

### Al Baraka Asset Products

#### 1. What are the major modes of Islamic banking and finance?

The following are the modes of finance which are three categories:

- i. **Participatory Modes of Finance**
  - a) Mudarabah
  - b) Musharakah
- ii. **Non-Participatory Modes of Finance**
  - a) Murabaha
  - b) Musawamah
  - c) Salam
  - d) Istisna
  - e) Ijarah
  - f) Diminishing Musharakah
  - g) Tijarah

For deposit management, Islamic banks create different pools of investment keeping in view the risk and maturity profile of the depositors. The deposits of the customers are placed in these pools and profit therefrom is distributed between the bank and the depositors as per weightage assigned at the time of agreement.

Mudarabah agreement cannot allow a lump sum amount of profit for any party nor can it determine the share of any party at a specific rate tied up with the capital. For example, if the capital is Rs.100,000/-, parties cannot agree on a condition that Rs.10,000 out of the profit shall be the share of the Mudarib nor can they say that profit equivalent to 20% of the capital shall be given to Rab-ul-Maal. However, they can agree that 40% of the actual profit shall go to the Mudarib and 60% to the Rab-ul-Maal or vice versa.

#### 2. What is Musharakah?

Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. Under Islamic banking, it is a partnership under which the Islamic bank provides funds which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management but are not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.

Following are the rules with regard to profit and loss sharing in Musharakah:

- i. The profit-sharing ratio for each partner must be determined in proportion to the actual profit accrued to the business and not in proportion to the capital invested by him. For example, if it is agreed between them that 'A' will get 10% of his investment, the contract is not valid.
- ii. It is not allowed to fix a lump sum amount for any one of the partners or any rate of profit tied up with his investment. Therefore if 'A' & 'B' enter into a partnership and it is agreed between them that 'A' shall be given Rs.10,000/- per month as his share in the profit and the rest will go to 'B', the partnership is invalid.

### Al Baraka Asset Products

- iii. If both partners agree that each will get a percentage of profit based on his capital percentage, whether both work or not, it is allowed.
- iv. Every partner has a right to participate in the Musharakah.

### 3. What is Murabaha?

Murabaha is one of the most common modes used by Islamic Banks. It refers to a sale where the seller discloses the cost of the commodity and the amount of profit charged. Therefore, Murabaha is not a loan given on interest rather it is a sale of a commodity at profit.

The mechanism of Murabaha is that the bank purchases the commodity as per the request of the client and sells him on a cost-plus-profit basis. Under this arrangement, the bank is bound to disclose the cost and profit margin to the client. Therefore, the bank, rather than advancing money to a borrower, buys the goods from a third party and sells those goods to the customer on profit.

A question may be raised that selling goods on profit (under Murabaha) and charging interest on the loan (as per the practice of conventional banks) appear to be one of the same things and also produces the same results. The answer to this query is that there is a clear difference between the mechanism/structure of the product. The basic difference lies in the contract being used. Murabaha is a sale contract whereas the conventional finance overdraft facility is an interest-based lending agreement and transaction. In case of Murabaha, the bank sells an asset and charges profit which is a trading activity, declared halal (valid) in the Islamic Shariah. Whereas giving loan and charging interest thereupon is pure interest-based transaction declared haram (prohibited) by Islamic Shariah.

### 4. What are the basic rules of a valid Murabaha transaction?

The following are the rules governing a Murabaha transaction:

- i. The subject matter of sale must exist at the time of the sale. Thus anything that may not exist at the time of sale cannot be sold and its non-existence makes the contract void.
- ii. The subject matter should be in the ownership, either actual or constructive, of the seller at the time of sale. If he sells something that he has not acquired himself then the sale becomes void.
- iii. The subject matter of sale must be in physical or constructive possession of the seller when he sells it to another person. Constructive possession means a situation where the possessor has not taken physical delivery of the commodity yet it has come into his control and all rights and liabilities of the commodity are passed on to him including the risk of its destruction.
- iv. The sale must be instant and absolute. Thus a sale attributed to a future date or a sale contingent on a future event is void. For example, 'A' tells 'B' on 1st January 2008 that he will sell his car on 1st February 2008 to 'B', the sale is void because it is attributed to a future date.
- v. The subject matter should be a property having value. Thus goods having no value cannot be sold or purchased.
- vi. The subject matter of sale should not be a thing used for an un-Islamic purpose.
- vii. The subject matter of sale must be specifically known and identified to the buyer. For Example, 'A' owner of an apartment says to 'B' that he will sell an apartment to 'B'. Now the sale is void because the apartment to be sold is not specifically mentioned or identified to the buyer.
- viii. The delivery of the sold commodity to the buyer must be certain and should not depend on  
a contingency or chance.

### Al Baraka Asset Products

- ix. The certainty of price is a necessary condition for the validity of the sale. If the price is uncertain, the sale is void.
- x. The sale must be unconditional. A conditional sale is invalid unless the condition is recognized as a part of the transaction according to the usage of trade.

#### 5. What is Murabaha used for in Islamic banks?

Murabaha is typically used to facilitate the short-term financing requirements of the customer. The following are the uses of Murabaha:

- i. Purchase of raw material, goods and merchandise of all kinds and description
- ii. Purchase of equipment
- iii. Import of goods and merchandise
- iv. Other financings of working capital nature

Presently, the majority of financing extended by Islamic banks is based on Murabaha.

#### 6. What is Bai Muajjal?

Bai Muajjal is the Arabic equivalent of "sale on deferred payment basis". The deferred payment becomes a debt payable by the buyer in lump sum or in installments as may be agreed between the two parties.

#### 7. What is Musawamah?

Musawamah is a general and regular kind of sale in which the price of the commodity to be traded is bargained between the seller and the buyer without any reference to the price paid or cost incurred by the former. Thus, it is different from Murabaha in respect of the pricing formula. Unlike Murabaha, the seller in Musawamah is not obliged to reveal his cost. Both parties negotiate on the price. All other conditions relevant to Murabaha are valid for Musawamah as well. Musawamah can be used where the seller is not in a position to ascertain precisely the costs of commodities that he is offering to sell.

#### 8. What is Ijarah?

Ijarah refers to transferring the usufruct of an asset but not its ownership. Under Islamic banking, the bank transfers the usufruct to another person for an agreed period at an agreed consideration. The asset under Ijarah should be valuable, non-perishable, non-consumable, identified and quantified. All those things which do not maintain their corpus during their use cannot become the subject matter of Ijarah, for instance, money, wheat etc.

#### 9. What are the salient features of Ijarah transaction?

The customer approaches the bank and expresses his desire for a particular asset/property. The bank acquires that asset as per the undertaking of the customer to acquire the said asset on Ijarah basis. The bank leases (transfers the use of the asset) it to the customer for an agreed period of time and against an agreed amount of rentals. An Ijarah agreement, signed between the bank and the customer, stipulates all the relevant conditions with regard to the transaction. According to this agreement, the bank is Lessor and the customer is Lessee. During the Ijarah period, the corpus of the leased property remains in the ownership of the bank and only its usufruct is transferred to the lessee.

### Al Baraka Asset Products

Following are the main points considered in the Ijarah transaction:

- i. As the corpus of the leased asset remains in the ownership of the Islamic bank, all the liabilities emerging from the ownership shall be borne by the bank. It is necessary for a valid lease transaction that the leased asset is fully identified by the parties.
- ii. The lessee (customer) cannot use the leased asset for any purpose other than the purpose specified in the lease agreement. However, if no such purpose is specified in the agreement, the lessee can use it for whatever legitimate purpose it is used in the normal course.
- iii. The lessee is liable to compensate the lessor (bank) for any harm to the leased asset caused by any misuse or willful negligence. The leased asset shall remain at the risk of the bank throughout the lease period in the sense that any harm or loss caused by factors beyond the control of the lessee shall be borne by the lessor.
- iv. A property jointly owned by two or more persons can be leased out and the rental shall be distributed between all joint owners according to the proportion of their respective shares in the property. A joint owner of a property can lease his proportionate share only to his co-sharer and not to any other person.
- v. The rental must be determined at the time of the contract for the whole period of the lease. It is permissible that different amounts of rent are fixed for different phases during the lease period, provided that the amount of rent for each phase is specifically agreed upon at the time of executing a lease. If the rent for a subsequent phase of the lease period has not been determined or has been left at the option of the lessor, the lease is not valid.
- vi. The determination of rental with regard to the aggregate cost incurred in the purchase of the asset by the lessor, as normally done in financial leases, is not against the rules of Shariah, if both parties agree to it, provided that all other conditions of a valid lease prescribed by the Shariah are fully adhered to.
- vii. The lessor cannot increase the rent unilaterally, and any agreement to this effect is void.
- viii. The lease period shall commence from the date on which the leased asset has been delivered to the lessee.
- ix. If the leased asset has totally lost the function for which it was leased, the contract will stand terminated.
- x. The rentals can be used on or benchmarked with some index as well. In this case, the ceiling and floor rentals would specifically be mentioned in the agreement for the validity of the lease.
- xi. At the end of the lease period, the ownership of the property may be transferred to the lessee against a nominal price through a separate sale deed to be executed after the expiry of the lease.

#### 10. What are the basic features of Tijarah transaction?

Tijarah is a mode of financing which is mainly based on Musawamah. In Tijarah transaction, customer sells its owned goods to bank in order to get the desired liquidity; it is alternative to conventional bank's pledge financing.

#### 11. What are the basic features of Diminishing Musharakah?

Diminishing Musharakah is a partnership contract for long-term financing such as: business expansion, setting up of new business, investment banking needs, project financing, house financing, car financing or for acquisition of any other fixed assets.

In a DM transaction, bank and customer jointly owns the particular asset and then bank leases out its share to customer against the rentals. Following are the distinguishing features of DM:

### Al Baraka Asset Products

- Partial risk-sharing of the financed asset
- Diminishing Musharakah caters to the requirement of customers for medium to long-term financing of land, vehicles, plants, machinery, and other fixed assets
- Commonly used for financing of fixed assets by Islamic banks which may include: development finance, fleet finance, plant and machinery, land / building, SBP refinance schemes, house financing, car financing, and any other fixed assets
- Ideal for investment banking and project financing needs
- The relationship between the bank and the customer changes at different stages of transaction:  
1. Partners 2. Lessor and Lessee 3. Buyer and Seller
- Initially, the bank and customer jointly own the asset
- The lease period commences from the date on which the Musharakah asset has been delivered to the customer
- After purchasing the asset jointly, the client uses the asset for business purposes and pay the rent to the bank for using its share in the asset
- After the commencement of lease period, the customer makes rental payments
- At maturity, complete ownership of the asset is transferred to customer

### **12. What is the difference between conventional mortgage financing and Islamic Mortgage financing?**

There are several key differences between conventional mortgage finance and Islamic mortgage finance.

Under conventional mortgage, in order to purchase a property the customer borrows money and repays it with an additional amount over a period of time. The additional amount is the amount of interest which is against the Shariah rulings of Islam. Under the Islamic mortgage finance facility, Islamic bank shares with the customer in purchasing his desired property. Accordingly, the customer and the bank become the joint owners of the property in proportion to their share in purchasing the property. In order to own and use the entire property, the customer purchases the share of the bank's property over a period of time and also pays the rent for using the bank's share of the property. Over a period of time, the customer manages to purchase the entire share of the bank in the property. Ultimately, the customer becomes the sole owner.

Further, in case of Islamic mortgage finance, the rent will be charged after the lessee has taken delivery of the property and it is in workable/usable condition. Rent cannot be charged from the day the price was paid to acquire the property/asset. If the supplier has delayed the delivery after receiving the full price, the lessee should not be liable for the rent of the period of delay. In case of conventional mortgage finance, normally the lease rentals start from the date the bank makes the payment for purchasing the property/asset.

### **13. The rental amount under Ijarah transaction is normally linked to interest-based benchmark like LIBOR or KIBOR. Is not it interest-based financing?**

The difference between an interest-based financing and a valid lease does not lie in the amount to be paid to the lessor. The basic difference is that in the case of Islamic Ijarah, the ownership and title of the asset/property rest with the lessor who assumes the full risk of the corpus of the leased asset. If the asset is destroyed during the lease period, the lessor will suffer the loss. Similarly, if the leased asset loses its usufruct without any misuse or negligence on the part of the lessee, the lessor cannot claim the rent, while in the case of interest-based financing, the financier is entitled

### Al Baraka Asset Products

to receive interest, even if the debtor did not at all benefit from the money borrowed. So far as this basic difference is maintained, (i.e. the lessor assumes the risk of the leased asset) the transaction cannot be categorized as an interest-bearing transaction, even though the amount of rent claimed from the lessee may be equal to the rate of interest.

Therefore, the use of the rate of interest merely as a benchmark does not render the Ijarah contract invalid as an interest-based transaction. It is, however, advisable at all times to avoid using interest-based benchmarks so that an Islamic transaction is totally distinguished from an un-Islamic one, having no resemblance of interest whatsoever.

#### **14. Interest rates are subject to unknown variations and linking the amount of rent with interest rate will create uncertainty (Gharar) impermissible in Shariah. How would the Ijarah contract remain valid under this scenario?**

It is one of the basic requirements of Shariah that the parties to the contract must exactly know its considerations. Under Ijarah agreement, the amount of rent is one of the prime considerations of the agreement. So far as the parties are agreed with mutual consent upon a well-defined benchmark which would serve as a criterion for determining the rent, and whatever amount is determined, based on such benchmark, will be acceptable to both parties, therefore, there should not be any dispute.

However, in order to save the parties from unforeseen losses due to either way movement in the interest rate, the scholars have advised that there should be a floor and cap for the amount of rentals stipulated in the contract in case variable benchmarks are taken to determine the rental amount.

#### **15. What is Ijarah-wa-Iqtina?**

It is allowed in Shariah that the lessor signs a separate promise, (but not an agreement or contract) to gift the leased asset to the lessee at the end of the lease period, subject to his payment of all amounts of rent. There can also be a unilateral promise by the lessee to purchase the asset at the end of the Ijarah period. Alternatively, there may be an undertaking by the bank to sell the asset to the lessee at the end of the Ijarah period. However, Ijarah agreement should not be dependent either on the promise by the lessee (to purchase) or the undertaking by the bank (to sell). This arrangement is called "Ijarah wa iqtina" and it has been allowed by a vast majority of contemporary scholars and is widely used by Islamic banks.

However, the validity of this arrangement is subject to two basic conditions:

- a) The agreement of Ijarah should not have a clause regarding the lessor's promise to gift or sell the leased property to the lessee at the end of the Ijarah period. Therefore, there should be a separate document stipulating this promise by the lessor.
- b) The promise should be unilateral and binding on the promisor only. It should not be a bilateral promise binding on both parties because in this case, it will be a full contract becoming effective on a future date, which is not allowed in the case of a sale or gift.

#### 16. What is Bai Salam?

Salam means a contract in which advance payment is made for goods to be delivered at a future date. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. Bai Salam covers almost everything which is capable of being definitely described as to quantity, quality and workmanship. For Islamic banks, this product is ideal for agriculture financing, however, this can also be used to finance the working capital needs of the customers. The permissibility of Salam is an exception to the general rule that prohibits forward sale.

It is a condition in Salam contract that subject matter must be homogeneous goods i.e. that goods whose exact alternate is available in the market

Bai-Salam has been permitted by the Holy Prophet (PBUH) himself, without any difference of opinion among the early or the contemporary jurists, notwithstanding the general principle of Shariah that the sale of a commodity which is not in the possession of the seller is not permitted. Upon migration from Makkah, the Prophet (PBUH) came to Madinah, where the people used to pay in advance the price of fruit or dates to be delivered over one, two or three years. However, such a sale was carried out without specifying the quality, measure or weight of the commodity or the time of delivery. The holy Prophet (PBUH) ordained: "Whoever pays money in advance for fruit to be delivered later should pay it for a known quality, specified measure and weight (of dates or fruit) of course along with the price and time of delivery"

The Salam transaction is subject to the strict conditions as follows:

- i. It is necessary for the validity of Salam that the buyer pays the price in full to the seller at the time of affecting the sale. In the absence of full payment, it will be tantamount to the sale of a debt against a debt, which is expressly prohibited by the Holy Prophet (PBUH). Moreover, the basic rationale for allowing Salam is to facilitate the "instant need" of the seller. If it is not paid in full, the basic purpose will not be achieved.
- ii. Only those goods can be sold through a Salam contract in which the quantity and quality can be exactly specified e.g. precious stones cannot be sold on the basis of Salam because each stone differs in quality, size, weight and their exact specification is not possible.
- iii. Salam cannot be affected on a particular commodity or on a product of a particular field or farm e.g. Supply of wheat of a particular field or the fruit of a particular tree since there is a possibility that the crop is destroyed before delivery and given such possibility, the delivery remains uncertain.
- iv. All details with respect to the quality of goods sold must be expressly specified leaving no ambiguity, which may lead to a dispute.
- v. It is necessary that the quantity of the commodity is agreed upon in absolute terms. It should be measured or weighed in its usual measure only, meaning what is normally weighed cannot be quantified and vice versa.
- vi. The exact date and place of delivery must be specified in the contract.
- vii. Salam cannot be affected in respect of things, which must be delivered on the spot.

#### 17. What is Istisna?

It is a specific kind of a Bai (sale) where the sale of the commodity is transacted before the commodity comes into existence. The legality of Istisna is accepted by the Shariah scholars because it does not contain any prohibition, As far as the financing mode, it has been legalized on the basis of the principles of Istihsan (public interest).

### Al Baraka Asset Products

Istisna is an agreement culminating in a sale at an agreed price whereby the purchaser places an order to manufacture, assemble or construct (or cause so to do) anything to be delivered at a future date. It becomes an obligation of the manufacturer or the builder (as the case may be) to deliver the asset of agreed specifications at the agreed period of time. As the sale is executed at the time of entering into the Istisna contract, the contracting parties need not renew an exchange of offer and acceptance after the subject matter is prepared. Istisna can be used for providing the facility of financing the manufacture or construction of houses, plants, projects and building of bridges, roads and highways etc. After giving prior notice, either party can cancel the contract before the manufacturing party has begun its work. Once the work starts, the contract cannot be cancelled unilaterally.

#### 18. What is the difference between Istisna and Ijarah?

Under Istisna, the manufacturer either uses his own material or arranges for the material himself whereas under Ijarah the material is provided by the customer and the manufacturer uses only his labour and skill meaning that his services will be hired for a specified fee paid to him. Further, under Istisna the purchaser has the right to reject the goods after inspection if these are not according to the specifications agreed at the time of contract whereas under Ijarah this right of inspection does not exist.

#### 19. What is the difference between Istisna and Salam?

The following are the main differences between Istisna' and Salam:

- i. In case of Istisna, the subject on which transaction of Istisna' transaction is based is always a thing which needs manufacturing/assembling/processing etc., whereas, in case of Salam, the subject matter can be a thing that does not necessarily need manufacturing etc.
- ii. The price in Istisna' does not necessarily need to be paid in full in advance. It is not even necessary to pay the full price at delivery. It can be deferred at any time according to the agreement of the parties. The payment may also be made in instalments. In case of Salam, the price has to be paid in full in advance.
- iii. The time of delivery does not have to be necessarily fixed in Istisna' whereas in case of Salam the time of delivery is an essential part of the sale.
- iv. Istisna contract can be cancelled before the manufacturer starts the work. Salam contract cannot be cancelled unilaterally.

#### 20. Is it permissible for an Islamic bank to impose a penalty / charity in case receivables are delayed?

In Islamic law, it is permissible to penalize a debtor who is financially sound but willfully delays payment of debt without any genuine reason. Such an act of the debtor is unjust as the Prophet (PBUH) has said,

*"A rich debtor who delays payment of debt commits Zulm".*

A heavy non-performing portfolio and default on the part of clients is a serious problem confronting financial institutions all over the world including Pakistan. This problem may be a threat to the success of the Islamic banking system if not properly addressed. If clients do not honour their commitments in respect of timely payment of a debt created in an installment sale, Murabaha, leasing or do not pay banks' share of profit in participatory modes or do not deliver goods at a stipulated time in Salam{ XE "Salam" } and Istisna, it could cause irreparable loss to the system. The

### Al Baraka Asset Products

banks, financial institutions, depositors and ultimately the economy will have to suffer its consequences. The jurists allow punishment (T'azir) to such willful defaulters in the form of fine. In view of the severity of the problem, the Islamic Fiqh Academy of the OIC and Shariat Appellate Bench of the Supreme Court of Pakistan have approved the provision of a penalty clause in the contractual agreements. This would also help in maintaining credit discipline in banking and act as a deterrent against debts becoming bad or unrealizable. However, the penalty proceeds would be used for charity as the penalty cannot become a source of income for the bank in any manner.

#### **21. Islamic bank financing is sometimes costlier than conventional banking. Why is it so?**

Islamic banking is in its early stage and is in the process of strengthening its base in the economies having conventional banking rooted deeply in the current interest-dominated system. The volume of business captured by the conventional banking system gives it an edge over Islamic banking in terms of cost due to its ability to have achieved economies of scale. The conventional banks can avail the economies of scale due to their wide network and huge volume of business which Islamic banking, in its nascent stage, cannot avail given the present volume of their business. Further, Islamic banking has to maintain some additional documentation which adds to the cost of its operations. While Islamic banking may appear to be marginally costlier at this stage, the incremental cost is not prohibitive in relation to the benefits.

#### **22. Does discounting of bills is allowed under Islamic Shariah?**

A promissory note or a bill of exchange represents a debt payable by the debtor to the holder. This debt cannot be transferred to anybody except at its face value. Discounting of a bill or a Note or a Cheque, therefore, involves interest. In an Islamic financial market, the papers representing money or debt cannot be traded (except at face value). However, the papers representing the holder's ownership in tangible assets, like shares, lease certificates, Musharkah certificates, etc. can be traded due to the underlying assets they represent. Islamic banks have various modes of finance through which the business needs of the customer can be satisfied without discounting the bill.

A majority of Islamic Shariah scholars do not allow Salam in gold, silver, currencies or monetary units, although a few jurists have allowed it. As such, a few Islamic banks have been using Salam in currencies as an alternative to bill discounting where subject matter of Salam is USD and price is PKR that is paid in full in advance.