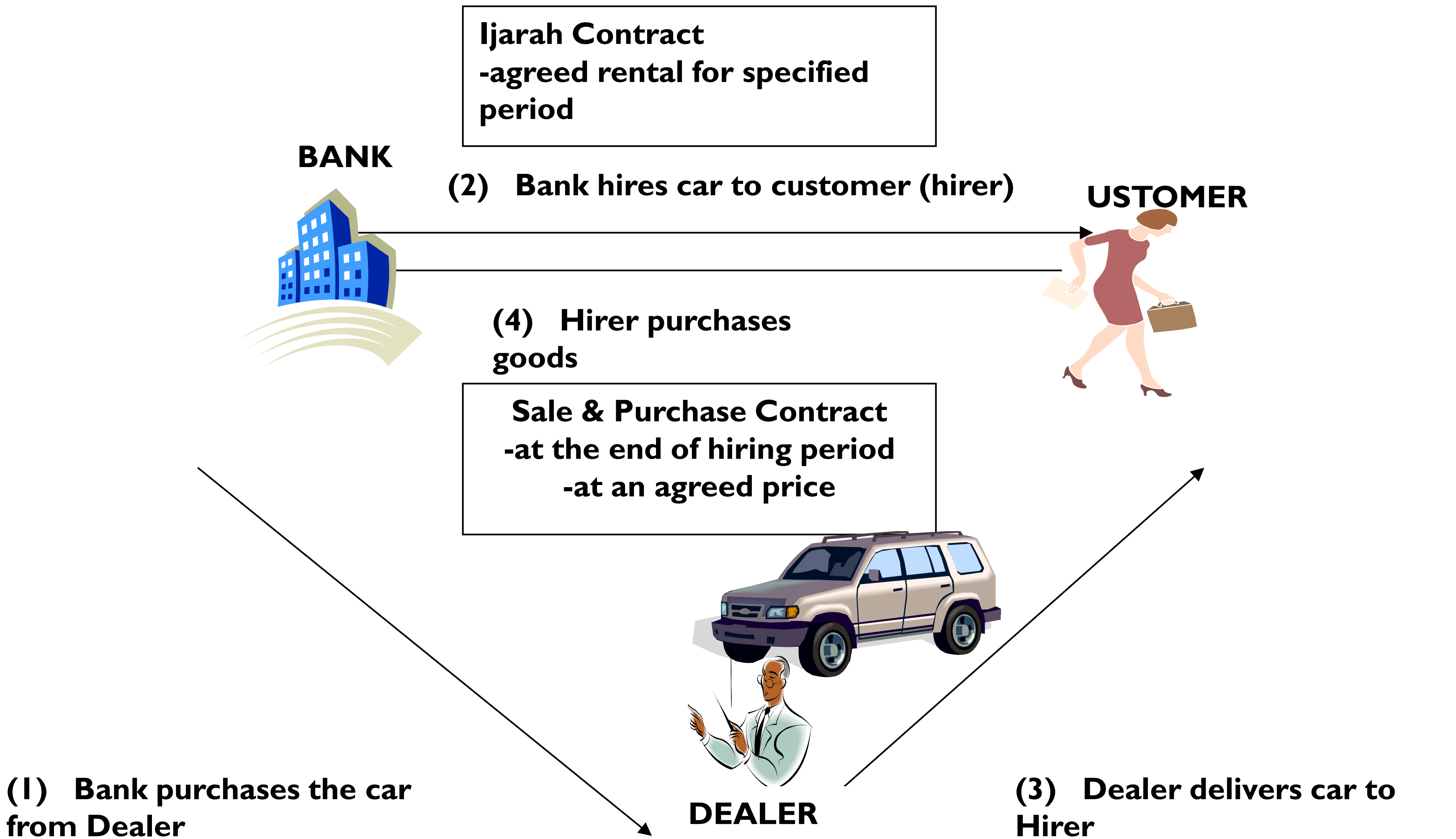
Ijarah Financing / IMBT

- Consists of two different contracts:

1. Contract of lease or *al-ijarah*
2. Contract of sale or *al-bay'*

   "It is a well settled rule of Islamic jurisprudence that one transaction cannot be tied up with another transaction as to make the former a precondition for the other."

Ijarah Financing Stages



Ijarah Financing Stages

1. Finance Company buys the vehicle from Vendor or car dealer, based on the order of the Customer.
2. Finance Company rents the vehicle to the Customer at a rate agreed upon for a specified period of time. The Customer (hirer) agrees to pay for road tax and insurance coverage. He also will be responsible for its maintenance.
3. At the end of the period the Finance Company and the Customer will sign the sale and purchase agreement.

Ijarah Security

- In order to recover the cost of the asset purchase, the lessor, after entering into *ijarah*, can sell the leased asset partly to a number of individuals.
- The purchase of the portion of the asset by each individual may be evidenced by a certificate which may be called *ijarah* certificate.
- As the asset is already leased to the lessee, the individual new owners of the asset may also enjoy the rent payment proportionally.
- On top of that, the holder of *ijarah* certificate can sell it in secondary market.

Conventional VS. Islamic Lease

	Conventional	Islamic
Rental payments	At time of funding through term of contract	• Only when asset is delivered. • No payments if asset is out of order
Risk of Destruct. / loss	Often transferred to lessee	Remains with lesser, except in case of negligence or misconduct or breach of contract
Ins. & Main. cost	Often on lessee	Has to be on Lesser, except minor expenses not essential for performance of leased asset
Pricing	Variable or fixed	Variable or fixed (first rental payment has to be fixed)
Penalty For late payment	Yes	If enforced has to be paid out in charity

No such thing as a finance lease in pure Islamic nominate contracts

Comparison- Murabaha and Ijarah

Murabaha	Ijarah
Prior promise to buy	Promise not necessary
Sale of Assets	Sale of usufruct
Mark-up on the cost	Profit is realised from rent
Short term financing mechanism	Long-term financing mechanism
The price is fixed	The rent may be revised

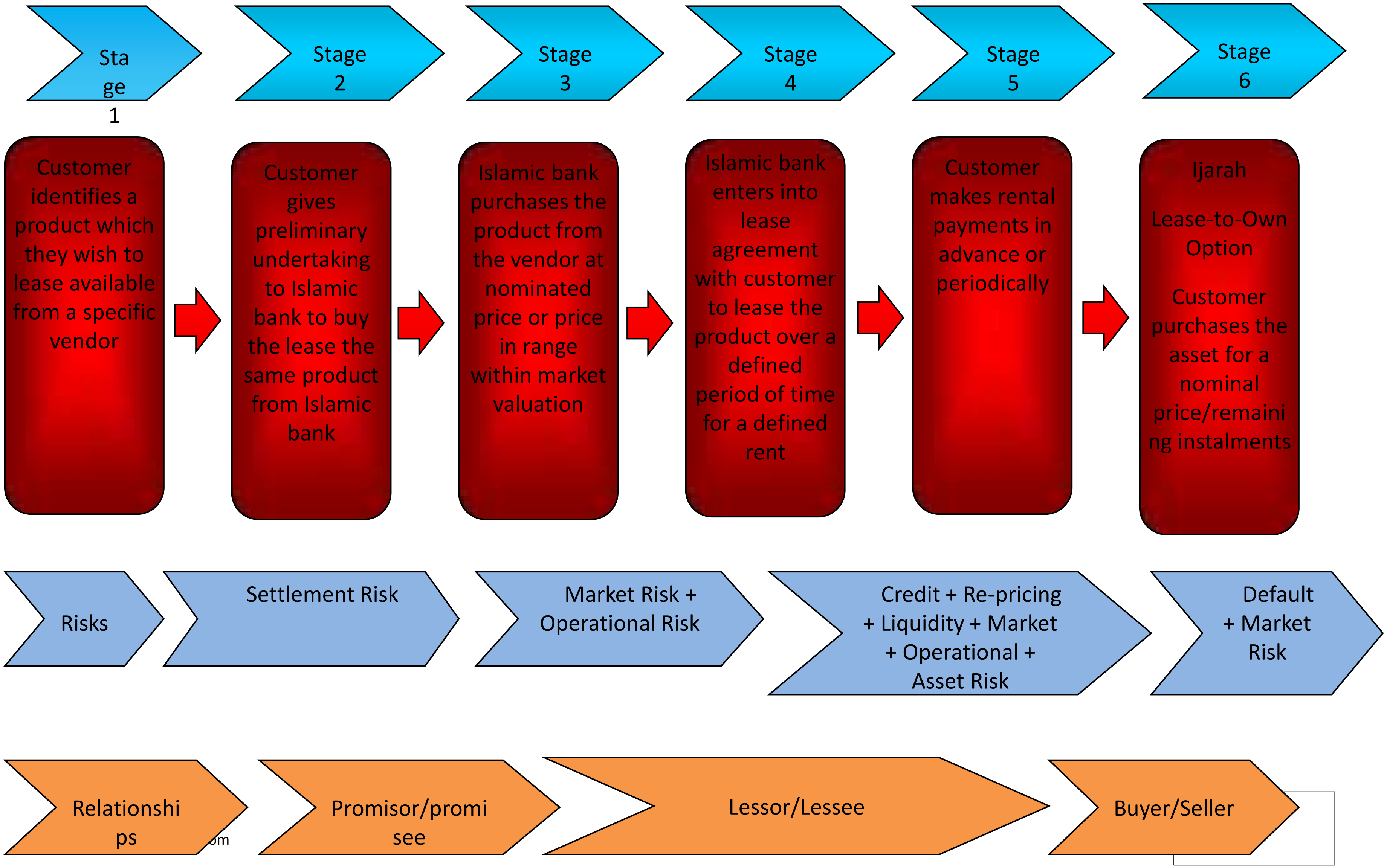
Comparison- Murabaha and Ijarah

Murabaha	Ijarah
Asset Ownership necessary	Asset not yet bought or benefit may be leased
The cost must be disclosed	It is not necessary
Necessary to disclose full mark-up	Necessary to show rental of the first period: in case of Floating rate
Ownership is transferred when contract Is signed	Ownership should be transferred later-in case of Ijaram Muntahia B.
The terms and profit are not changeable	The period and rental may be adjusted
No obligation for rebate for early payment	Obligation to give discount possible

Conventional VS Islamic Home Finance

Conventional mortgage finance	Islamic home finance
• Ownership with the customer where the financier holds mortgage over the asset	• Structured only as an operating lease where the ownership of the asset remains with the financier
• Late payment penalties or penal interest is levied	• No late payment penalties – no income for the lessor (A flat fee to cover collection charges can be levied)
• Early settlement fees and termination charges are applicable	• No early settlement fees or termination charges
• Insurance cost borne by the customer	• Only Life Insurance paid by the customer or by the Company and recovered from the customer - either as a lump sum or with monthly installments (i.e. customer preference)
• No recovery on premium under conventional insurance	• Insurance to be under Takaful whereby the customer may be able to recover a certain portion of the premium in case the Islamic insurance company makes profits

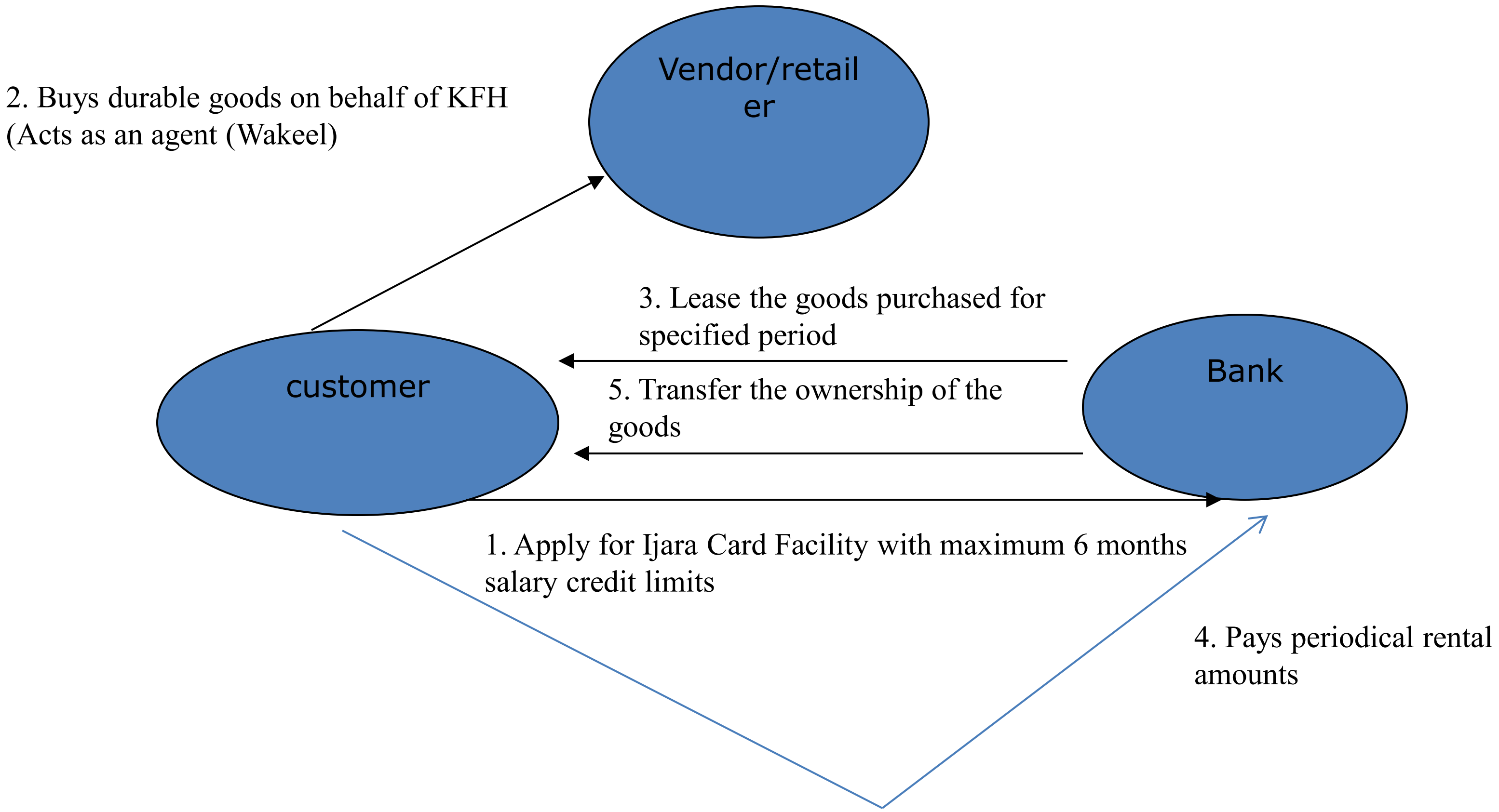
Risks in Ijarah



Kuwait Finance House Credit Card

- Al-Ijarah credit card allows cardholders to acquire durable goods on a "lease-to-own“ transaction
- Example: a customer on behalf of the bank (*wakeel*) purchased a TV (BD 50) by presenting his Ijarah card in Geant. The bank then immidiately enters into a “leases-to own” transaction with the customer where by the TV will be rented to the customer for 12 months (BD 5/month) and sold at the end of the period at the price of BD 1.

Ijara Card - KFH



Advantages

- Shari'a complaint
- Maximum credit (6 times the salary)
- Fixed profit rate of 0.7% per purchase (the lowest rate within the country)
- Easy repayment s with a choice of financing period of two years.
- Enhanced flexibility and speedy processing times.
- Reduces worry of private credit risk, as with credit cards
- 0% Merchant fee
- Simple, easy, and effective

Disadvantages

- Only certain product (durable goods) can be purchased and not services such as car accessories, furniture, house hold appliances, electronics , etc.

- The good should be from pre-approved list of merchants only.

- It has a limited market so far, and people fear the new !