EXCEPTIONAL SALES: SALAM AND ISTISNA'

- *Murabaha* and *ijara* constitute the core financing activities of Islamic banks. They are easily understood because of their proximity to conventional financing techniques, such as, installment sales and leasing.
- Nevertheless, other debt-based financing techniques are currently making their appearance on the Islamic finance scene.
- Before discussing these products it is important to remember that in order for a commodity to be sold while still abiding by *Shari'a* law, three conditions must be satisfied.
    1. The commodity must be in existence
    2. The commodity must be owned by the seller at the time of sale.
    3. The commodity must be in the physical (or constructive) possession of the seller at the time of sale.
- There are only two exceptions to these general principles in the *Shari'a*. One is *salam* and the other is *istisna'*. Both are sales of a special nature.

I. Salam (Deferred Delivery Sale)

The Concept of *Salam*

1. *Salam* (or Bay' As-*salam*) is a forward sale contract whereby the seller undertakes to supply some specific goods to the buyer at a definite future date in exchange for an advanced price fully paid at spot.
2. The main idea behind this type of sale is to meet the needs of small farmers and traders who need money to grow their crops and to feed their families up to the time of the harvest. After the prohibition of *riba*, they could not take interest-based loans. Therefore, it was allowed for them to sell the agricultural products in advance.

3. The permissibility of *salam* under the *Shari'a* was an exception to the general rule that prohibits the forward sales, and therefore, it was subject to more strict conditions than other types of sale.
4. Under *salam* contract, a trader in need of short-term funds sells commodity to the bank on a deferred delivery basis. It receives full price of the merchandise on the spot that serves its financing need at present. At a pre-agreed future date, it delivers the merchandise to the bank. The bank sells the commodity in the market at the prevailing price. Since the spot price that the bank pays is lower than the expected future price, the transaction should result in a profit for the bank.
5. *Salam* is considered a good instrument of Islamic finance because it is beneficial to both the buyer and the seller involved in a transaction.
    - It is beneficial to the **buyer** (the bank) because normally, the price in *salam* is lower than the price in spot sales. This way the buyer will be secured against the fluctuations of prices. The buyer also gets the commodity it is planning to trade on in the time he decides. Because the commodity becomes the liability of the seller who meets his obligation.
    - It is also beneficial to the **seller**, because he receives in advance the money he wants in exchange of his obligation to deliver the commodity later. He benefits from the *salam* sale by covering his financial needs whether they are personal expenses, family expenses or expenses for productive activity

Salam Process

- A simple *Salam* process is presented in the following steps:
    1. Client sells commodity X to Bank on forward basis and receives price P in time period 0;
    2. At future time period t, Client delivers X to Bank.
    3. At the time of the delivery of X the bank has several options

- The bank can sell the commodity either for cash or on credit.
- The bank can authorize the seller to sell the commodity on its behalf as against fees (or without fees).
- The bank can direct the seller to deliver the commodity to a third party according to a previous promise of purchase.

4. When bank sells X it realizes the amount of S.
5. The difference between S and P constitutes profit for the bank.

Associated Risk

✧ Since "selling what one does not have" is generally unacceptable on grounds of *gharar,* the above structure does not permit the bank to sell X before taking delivery of the same. Thus, the bank would need to wait until time of actual delivery before it can get back its investment and profits. This at times may not be desirable, given the financial position of the bank.

✧ Another problem with the simplified structure is the price risk that the bank is now exposed to. It is quite possible that price of the commodity declines during time period t to a level below P resulting in losses to the bank. This risk is mitigated in a parallel or back-to-back s*alam*, as the bank need not to participate in the market at all.

✧ In the case of **parallel *salam,*** once *salam* contract is concluded, the bank can enter the market as a seller of goods of similar specifications as it has previously purchased on first s*alam* without making one contract depends on the other. Terms can be designed to fall at the same date of delivery. Since the period of *salam* in the second parallel transaction is shorter than the first transaction, the price may be a little higher, and the difference between the two prices becomes the profit earned by the bank or financial institution.

✧ It is important to note here that bank is not actually selling those same goods, which were the subject of the first s*alam*, but only the same. Hence there are two separate contracts, one the bank as a buyer and the other as a seller.

- ✧ The price risk for the bank can also be mitigated in another way. If a third party makes a unilateral promise to buy the commodity at a predetermined price at time period t, then the bank need not participate in the market. Thus, it would be insulated from price risk. This unilateral promise is binding. Once the rights resulting from the promise are transferred to the bank, it assumes the role of seller to the third party customer at time period t.
- ✧ Since it is only a promise, and not the actual sale, the clients will not have to pay the price in advance. Therefore, a higher price may be fixed and as soon as the bank or financial institution receives the commodity, it will be sold to the third party according to the terms of the promise.

Shari'a **Considerations of Salam Contract**

1. For a *salam* contract to be valid, the commodity should be known. Ignorance about the commodity leads to dispute which invalidates the contract.
2. The specifications of the commodity to be sold must be well described to both the buyer and seller. Description should include all quality and quantity characteristics that affect its price leaving no ambiguity, which sometimes leads to disputes.
3. Subject should be something that is going to be produced or purchased by seller. If the good can be pinpointed at the time of contracting, then *salam* is not applicable. Therefore, a given automobile or a known building can never from *Shari'a* point of view be considered as a *salam* contract.
4. Price has to be determined, and must be paid in full to the seller at the time of the contract. If a bank wishes to release *salam* funds to a borrower according to the latter's production schedule, the bank should sign more than one separate *salam* contracts with the borrower, one for each stage of

ending. The principal of each contract will be paid at the exact time of its conclusion.

5. The due date must be known to avoid ignorance, which may lead to dispute. Thus, the period of the duration of the contract must be specified, either as a date in the future or as a number of days, weeks or months.
6. It is a condition that the place of delivery is stated in the contract if the commodity needs loading or transportation expenses.
7. *Salam* is permissible on a commodity of a specific locality if it is assured that it is usually available in that locality and it rarely becomes unavailable.
8. Buyer is not allowed to sell the goods brought before actual delivery "possession", because the *salam* commodity is a liability debt on the seller and not an existing commodity. Instead of that, it is permissible for the buyer to draw a parallel *salam* contract without connecting it to the first *Salam* contract, as discussed before.
9. It is permissible to take mortgage and guarantor on *salam* debt to guarantee that the seller satisfies his obligation by delivering the commodity sold, which is a liability on the due date.
10. The probability of the existence of the commodity at the time of delivery must be high; if the contrary is the case, *salam* is impermissible.

AREAS OF APPLICATION

- ✧ *Salam* sale is suitable for the finance of agriculture operations, where the bank can transact with farmers who are expected to have the commodity in plenty during harvest either from their own crops or crops of others, which they can buy and deliver in case their crops fail.
- ✧ The *salam* sale is applied by the bank in financing craftsmen and small producers by supplying them with inputs of production as a *salam* capital in exchange of some of their commodities to remarket.

- *Salam* sale is also used to finance the commercial and industrial activities, especially phases prior to production and export of commodities and that is by purchasing it on *salam* and marketing them for lucrative prices.
- The following example shows how *salam* can be used in international trade.

Example: Pre-shipment Export Finance:

This is undertaken in the following steps.

1. Bank receives an export letter of credit (LC) in favor of its client, covering certain goods; Client gives the letter of credit under bank's lien. Thus, allowing the bank to assume the role of seller to the foreign buyer.
2. To comply with the LC requirement, bank agrees to buy the goods from its client under a *salam* contract and makes upfront payment to him. *Salam* contract devised for this purpose should include specific delivery date and place. Delivery date should be reasonably ahead of the latest shipment date stated in the letter of credit.
3. As for the place, it should be the port of destination mentioned in the LC. Submission of in-order shipping documents (viz. bill of lading and certificate of origin) by the client may be deemed equivalent to the satisfactory delivery.
4. The agreed payment (pre-shipment finance) made by the bank to its client will be lower than the amount of the export LC, difference being bank's profit.

II. Istisna' (Manufacture-Sale)

- *Istisna'* is the second exception to the basic rules of sale within *Shari'a* law. It is basically a contract of manufacture.
- ***Istisna'*** is an agreement wherein a customer requiring a commodity with clear specifications to be manufactured or developed approaches the bank for financing. The bank offers to have the said commodity manufactured or developed, for him and then, after adding its profit margin, sell it to him. The customer can later pay the price either in lump sum or in installments.
- The unique feature of *Istisna'* is that nothing is exchanged on spot or at the time of contracting. It is a pure and perhaps the only forward contract where the obligations of both parties relate to the future. The buyer makes payment of price in parts over the agreed time period or in full at the end of the time period.

Istisna' Process

- *Istisna'* thus, is now transformed into a financing product. The simplified structure of *Istisna'* is presented as follows:
  1. Client asks Bank to develop, construct, or manufacture an asset X with clear specifications;
  2. Bank asks Manufacturer to develop, construct or manufacture asset X with same specifications
  3. Manufacturer develops or constructs or manufactures asset X, receives progress payments from Bank as per agreed terms during different stages of manufacturing;
  4. Manufacturer gives delivery of asset to Bank;
  5. Bank gives delivery of asset to Client;
  6. Client pays in full or in parts over agreed period of time
- The difference between the price received from the client and the price

paid to the manufacturer constitutes profit for the bank. *Istisna'* facility is suitable for commercial or residential buildings, industries, roads, aircraft, vessels, etc.

Associated Risks

- *Istisna'* involves various construction-related risks and **risk of non conformity to specifications** (**a performance risk**). Since bank's client has no contractual relationship with the actual manufacturer or contractor, the bank will always be liable for any failure.
  1. In order to mitigate such risks the agreement may contain a penalty clause.
  2. Taking performance bond from the manufacturer or contractor or LG from contractors and warranties after delivery can reduce this risk.
  3. Another alternative for the bank is to nominate the client as an agent to oversee satisfactory completion of the job.
  4. If considered necessary, the bank may hire the services of an independent surveyor to monitor the progress of the project.
- Like other financing mechanisms, *Istisna'* involves risk of default and delinquencies and a bank can take various measures such as mortgage on land on which the asset is being built, any other property or personal or third party guarantee to mitigate such risk.
- In all cases the two contracts (bank vs. client, and bank vs. contractor or manufacturer) should always be separate.

Shari'a **Considerations of** ***Istisna'*** **Contract**

1. It is important that the price is fixed between the two parties and the specifications of the commodity to be manufactured are known for an *Istisna'* transaction to be valid.
2. It is a condition in the *Istisna'* contract to state in the clearest of terms, the type, dimensions and all the specifications required because it is a

condition in all commutative contracts the sold commodity must be known to avoid ignorance which leads to dispute.

3. *Istisna'* contract is valid for objects that can be made. It is invalid for corn, wheat, barley or fruit, and all natural products whose sale on liability is a *Salam* and not *Istisna'*.
4. Before the producer starts the manufacturing process, an *Istisna'* transaction simply creates a moral obligation between the producer and the client and the contract may be revoked by anyone of the two parties involved after giving a notice to the other. However, after the manufacturer has started the work, the *Istisna'* contract is binding to the two parties, and no party has the right to retract;
5. If the commodity does not conform to the specifications demanded, can the buyer have the option.
6. It is a condition that the period of delivery is specified whether it is short or long so as to avoid ignorance which leads to conflict between the two parties. If the producer delays the delivery of the commodity after the set time limit, the client will not be required to accept the commodity or pay the set amount. In order to prevent the late delivery of commodities, a penalty levied on the producer may be calculated on a daily basis.
7. It is a condition that the place of delivery is (specified) stated if the commodity needs loading or transportation expenses.
8. The buyer may stipulate in the *Istisna'* contract that the commodity shall be manufactured or produced by a specific manufacturer, or manufactured from specific materials. This is not permitted in the case of *Salam* sale.

AREAS OF APPLICATION

- *Istisna'* contract is applied in high technology industries such as aircraft industry, locomotive and ship building industries, in addition to the different types of machines produced in the big factories or workshops.
- It is also applied in the construction industry such as apartment buildings, hospitals, schools, universities to whatever that makes the network of modern life.
- *Istisna'* contract is applicable to the various industries as long as one can be monitored by measurement and specifications such as the food processing industry.

III. Istijrar (Recurring Sale)

- Under istijrar, the buyer purchases different quantities of a given commodity from a single seller over a period of time. In other words, the seller delivers the total quantity of commodity purchased in installments.
- There is some divergence of views regarding timing of fixation and payment of price. Since istijrar involves repeat purchases from a single seller, some scholars see a room for flexibility in the matter of fixation and payment of price. According to this view, the payment of price may be deferred to a future date and may indeed be based on a normal price or average price prevailing in the market.

IV. Qard Hasan (Benevolent Loan)

- This is the simplest of all financing schemes.
- Under this scheme, a borrower in need of a specific amount of funds borrows the same from a lender as *qard hasan* with or without a clear stipulation regarding the maturity date.
- The loan is repaid on maturity without an increment or interest.

- When no maturity is stipulated, the loan is repaid when asked by the lender, again without any increment.
- The early loan schemes introduced by many interest-free credit societies when the modern Islamic bank was yet to come into existence were based on this concept.
- The lender is allowed to ask for an asset as collateral that is governed by the fiqhi rules of ruhn.
- The lender is allowed to charge the borrower actual administrative expenses incurred in operation of the mechanism.
- The simple *qard* financing structure is presented as follows
    1. Client approaches Bank for loan of L and offers collateral X whose market value exceeds L by the specified margin;
    2. Bank lends an amount L to Client now;
    3. Client repays L plus expenses to Bank; in part or in full over future.