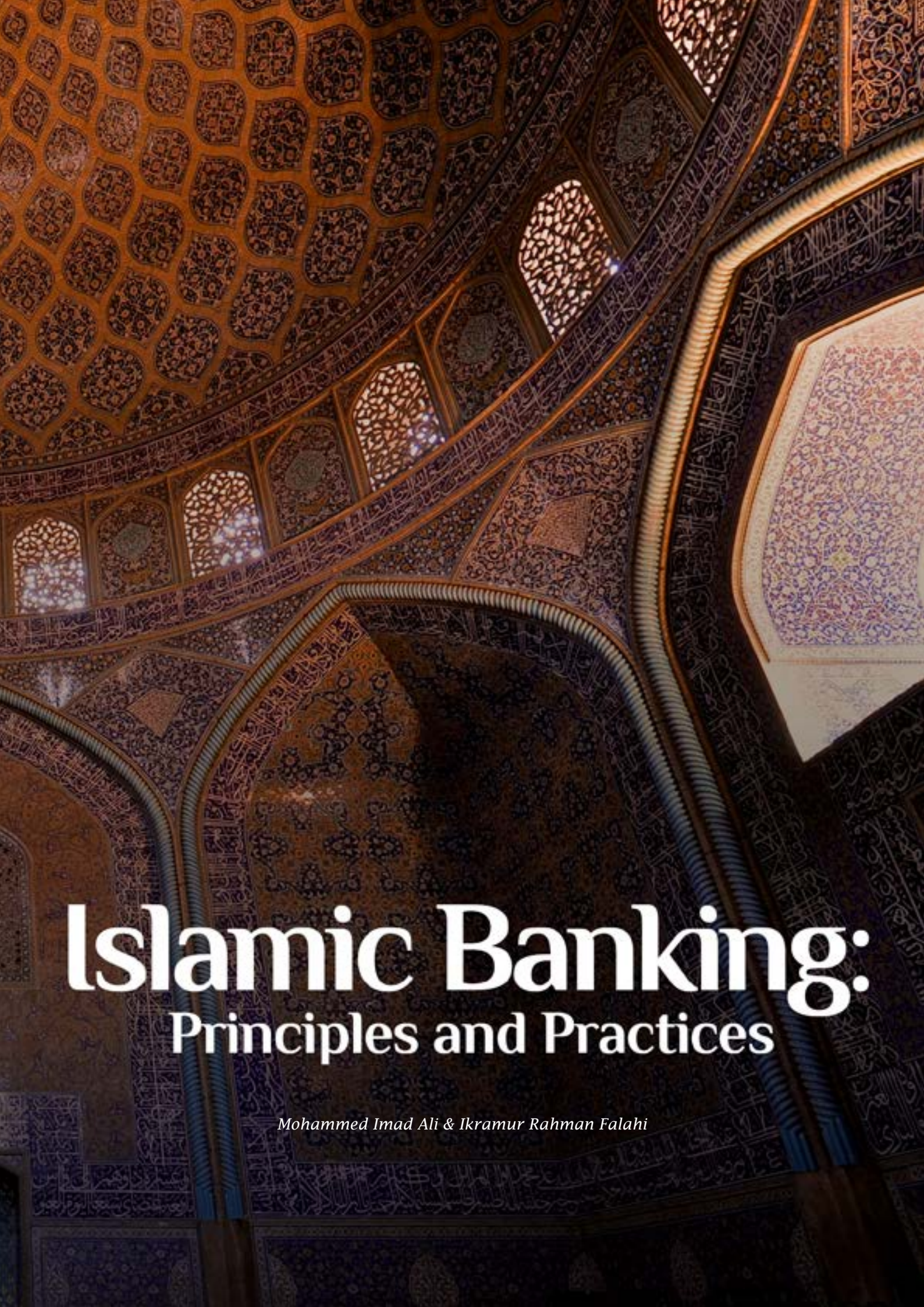


The background of the cover is a photograph of an interior space, likely a mosque or a palace, featuring a large, ornate dome. The ceiling is covered in intricate, repeating geometric and floral patterns in shades of gold, brown, and blue. Several arched windows with decorative grilles are visible, allowing light to filter through. The walls and lower parts of the dome are also decorated with similar patterns. The overall atmosphere is one of grandeur and historical significance.

Islamic Banking: Principles and Practices

Mohammed Imad Ali & Ikramur Rahman Falahi



ISLAMIC BANKING:

PRINCIPLES AND PRACTICES



Mohammed Imad Ali & Ikramur Rahman Falahi

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We are sure that this is not a piece of reading material on Islamic banking and Finance without shortcomings, and we therefore request you to tell us where we have erred so that we correct those portions in our next edition.

We pray to Allah that our humble effort be accepted and all those who have supported us be rewarded immensely for their support.

Marifa Academy

Marifa Academy aims to disseminate knowledge, provide easy access to the relevant information and promote the practices and principles of Islamic banking and finance across different cultures and societies of the world, while using only the most innovative learning techniques in the process.

In the recent years, Islamic finance has witnessed a fast-paced momentum and is becoming widespread across the globe. Numerous individuals are showing great interest in this relatively new field and are eager to educate themselves with the ideas and concepts surrounding Shariah-based finance. In response to the newfound interest, various efforts are being undertaken to put the right information out there, as well as equip people with an arsenal of theoretical and practical knowledge for their own use and application. One such effort is this wonderful book; Islamic Banking and Finance: Principles and Practices.

It is a clear and simple practical guide that caters to anyone looking for a one-stop shop to discover the realm of Islamic banking and finance. Illustrated with a plethora of examples and drawn from solid references, the book provides in-depth details, spanning from the fundamental principles, sources, history and development of Islamic finance, to the myriad of products, innovations and structures adopted.

The level of meticulous care and ingenuity employed by the Marifa team to present the content in a comprehensive manner is highly commendable. I pray to Allah that their efforts be rewarded and that the product of their hard work be beneficial and accessible to the masses at large.



Sheikh Nizam Yaquby

Sheikh Nizam is an internationally acclaimed scholar in the Islamic banking industry. With an advanced degree in Economics and Comparative Religion from McGill University and having authored numerous fatawa related to innovative Shariah compliant financial products, Sheikh Nizam is internationally acclaimed as one of the leading scholars of modern Islamic finance.

- Sheikh Nizam serves on the Shariah supervisory boards of many financial institutions worldwide, including several key memberships on the boards of the Dow Jones Islamic Market Indexes and the Auditing and Accounting Organization of Islamic Financial Institutions («AAOIFI»). He has served in Bahrain Mosques from 1981 to 1990 where he taught Tafsis, Hadith and Fiqh in Bahrain since 1976.

- He is an advisor to a number of multinational banks and financial institutions including Citi Islamic Investment Bank. The Wall Street Journal lists Sheikh Nizam as «one of Islamic finance's foremost scholars.»

Foreword

I congratulate Marifa Academy for coming up with a detailed, relevant, practical and simple guide on Islamic Banking and finance. I consider myself fortunate, to have been associated with both, the academic and practical world of Islamic banking and finance and from that perspective I feel it is quite important that a book should cover both theoretical as well as practical aspects of Islamic finance. I do believe that this book was quite successful in blending the academic and practical side of Islamic finance in a cogent manner.

Many students ask me which book to refer to, in order to have a comprehensive view of Islamic banking and finance. Apart from a few other sources, I can now suggest that they refer to this book. Collation, analysis and presentation of knowledge is quite important in understanding a domain of knowledge and I feel this book has done it quite successfully in relation to Islamic finance.

I am sure based on the feedback from the members of the academic and professional world of Islamic finance, this book will further enhance the quality of its contents in their next edition. I pray to Allah that this effort of Marifa Academy be accepted and people benefit from this book.



Dr. Aznan Hasan

Dr. Aznan Hasan was educated at University of al-Azhar, Egypt where he obtained a Bachelor in Shariah (Hons.) in 1994. He holds a Master in Shariah (First Class) from Cairo University, Egypt and a Ph.D from University of Wales, Lampeter, United Kingdom.

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- Advisory Committee Member: Bursa Malaysia's FBM Index. - Malaysia.
- Member: International Shariah Research Academy for Islamic Finance (ISRA) - Malaysia.



Mohammed Imad Ali

Imad has spent more than a decade reviewing, structuring and advising on Islamic banking and finance structures and transactions. He is passionate about research and training and has developed and provided multiple training sessions. The experience which Imad has gained working with Shariah support and advisory departments of Citi Islamic and HSBC Amanah helps him appreciate the nuances of Islamic finance education.

Imad is the Islamic Control Officer for Citi Islamic Investment Bank, and based in Bahrain. Imad works closely with the Islamic finance business team as well as the Legal and Compliance functions. Imad is the primary contact point for coordination with Citi's Shari'ah Advisory Board and advises Citi internally on Shari'ah related matters. Prior to Citi, Imad was with HSBC Amanah in Dubai where he worked in the Shari'ah compliance department advising on Shari'ah matters, monitoring and auditing the global markets, wealth management, private bank, and treasury businesses for Shari'ah compliance.

Prior to his working at HSBC Amanah, he worked as a lawyer with the Islamic finance team at Dentons. Imad obtained his Master's degree in Comparative Laws from Islamic University Malaysia specializing in Islamic banking jurisprudence. He has read law and is admitted as a lawyer in India. Imad is currently pursuing his Phd in field of Islamic banking and finance.



Ikramur Rahman Falahi

Ikram has vast experience and expertise in Islamic finance documentation review, Sharia audit reviews as well as advising on product structuring and operational issues. He has over a decade of experience in business development, providing Islamic banking training, Shariah audit and the structuring of Islamic banking products. Ikram has unique ability to structure sophisticated Islamic finance solutions for all banking businesses including retail, treasury, corporate and investment. Ikram has developed, designed and launched the Islamic Banking training programs.

Ikram currently heads the Shariah structuring and coordination team at Abu Dhabi's Al Hilal Bank. He had previously worked as Shariah Auditor at Dubai Islamic Bank. His wide-ranging expertise includes the review of Shariah structures and Islamic finance transaction documentation related to retail, corporate, treasury and investment banking. Ikram is proficient in the provision of Shariah alternatives to practical issues pertaining to the day-to-day banking operations. He has an MBA in Banking & Finance from Preston University, USA (Ajman - UAE Campus), and a bachelor's degree in Economics from Jamia Millia Islamiah, New Delhi. He is a Hafiz, and a holder of the Fadheelat degree, as well as Al Aalamiyah from Jamiatul Falah, India. He is currently pursuing Master in International Business law from the University of Paris Sorbonne - Abu Dhabi.





INTRODUCTION

TO ISLAMIC ECONOMICS AND FINANCE

Learning Objectives:

After completing this module the reader should be able to:

- Know the fundamental principles of Islamic Economics and Islamic Finance.
- Understand the difference between Islamic Economics and Modern Economics.
- Understand the difference between Islamic Finance and Conventional Finance.
- Understand the sources of Islamic Law.
- Understand the basic concepts such as Shariah, Fiqh, Madhahib, Riba, Gharar, Maysir etc.
- Know the evolution, growth and development of the Islamic Finance industry in different periods.





INTRODUCTION

Islam as a comprehensive system provides guidelines for human behaviour throughout life. It does that through a set of beliefs. These beliefs organise the relationship between the individual and Allah, the individual and other human beings, as well as the individual and the environment.

Economics is one of the most important aspects of human life. Economic behaviour, as expressed in terms of economic activities involves the production, distribution and consumption of goods and services. As a part of its guidance, Islam renders clear guidelines towards the economic behaviour of human beings. In the last few decades, the world has witnessed a renaissance of Islamic Economics. Islamic Economics and Finance is not an uncommon terminology and philosophy at present. Following the recent global financial crisis, a great deal of attention has been given to this subject by scholars and people.

In the view of its importance, a module to introduce the subject of Islamic Economics and Finance is being presented. Let us begin with the subject of Islamic Economics. The principles and fundamentals of Islamic Economics are derived from two primary sources, i.e., the Quran and the Sunnah.

QURAN

The first of two sources is the Quran. Literally, the word Quran means 'the recital'. So clearly, one of the essential implications of this designation of the Quran is that it is a recital. Therefore, the Quran is a book meant to be recited. The purpose is not just limited to recitation, but to understand and implement. It is a divine book and the word of Allah, revealed as the final revelation and guidance. It was revealed to Prophet Muhammad (Peace be upon Him), Allah's final prophet and messenger. The Quran contains 114 chapters containing more than 6000 verses discussing legal principles and injunctions dealing with every aspect and sphere of human life and existence such as rituals, marriage, divorce, succession, inheritance, economics, commerce, etc.

Given the importance of economic activities in human society, Allah provides in the Quran more than 80 verses - one of which is the longest in the Quran - that relate, directly and sometimes indirectly to the subject of economics, business and commerce.

SUNNAH

Having given a brief definition of the first source of Islamic economics let us now briefly outline the Sunnah. The term Sunnah refers to the traditions of the Prophet Muhammad (Peace be upon Him) that include his sayings, actions and tacit approvals. Prophet Muhammad (Peace be upon Him) is the last messenger and the last law bearer in the series of prophets and messengers. He was the restorer of the monotheistic faith with which Adam, Noah, Abraham, Moses, Jesus and other prophets (Peace be upon them all) were sent by Allah. The tradition attributed to the Prophet Muhammad (Peace be upon Him) is also known as Hadith. Using the method of biographical analysis, those Ahadith were collected and

compiled by different scholars, among others, a body of six most authentic books known as Saha-e-Sittah.

ISLAMIC ECONOMICS

Islamic economics is the knowledge and application of injunctions and rules of the Shariah (Islamic law) that prevent injustice in the acquisition and disposal of material resources in order to provide satisfaction to human beings and enable them to perform their obligations to Allah and the society.

In the Quran Allah says:

“But seek, with that (wealth) which Allah has bestowed on you, the home of the Hereafter, and forget not your portion of lawful enjoyment in this world; and do good as Allah has been good to you, and seek not mischief in the land. Verily, Allah likes not the Mufsideen (those who commit crimes and sins, oppressors, tyrants, mischief-makers, corrupters)”-(Al Quran 28:77).

Let us discuss a few - principles of Islamic economics that are derived from the Quran and Sunnah.

REAL OWNER

The first principle of Islamic economics is that of ownership or that of the real owner. It is clearly mentioned in the Quran that Allah has created all the wealth available on the earth and in the heavens. Hence, He is the real owner of this world with all its resources, wealth and factors of production.

In the Quran Allah says:

“To Allah belongs all that is in the heavens and all that is on the earth”-(Al Quran 02:284).

The individual and collective ownership of human beings in the resources and wealth is recognized in a sense that one should acquire the resources with one's personal efforts and utilise them, thus adding and deriving utility through economic activities.

Every human being has an equal right to utilise the natural resources created by Allah. It is not permitted to hold the property or resources unused or barren for a reasonably longer period. The Quran states that if some property or wealth is left behind after an individual's demise, then it has to be distributed to others through the Quranic 'law of inheritance'.

In the Quran Allah says:

**“There is a share for men and a share for women from what is left by parents and those nearest related, whether the property be small or large - a legal share...”
(Al Quran 04:07-12).**

If no one is left to benefit and make proper use of the left or inherited property, then the property must be placed under state ownership and utilised for public welfare activities.

Islamic Economics, therefore, neither recognises nor appreciates wrong or illicit means and laws of acquiring, utilising and distributing the wealth.

Every human being has an equal right to utilise the natural resources created by Allah. It is not permitted to hold property or resources unused or barren for a reasonably long period.



Islamic Economics, therefore, neither recognizes nor appreciates wrong or illicit means and laws of acquiring, utilizing and distributing the wealth. Islam believes that wrong means and laws for the acquisition, utilisation and distribution of wealth may consolidate or circulate the resources and wealth only in a few hands, leading to monopoly, which may further disturb the natural phenomenon of wealth management. So, from the Islamic perspective, the real owner of the resources of the world is Allah who has created, sustained and distributed them on the earth and in the heavens and human beings are just trustees who are entitled to utilise and transfer its ownership to others in the way prescribed by Allah.

MAN AND HIS POSITION

Now, we move on to discuss the second principle of Islamic Economics: Man and his Position on earth. Among the many ideologies or ways of life prevalent on earth, only Islam charts the actual position to man. Allah states in the Quran that He has sent man as His vicegerent or Khalifa on earth.

In the Quran Allah says:

"Verily, I am going to place (mankind) generations after generations on earth"-(Al Qur'an 02:30).

Human beings have been created in the best stature.

In the Quran Allah says:

"Verily, We created man in the best stature (mould)"-(Al Quran 95:04).

They have an in built ability to discern and choose between good and evil. They have rights and duties. They should fulfill both the rights of Allah and the rights of Allah's creations. Humans should follow the guidelines sent down by Allah in the form of divine books for they are accountable for all their deeds. On the basis of their actions, whether good or evil, they would either be rewarded or punished. Choosing and following the right path, i.e., the path of Islam, i.e., submission to the will and laws of the Creator, would be the determinant in their reward or punishment.

Such a sense of accountability creates responsible citizens who by virtue of being vicegerents, rather than owners of earth and its resources act as travellers in this world; they act as tenants whose permanent destination or ultimate residence is the hereafter. As travellers, how much can then they amass? They would only want to get what they need for the journey to be undertaken successfully, without excess.

WEALTH AND RESOURCES

The third principle of Islamic Economics relates to wealth and resources. Allah has created abundant wealth and resources, both actual and potential that support man's existence on this earth.

In the Quran Allah says:

“And indeed We have honoured the Children of Adam, and We have carried them on land and sea, and have provided them with At-Tayyibat (lawful good things), and have preferred them above many of those whom We have created with a marked preferment”-(Al Quran 17:70).

The resources that directly support man’s existence are known as actual resources and the resources that are useful for humans after adding the utility in terms of economic benefits are known as potential resources. Every human being is encouraged to work hard to acquire, earn, harness and utilise those resources but only in the way prescribed by Allah. While earning and harnessing the wealth, one must, for example, not forget that wealth is created for human beings and human beings are not created for wealth; they are travellers. Allah has clearly differentiated between what is permissible and what is prohibited. Every human being has the right to earn and acquire as much wealth as possible, but within the permissible boundaries set by Allah, without transgression to Allah or to any human or non-human creation.

ECONOMIC TRUST AND RELATIONSHIP

The fourth principle of Islamic Economics relates to the concept of Economic Trust and Relationship. Allah has distributed all the resources and wealth unequally on the earth.

In the Quran Allah says:

“It is We Who portion out between them their livelihood in this world, and We raised some of them above others in ranks, so that some may employ others in their work”-(Al Quran 43:32).

Due to this diversity, we do not find two landscapes equally fertile or equally favourable for production, and two individuals equally able to struggle or equally efficient to work and equally intelligent to utilise the opportunity. Hence, it is possible for one individual to acquire more wealth than the other. Therefore, in Islam, a part of the surplus earned (in a specific time period) by individuals due to Allah’s mercy or due to ability and favourable conditions bestowed by Allah Himself, must go to their fellow beings as their share.

In the Quran Allah says:

“They ask you (O Muhammad) what they should spend. Say: Whatever you spend of good must be for parents and kindred and orphans and Al-Masakin (the poor) and the wayfarer, and whatever you do of good deeds, truly, Allah knows it well”-(Al Quran 02:215).

This concept is known as the Economic Trust.

In the Quran Allah says:

“...And give them something (yourselves) out of the wealth of Allah which He has bestowed upon you....”-(Al Quran



The surplus wealth that remains after the distribution of the share of all the parties can once again be reinvested in the business and trade in the light of the same Islamic principles.

One cannot trade in the commodities that are clearly prohibited in Quran and Ahadith and that are not in the collective interest of the society.



24:33). By this principle of inter-dependency and economic trust, Allah wants to create a strong relationship among fellow human beings.

ECONOMIC ACTIVITIES

The fifth principle of Islamic Economics relates to the economic activities. The economic activities include the production, distribution and consumption. First, there should not be exploitation of the weak and the poor in the activity of production.

In a Hadith the Prophet Muhammad (Peace be upon Him) said: “The wages of a labourer must be paid to them before the sweat dries upon their body”-(Ibn Majah, No: 2434).

One cannot produce the goods and services that are prohibited in Islam and are harmful to the society. The commodities and services to be produced are categorized into necessities, comforts and luxuries. The first preference in the production process shall be given to necessities, then comforts and then followed by luxuries.

Second, towards distribution, whatever is being produced should be divided among those involved in the production, according to their share, without any deception. In the process of distribution too, it is mandatory to follow the Islamic guidelines and laws provided in the Quran and Sunnah. The surplus wealth that remains after the distribution of the share of all the parties can once again be reinvested in the business and trade in the light of the same Islamic principles. Third, towards consumption, those who are provided with the bounties of wealth are not expected to live as they wish and consume in a manner they desire. It is neither allowed to squander nor to hoard wealth in a few hands.

In the Quran Allah says:

“What Allah gave as booty (Fai’) to His Messenger (Muhammad) from the people of the townships - it is for Allah, His Messenger (Muhammad), the kindred (of Messenger Muhammad), the orphans, Al-Masakin (the poor), and the wayfarer, in order that it may not become a fortune used by the rich among you. And whatsoever the Messenger (Muhammad) gives you, take it; and whatsoever he forbids you, abstain (from it). And fear Allah; verily, Allah is Severe in punishment” (Al Quran 59:07).

Moderation and self-control are rather expected. Extravagance and wastage in consumption are prohibited. In the Quran Allah says:

“...And those who, when they spend, are neither extravagant nor niggardly, but hold a medium (way) between those (extremes)...”-(Al Quran 25:67).

Islam does not discourage an individual to lead a comfortable life, but in fact encourages it, provided the purpose behind the acquisition of comforts is to appreciate the bounties of Allah and not to pomp or show.

TRADE AND BUSINESS:

The sixth principle of Islamic Economics relates to trade and business, which plays a pivotal role in economics. Therefore Allah has permitted the trade.

In the Quran Allah says:

“...they say: “Trading is only like Riba (usury),” whereas Allah has permitted trading and forbidden Riba (usury)...”- (Al Quran 02:275).

The Prophet Muhammad (Peace be upon Him) too preferred trade and always encouraged business.

In a Hadith the Prophet Muhammad (Peace be upon Him) said: “A truthful businessman will be under the shade of the throne of Allah Ta’ala on the Day of Resurrection”-(Al-Isbihani). In another Hadith the Prophet Muhammad (Peace be upon Him) said: “The truthful merchant [is rewarded by being ranked] on the Day of Resurrection with prophets, veracious souls, martyrs and pious people”-(Tirmidhi, No: 1130).

But to prevent the oppression or aggression, a few basic conditions are advanced to regulate the trade and to safeguard the interest of all those involved in it.

Trade is allowed by mutual consent without harming one another.

In the Quran Allah says:

“O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent. And do not kill yourselves (nor kill one another). Surely, Allah is Most Merciful to you...”- (Al Quran 04:29).

It is mandatory to have ‘transparency’ in trade and business. In a Hadith the Prophet Muhammad (Peace be upon Him) said: “Do not sell what you do not have”- (Tirmidhi, Buyu’, Book 12, chapter 19, hadith 1232). One cannot trade in the commodities that are clearly prohibited in Quran and Ahadith and that are not in the collective interest of the society. One is not allowed to adopt the means and ways in trade that involves uncertainty.

ROLE AND NATURE OF MONEY

The seventh principle of Islamic Economics relates to the role and nature of money. Islam views ‘money’ as only a medium of exchange and a measure of value. The rationale behind this principle is that, every human being needs a large number of commodities for survival. The transaction of exchange is inevitable among people who have the commodities and those who need such commodities. But there must be a measure on the basis of which price can be determined, because the exchanged commodities are neither of the same type, nor of the same measure which can determine how much quantity of one commodity is a just price for another. Therefore, all these commodities need a medium to measure their exact value. Hence, ‘money’ is invented as the medium to measure all the



Money has no intrinsic value; it cannot be utilised in direct fulfillment of human needs. It can only be used for acquiring some goods or services. A commodity, on the other hand, has intrinsic utility and can be utilised directly without exchanging it for some other thing.

Debt is generally discouraged in Islam except under conditions where it becomes a necessity. And people engaging in debt based transactions should ensure they have the potential ability or capability to repay in accordance with the terms and conditions of the debt arrangement.



commodities, services, assets or wealth as a whole. Money is a tool to measure the value of all commodities and it is not a commodity in itself. Money has no intrinsic value; it cannot be utilised in direct fulfillment of human needs. It can only be used for acquiring some goods or services. A commodity, on the other hand, has intrinsic utility and can be utilized directly without exchanging it for some other thing. The commodities can be of different qualities, while money has no quality except that it is a measure of value or a medium of exchange. Therefore, all units of money of the same denomination are a hundred percent equal to each other.

DEBT IN ISLAM

The eighth principle of Islamic Economics relates to the concept of debt in Islam. Generally, debt is created by two means. One is when an asset or commodity is sold on deferred payment basis and the second is when someone seeks fund through financial loan. In Islam, both types of debts are considered as an obligation. In Arabic the equivalent to debt is dayn. The linguistic meaning of the word Dayn has to do with submission and humiliation. Islam takes the matter of debt very seriously and warns against it and urges the individuals to avoid it as much as possible. Debt is generally discouraged in Islam except under conditions where it becomes a necessity. And people engaging in debt based transactions should ensure they have the potential ability or capability to repay in accordance with the terms and conditions of the debt arrangement. Contracting a debt and not repaying, or without intention to repay is a grave sin. Certain verses in the Quran and sayings in the Hadith are clear about entering into a debt contract and supplications for the repayment of debt.

In the Quran Allah says:

“O you who believe! When you contract a debt for a fixed period, write it down....”-(Al Quran 02:282).

In a Hadith the Prophet Muhammad (Peace be upon Him) prayed: “O Allah, I seek refuge with You from sin and heavy debt”-(Dua). The Prophet Muhammad (Peace be upon Him) on many occasions has warned about the punishment for not repaying the debt. Once he is reported to have offered obsequies or the funeral prayer for a deceased person who had an unsettled debt, only after the debt was settled. Here is a Hadith for reference: “The Prophet (Peace be upon Him) refrained from offering the funeral prayer for one who had died owing two dinars, until Abu Qataadah (may Allah be pleased with him) promised to pay it off for him. When he saw him the following day and said, I have paid it off, the Prophet (peace and blessings of Allah be upon Him) said: “Now his skin has become cool for him”-(Musnad Ahmad (3/629).

In addition, according to the findings of some studies, the spending behaviour of a person who raises funds on debt is different from the one who spends his own money.

ZAKAT AND CHARITY

Zakat and charity constitute the ninth principle of Islamic

Economics. The word Zakat, literally means growth in goodness or increase, purifying or making pure. Therefore, the act of giving Zakat is purifying one's wealth to gain Allah's blessing to make it grow in goodness. As discussed earlier, Islam encourages every individual to earn and acquire as much wealth as they can in a righteous way. There is no restriction on the amount or value of wealth one can own. But, the basic principle is that from the surplus of the wealth one owns, there is need to spend a portion or part in the way of Allah for the benefit of the individuals in the society who are in need.

In the Quran Allah says:

“Believe in Allah and His Messenger (Muhammad), and spend of that whereof He has made you trustees. And such of you as believe and spend (in Allah's Way), theirs will be a great reward...”-(Al Quran 57:07).

This principle is derived from the fact that all wealth belongs to Allah, and people are only trustees for Allah's wealth. It is Allah's invisible hand that turns the wheel of economic life. Hence, Allah has made it obligatory that a small portion of the surplus wealth He entrusted to individuals to be paid in the form of Zakat as a way of purification of one's wealth, and as the share of the poor and the needy and those who are eligible to receive it.

In the Quran Allah says:

“And perform As-Salat (Iqamat-as-Salat), and give Zakat....”-(Al Quran 02:110).

Apart from legal obligations like Zakat, Islam also encourages an individual to spend for social welfare in informal ways like charity. Technically speaking, Zakat is a determined amount of wealth that is paid from a person's wealth in accordance with the methods and rulings of Islam to those who have the right to receive it as specified in the Quran in order to attain Allah's pleasure. Charity, however, is an optional act of giving wealth to all needy persons in order to attain Allah's pleasure. The worldly objective of both Zakat and Sadaqah is the downward flow of wealth from those who have to those who need it. The principle of Zakat and charity discourages the circulation and monopoly of wealth in a few hands.

SAVINGS IN ISLAM

It is a very much misunderstood concept that Islam tries to cultivate only spending behaviour among human beings and is silent on the aspect of saving. This assumption is not right. In fact, Islam encourages saving for the future needs. In the Quran there are verses that guide towards saving.

In the Quran Allah says:

[(Yusuf (Joseph)) said: “For seven consecutive years, you shall sow as usual and that (the harvest) which you reap you shall leave it in the ears, (all) except a little of it which you may eat.”Then will come after that, seven hard (years), which will devour what you have laid by in



The worldly objective of both Zakat and Sadaqah is the downward flow of wealth from those who have to those who need it. The principle of Zakat and charity discourages the circulation and monopoly of wealth in a few hands.

advance for them, (all) except a little of that which you have guarded (stored). “Then thereafter will come a year in which people will have abundant rain and in which they will press (wine and oil)”-(Al Quran 12: 47-49).

We also find Ahadith where the Prophet Muhammad (Peace be upon Him) advised not to leave one’s children begging or poor behind after one’s death.

Here is a Hadith for reference: “Sa`d b. Abi Waqqas, who wanted to make out a will giving away in charity everything that he owned: He went to the Prophet (Peace be upon Him) and said to him: “O Messenger of Allah! I have a lot of wealth and only my daughter to inherit it from me. Should I bequeath all of my wealth in charity?” The Prophet ((Peace be upon Him) told him that he should not do so. Then Sa`d suggested bequeathing two-thirds of his wealth to charity. When the prophet again refused, Sa`d then suggested half of his wealth. At this point the Prophet (Peace be upon Him) replied: “One-third, and that is still too much. It is better for you to leave your heirs wealthy, rather than leaving them dependent and begging from others”-(Sunan al-Tirmidhi (2042), Sunan Abi Dawud (2480), Sunan al-Nasai (3567) and Sunan Ibn Majah (2699)).

Even if we view the application of law of Zakat, it clearly reflects that without savings of cash and possession of other forms of wealth, it is not possible to practice this law



Even if we view the application of law of Zakat, it clearly reflects that without savings of cash and possession of other forms of wealth, it is not possible to practice this law, as Zakat is levied on a specific value of cash saved and wealth possessed. One can save as much as one wants, but the condition is that one should give the due share of the poor, the needy and the one who asks for.

REWARD

The tenth principle of Islamic Economics relates to the concept of reward. Islam states that self-satisfaction, profit, and self-development do matter, but not to the extent that Islam accords to the life hereafter. There is much beyond these materialistic rewards, in the form of heaven and true success in the eternal life.

In the Quran Allah says:

“And whatever you spend in good, it will be repaid to you in full, and you shall not be wronged....”-(Al Quran 02:272).

In fact, by following the divine principles in acquisition, utilisation and distribution of wealth, both the individual and the society enjoy the fruits of prosperity, development and success in the life here and that of here after.

Having outlined the principles of Islamic Economics, we now state that Islamic Economics, in simple terms, is the subject or science that studies and guides the economic behaviour of man in the light of divine guidance. The fundamental principles of Islamic economics rest on and are grounded in a sense of accountability, responsibility, mutual trust, equity, justice and equal opportunity. If viewed from a practical sense, then it is clear that all the principles of Islamic economics are designed to achieve the betterment of mankind.

ISLAMIC FINANCE

Following a brief introduction to the fundamental principles of Islamic economics, let us now explore the concepts and practice of Islamic Finance. The money that makes it possible to acquire existing wealth for consumption or as inputs in the production process can be referred to as Finance. It also implies the flow of funds from those who have (surplus) to those who need (deficit) it. Today, finance is needed not only by individuals but also institutions, private as well as public, as it helps in the production of additional wealth. If this financing activity is carried out in the light of Shariah principles, then it is known as Islamic Finance.

SHARIAH

To begin with, let us understand what the term Shariah denotes and connotes. Shariah literally means the path to the watering place. In technical and legal usage, however, Shariah refers to the commands, prohibitions, guidance and principles derived from the primary sources of Islam, the Quran and Sunnah. Shariah can be broadly divided into five main branches:

1. *Rituals and worship that are referred in Arabic as Ibadah*
2. *Transactions and contracts that are referred in Arabic as Muamalaat*
3. *Morals and manners that are referred in Arabic as Aadaab*
4. *Beliefs that are referred in Arabic as Itiqadaat*
5. *Punishments that are referred in Arabic as Uqubaat*

The laws related to finance and business transactions come under the Shariah branch of Muamalaat. Shariah states a general rule about the permissibility of any business and trade. The rule is that, "Unless there is a clear prohibition in either the Quran or Sunnah, every business or transaction is permitted."

FIQH

Let us move on to look at another important concept that comes into mind while discussing Shariah i.e. Islamic jurisprudence or Fiqh. Islamic jurisprudence is an expansion of the Shariah or code of conduct which is basically derived from the Quran and the Sunnah. It can be said that Fiqh is the product of Muslim jurist's understanding and interpretation of Shariah.

Having said that, we can now state that Islamic finance is a financial system that is in agreement with the principles of Shariah. And this is the main difference between conventional and Islamic Finance. The goal of Islamic finance is to offer economic benefits like acquisition of wealth, increase in income, earning profit, economic growth and development to the society. Islamic finance serves an individual or an organization by providing financial services that are more transparent, more reliable and justice-based.

FEATURES OF ISLAMIC FINANCE

The basic and most important features of Islamic finance are its freedom from Riba, Gharar, Maysir and avoidance of trade in unlawful goods and services. Furthermore, the features also include the principle of justice and equity.



The fundamental principles of Islamic economics rest on and are grounded in a sense of accountability, responsibility, mutual trust, equity, justice and equal opportunity. If viewed from a practical sense, then it is clear that all the principles of Islamic economics are designed to achieve the betterment of mankind.

Today, finance is needed not only by individuals but also institutions, private as well as public, as it helps in the production of additional wealth. If this financing activity is carried out in the light of Shariah principles, then it is known as Islamic Finance.



PROHIBITION OF RIBA

The word Riba is simply translated into English as usury or interest. There are many verses in the Quran and a number of Ahadith commanding the strict prohibition of Riba.

In the Quran Allah says:

“Those who eat Riba (usury) will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitan (Satan) leading him to insanity. That is because they say: “Trading is only like Riba (usury),” whereas Allah has permitted trading and forbidden Riba (usury). So whosoever receives an admonition from his Lord and stops eating Riba (usury) shall not be punished for the past; his case is for Allah (to judge); but whoever returns [to Riba (usury)], such are the dwellers of the Fire - they will abide therein. Allah will destroy Riba (usury) and will give increase for Sadaqat (deeds of charity, alms, etc.) And Allah likes not the disbelievers, sinners. Truly those who believe, and do deeds of righteousness, and perform As-Salat (Iqamat-as-Salat), and give Zakat they will have their reward with their Lord. On them shall be no fear, nor shall they grieve. O you who believe! Be afraid of Allah and give up what remains (due to you) from Riba (usury) (from now onward), if you are (really) believers. And if you do not do it, then take a notice of war from Allah and His Messenger but if you repent, you shall have your capital sums. Deal not unjustly (by asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums)...”-(Al Quran 2:275 to 279).

Trading in interest and violating the law of prohibition of Riba is referred as a major sin. In various Ahadith the Prophet (Peace be upon Him) elaborated and made clear the definition of Riba. Here is a Hadith for reference: “The selling of gold for gold is Riba except if the exchange is from hand to hand and equal in amount, and similarly, the selling of wheat for wheat is Riba unless it is from hand to hand and equal in amount, and the selling of barley for barley is Riba, unless it is from hand to hand and equal in amount, and the selling of dates for dates is Riba, unless it is from hand to hand and equal in amount”-(Bukhari Volume 3, Book 34, Number 382). Riba in its simplest terms is any excess or premium charged on money lent. The excess can be in terms of quality or quantity or in terms of a tangible thing or intangible benefit or is stipulated at the time of contract or while determining the period of delay for satisfaction or during the period of delay or the stipulation is in writing or is part of customary practice.

Riba is also prohibited by certain other religions such as Judaism, Christianity and Hinduism. The scriptures of Judaism and Jewish Law consider charging of interest is a major sin. Similarly, the Bible too forbids interest based lending. A similar text can be found in the Hindu scripture Masnsmriti prohibiting interest. Though the prohibition in the Quran and Hadith is enough to understand the ill effects of Riba, a few other references are given to show that not only Islam but other religions also prohibit the dealing in interest.

Moreover, not only religious communities, but also some secular communities prohibit the dealing in interest. For example, the co-operative society Jord Arbejde Kapital (JAK), founded in Denmark during the Great Depression in 1931, started an interest-free savings and loan system and a Local Exchange Trading System in 1934. JAK co-operative society made interest-free banking possible by saving points system. The members of this co-operative society accumulate points during saving periods and use those saving points while seeking an interest free loan.

PROHIBITION OF GHARAR

The word Gharar simply refers to uncertainty. Prophet Muhammad (Peace be upon Him) prohibited business and transactions that involve Gharar. In a Hadith the Prophet Muhammad (Peace be upon Him) said: “Whoever sells a defective commodity without disclosing it remains in Allah’s wrath”. There are many examples of Gharar-based transactions like the sale of the offspring in the womb of a pregnant animal, sale of fish in water and birds in the sky. The reason behind the prohibition of these transactions is that the ability of the seller to deliver these items is uncertain.

Gharar, in practice, relates to issues such as pricing, delivery, quantity and quality of assets that are transaction-based and could affect the degree or quality of consent of the parties to a contract. This may rise from misrepresentation, mistake, fraud, duress, or terms beyond the knowledge and control of one of the parties to the contract.

PROHIBITION OF MAYSIR

Gambling games of chance or speculation are forbidden. Gambling is a zero sum game which creates no additional value to the society.

UNLAWFUL GOODS AND SERVICES

Apart from being Riba and Gharar free, Islamic finance business keeps a distance from trading in unlawful goods and services that are prohibited and are clearly mentioned in the Quran and Hadith. Some of the notable prohibited goods and services include non-Halal foods such as pork, animals that are not slaughtered according to Islamic principles, intoxicating drinks, pornography, tobacco-related products and weapons. Non-involvement is not only limited to buying or selling but also includes all chains of production and distribution, such as packaging, transportation, warehousing and marketing of these prohibited goods and services.

JUSTICE AND EQUITY BASED

The application of Islamic guidelines in finance is not just for cleaning the financial system from interest and Gharar, rather it is to establish justice in finance for which Riba and Gharar have been prohibited. Islamic finance tries to promote social justice and equity in human society. Justice in business or partnership requires that both the parties should contribute cash, assets or work and bear or share the risk in business. On the basis of contribution and risk bearing or sharing, the profit and loss are distributed to the parties. With regard to trade, the Shariah provides the rulings to protect the consumers from producers or sellers



The basic and most important features of Islamic finance are its freedom from Riba, Gharar, Maysir and avoidance of trade in unlawful goods and services. Further, the features also include the principle of justice and equity.

Riba in its simplest terms is any excess or premium charged on money lent. The excess can be in terms of quality or quantity or in terms of a tangible thing or intangible benefit or is stipulated at the time of contract or while determining the period of delay for satisfaction or during the period of delay or the stipulation is in writing or is part of customary practice.



in the event of the latter manipulating prices, and protect the producers or sellers from consumers should the latter refrain from paying or default in their payment without a valid reason. In this manner, establishment of justice and equity becomes the additional feature of Islamic finance.

SOURCES OF LAW AND ISLAMIC COMMERCIAL LAW

Following a brief introduction to the basic features of Islamic finance, let us now understand the law and regulation of Islamic finance. Unlike conventional finance which is regulated under conventional commercial law, Islamic finance is regulated under Islamic commercial law, which is derived from two sources – primary and secondary.

PRIMARY SOURCES

The primary sources are based on revelation. As mentioned earlier, they are the Quran and Sunnah. These sources are not subjected to any change or alteration.

SECONDARY SOURCES

The secondary sources are based on human interpretation and reasoning, which, in practice, is or should be traced back to primary sources. When a specific decision or authority related to a particular case is not found in the Quran or the traditions of the Prophet Muhammad (Peace be upon Him), then the accepted methodology is to undertake legal reasoning and interpretation to find out the answer. This methodology of law-making, in the light of the Quran and Sunnah is known as legal reasoning or Ijtihad, which forms the secondary source for Islamic law. The subsidiary sources for Ijtihad are:

- a) Ijma (consensus of Muslim jurists): This refers to the consensus of Muslim jurists on a particular legal issue at a particular point of time after the demise of the Prophet Muhammad (Peace be upon Him).
- b) Qiyas (analogical reasoning): Qiyas is an extension of a Shariah value from an original case (asl) to a new case, because the latter has the same effective cause (illah) as the former. The original case is ruled by the Quran or Sunnah and Qiyas aims to extend the same ruling to the new case based on the same illah. For example, prohibition of wine drinking is extended to the consumption of drugs at the present time.

MADHAHIB - SCHOOLS OF ISLAMIC LEGAL THOUGHT

Following our above discussion on the sources of Islamic law, we take a look at Madhahib, which could be understood as the schools of Islamic legal thought. The different schools of Islamic legal thought emerged due to the independent interpretations of general principles of the Quran and Sunnah in relation to specific cases by various prominent Shariah scholars over the centuries. Each school is designated the names of its founding scholars. Among those Islamic schools of law, the most prominent were: The Hanafi School of Law, The Maliki School of Law, The Shafi'i School of Law and The Hanbali School of Law, which are explained briefly below.

THE HANAFI SCHOOL OF LAW

The oldest and largest among the four Sunni schools of Islamic legal thought is the Hanafi School of Law. It is named after its founder Abu Hanifa an-Numan (May Allah's mercy

be upon him)-(699 A.D - 767A.D.). This school of law follows the Iraqi tradition and is known for placing extra emphasis on the role of reasoning and logic in the understanding and practice of the Islamic rulings. This school has been the most flexible and workable in the area of commercial transactions.

THE MALIKI SCHOOL OF LAW

The second of the four Islamic schools is the Maliki School of Law. It is named after its founder Malik bin Anas (May Allah's mercy be upon him)-(711 A.D. - 795 A.D.). It was founded in Medina where Malik relied heavily upon the well-established practices of the early companions of the Prophet Muhammad (Peace be upon Him) living in Madina, for his legal formulations. The Muwattah and Mudawwana of Malik bin Anas primarily formed the basis for Maliki School.

THE SHAFI'I SCHOOL OF LAW

The third of the four Islamic schools is the Shafi'i School of Law. It is named after its founder Muhammad bin Idris al Shafi'i (May Allah's mercy be upon him) - (767 A.D. - 820 A.D.). He was thoroughly familiar with and well-versed in the doctrines of both the Hanafi and Maliki schools. The Shafi'i school of law is derived primarily from Shafi'i's works *ar-Risala fi Usul-al Fiqh* and *Kitab al Umm*. Shafi'i's contribution lies in his collation and synthesis of legal theory in Islamic jurisprudence.

THE HANBALI SCHOOL OF LAW

The fourth Islamic school is the Hanbali School of Law. It is named after its founder Ahmad bin Hanbal (May Allah's mercy be upon him)-(780 A.D. - 855 A.D.). This school is more of an exercise on the traditions than on the science of law and jurisprudence.

Having introduced the four traditional schools of Islamic legal thought, it is important to state in this context that Muslims attribute an equal value to all four schools. The differences between them are in the domain of the application of the law and not in the principles of the law.

From the above discussion, it is clear that Islamic finance comprises the following features:

- *Interest-free*
- *Gharar or uncertainty-free*
- *Shariah-compliant*
- *Risk-bearing and Risk sharing*
- *Equity and justice based*

HISTORY AND DEVELOPMENT OF ISLAMIC FINANCE

After knowing the basic principles of Islamic economics and Islamic finance, let us explore briefly the evaluation and development of Islamic Finance and financial industry through the ages.

650 AD - 750 AD

Islam was revealed unto the Prophet Muhammad (Peace be upon Him) and spread through the cities of Mecca and Madina. Earlier, these cities prospered through local business and international trade. Interest based loans were the major source for the financial needs. The businessmen of



Gharar, in practice, relates to issues such as pricing, delivery, quantity and quality of assets that are transaction based and could affect the degree or quality of consent of the parties to a contract.

The application of Islamic guidelines in finance is not just for cleaning the financial system from interest and Gharar, rather it is to establish justice in finance for which Riba and Gharar have been prohibited.



Mecca and agricultural farmers of Madina met their financial requirements by participating in the interest based loans.

After the emergence of Islam, there was a significant change in the financial set up of these cities. The Quranic verses that prohibit the dealing in interest, the consumption of certain commodities and the methods of trade laid the foundation of Islamic finance business. These principles were practiced successfully in the two cities and also spread to other parts of the world for centuries. Baitul-mal which was the central Islamic treasury intended for the benefit of the needy Muslims in Prophet Muhammad's (Peace be upon Him) regime is evidence that the development of Islamic financial system started during that time.

Mosque of Madina was used as the treasury by the Prophet Muhammad (Peace be upon Him). But Omar (May Allah be pleased with Him), the second caliph, established and operated Baitul-mal as a separate entity. Zakat, land tax or Kharaj, poll tax or Jizia, customs duties, donations, property with no ownership and estates of deceased persons who had no legitimate heirs were the major sources of revenue for Baitul-mal.

Apart from the establishment of Baitul-mal, historical evidence confirms the existence of the bill of exchange and cheques in the early days of Islam. For example, Ibn Abbas (May Allah be pleased with Him) received the Wariq (silver minted into dirhams) and sent an acknowledgement to Kufa (a city in Iraq). Similarly, Abdallah Ibn Az Zubair (May Allah be pleased with Him) received cash in Mecca and wrote to his brother in Iraq who repaid the depositors when they arrived in Iraq. Sayf al-Dawalah al-Hamdani was probably the first person in Islamic banking history to use cheques. This is a brief history of Islamic finance during the period around 650 AD to 750 AD.

750 AD - 1900 AD

Unfortunately there is no significant literature available on how Islamic economics and finance had developed during 750 AD to 1900 AD. Particularly, detailed information on the financial system during the Ottoman Empire in Turkey, as well as the Moghul Empire in India and Damascus, is not available. One can say that there was a massive expansion in regional, national and international trade, which was spread over Rome, Tunisia, Turkey, India and Sumatra. It was mostly carried on Musharaka (profit & loss sharing) basis. In addition, the financial instruments like Sak or Sukuk, Saftija, Bai al-wafa and Bai al-nuqud were also used and practiced.

1900 AD - 2000 AD

After a brief note on the development of Islamic Finance during 650 AD to 1900 AD, let us now move on to the development of Islamic finance in modern times. By this we mean the developments in the 20th century.

There was a massive expansion of the interest based banking system after the industrial revolution in the early period of 20th century. The Muslim scholars of the time took this

expansion of interest based banking seriously and called for an alternative financial mechanism within the Shari'ah norms for Muslim societies.

In 1903, the Egyptians opposed the 'interest' in a formal way when the payment of interest on post office saving funds was declared illegal by Shari'ah scholars in Egypt. It was followed by the movement against the interest based funds for the construction of the Suez Canal raised by Barclays Bank.

Additionally, in India, an institution for interest-free loans was established during 1890s. It was followed by another such institution called "Anjuman Imdad-e-Bahmi Qardh Bila Sud" (Interest Free Credit Society) in Hyderabad in 1923.

Later, in the 1950s a local Islamic bank, which is said to be the first modern Islamic financial institution was established in Pakistan. By the end of the 1950s the Muslim society had successfully developed an interest-free bank based on trust financing or Mudarabah and agency or Wakala.

The demand for Shari'ah-compliant banking was met by the establishment of Mit Ghamr Local Savings Fund in Egypt in 1963 by noted social activist Ahmad-al-Najjar and is widely considered to be the first modern Islamic bank. During the same period, there were efforts in Malaysia to develop a savings scheme for Muslims to perform the Pilgrimage which resulted in the Pilgrims' Savings Corporation. It was later incorporated into the Pilgrims' Management and Fund Board, which was popularly known as Tabung Haji in 1969.

In 1971, the Nasir Social Bank was established in Egypt. It was the first state-sponsored interest-free institution established by a presidential decree. The prominent Islamic banks i.e. the Dubai Islamic Bank and Islamic Development Bank were established in the year 1975. In addition to that, an investment company known as Islamic Investment Company (IIC) was established in Bahamas in the year 1977. Moreover, to carry out comprehensive research in this field, the first specialised research institution; namely, the Centre for Research in Islamic Economics was established at the King Abdul Aziz University of Jeddah, in 1978.

The Islamic financial services industry began its rapid growth and expansion during 1980s. The major developments of the 1980s include serious research work, constitutional protection in three Muslim countries namely Iran, Pakistan and Sudan, and the involvement of conventional bankers in offering Shari'ah-compliant services. The International Monetary Fund (IMF) initiated research on the macroeconomic implications of an economic system operating on interest free basis. Countries such as Malaysia and Bahrain started Islamic banking within the framework of the existing system. Bank Islam Malaysia Berhad (BIMB) was established in July 1, 1983 in Malaysia. Another significant development during this period was the granting of an Islamic bank license in Saudi Arabia to the fifty year old Al-Rajhi Company, a firm that started operation in 1985 under the name Al-Rajhi Banking Investment Corporation.



When a specific decision or authority related to a particular case is not found in the Quran or the traditions of the Prophet Muhammad (Peace be upon Him), then the accepted methodology is to undertake legal reasoning and interpretation to find out the answer. This methodology of law-making, in the light of the Quran and Sunnah is known as legal reasoning or Ijtihad, which forms the secondary source for Islamic law.

The different schools of Islamic legal thought emerged due to the independent interpretations of general principles of the Quran and Sunnah in relation to specific cases by various prominent Shariah scholars over the centuries.



SINGLE VERSUS DUAL BANKING SYSTEMS

There had been a great debate over whether a single or a dual banking system was to be adopted by the institutions during 1980s. Basically, a single banking system means that all financial systems must be Shari'ah compliant. A dual banking system allows both Islamic and conventional financial institutions to co-exist.

In the early 1980s, Pakistan, Sudan and Iran were among the first to adopt a single banking system that sought to fully implement Shari'ah principles. Within a short period of time all financial institutions in these countries had to comply with Shari'ah principles and exclusively provide Shari'ah-compliant financial services. Other countries, including Malaysia, United Arab Emirates, Kuwait and Bahrain adopted a more gradual approach that led to the creation of a dual banking system.

2000 AD TILL DATE

The rapid growth and expansion of Islamic financial institutions raised the need of a regulatory framework at the local and international level. Therefore, the period of 1990s and the early period of the 21st century saw the development of international standard setting and benchmarking institutions and agencies. Prominent institutions like International Islamic Financial Market (IIFM) were established in 2001. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), International Accounting Standards Board (IASB), the Islamic Financial Services Board (IFSB), and Islamic International Rating Agencies (IIRA), were established in 2002.

Later, the General Council of Islamic Banks and Financial Institutions (CIBAFI) and the Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI), etc, were established. These institutions legislate, govern and regulate the industry to ensure a sound and stable system through effective supervision, disclosure, transparency and market discipline. They also try to ensure that Islamic financial institutions comply not only with Shari'ah principles and domestic legal requirements but also with global standards and best practices which are not in conflict with the established rules and principles of Shari'ah.

ISLAMIC BANKING IN THE WEST

The Islamic banking and finance spread in the western nations too. The prominent Islamic banking and financial institutions in the west are Islamic Banking International Holding (Luxembourg) established in 1978, Dar-al-mal-al-Islami (Geneva) established in 1981, 'Al-Baraka' group established in 1982, Islamic International Bank of Denmark established in 1982 and Islamic Finance House (London) established in 1983.

Apart from the above mentioned banks and institutions, a few other renowned international conventional banks that are offering Islamic banking services include Chase Manhattan, Citibank (Bahrain), the Hong Kong and Shanghai Banking Corporation (HSBC), Union Bank of Switzerland (UBS), American Express Bank Ltd., American Bank, BNP-Paribas, Kleinwort Benson, Morgan Stanley, Goldman and Standard Chartered.

SNAPSHOT OF WHAT WE HAVE LEARNED

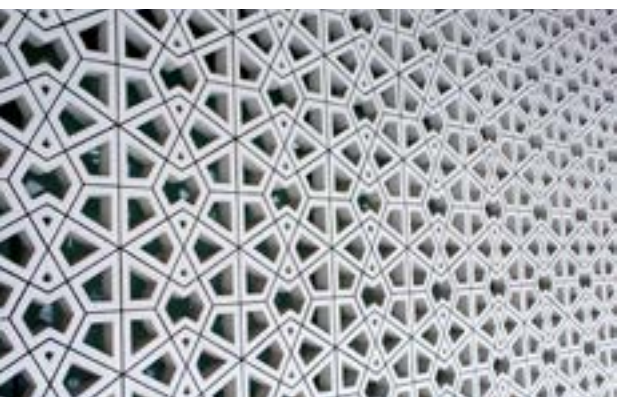
In this module we have learned about:

- **Quran:** The divine book revealed as the final revelation upon our beloved Prophet Muhammad (Peace be upon him) as the guidance for Humanity. It contains 114 chapters and more than 6000 verses discussing legal principles of every aspect of life.
- **Sunnah:** The traditions of the Prophet Muhammad (Peace be upon him) which include His sayings, actions and tacit approvals.
- **Shariah:** The law derived from the Quran and Sunnah. Shariah is divided into five major branches, i.e., Ibaadaat, Muamlaat, Aadaab, Itiqadaat and Uqbaat.
- **Fiqh:** Expansion of Shariah by Islamic Jurists in the light of Quran and Sunnah.
- **Primary sources of Islamic Law:** The primary sources of Islamic law are based on the revelation and are Not subjected to any change. They are the Quran and the Sunnah.
- **Secondary sources of Islamic Law:** The secondary sources of Islamic law are based on the human interpretation and reasoning, which in practice should be traced back to primary sources. Ijtihad is the secondary source. Subsidiaries of Ijtihad are Ijma and Qiyas.
- **Hanafi School of Law:** First of the four major Madhahib. It is named under Abu Hanifa An-Nauman (RA). This school of law follows Iraqi tradition and has been more flexible in the area of commercial transactions.
- **Maliki School of Law:** Second of the four major Madhahib. It is named under Malik Bin Anas (RA). He relied heavily upon the well established practices of the Holy Companions (Ra) in Madina. His works Muwattah and Mudawana formed the basis for this school.
- **Shafi'i School of Law:** Third of the four major Madhahib. It is named after Muhammad Bin Idris Bin al-Shafi'I (RA). He was familiar with both Hanafi and Maliki schools. His works Ar-Risala-fi-Usul-al-Fiqh and Kitab-al-Umm formed the basis for this school.
- **Hanbali School of Law:** Fourth of the four major Madhahib. It is named after Ahmed Bin Hanbal (RA). This school is more of an exercise based on the traditions rather than on the science of law and jurisprudence.
- **Real Owner:** Allah (SWT) is the real and ultimate owner of the wealth and resources available on the earth and in the heavens. Human ownership is recognised only if the person puts in individual efforts to acquire these resources.
- **Man and his Position:** Man is the vicegerent (Khalifa) of Allah (SWT) and is obliged to follow the guidelines sent down by Him in every sphere of life for success in the life here and the hereafter.
- **Wealth and Resources:** Allah has created abundant resources (both actual and potential). But these resources are unequally distributed around us with wisdom to create a relationship among the human beings. Every human being has equal right to acquire these resources through righteous means.
- **Economic Trust:** The natural inequality enables some people to earn more than the others. To maintain a balance in the society, it is required that a part of the surplus earned by a person should go to one who is not able to earn. This principle is known as Economic Trust.
- **Economic Activities:** Islam provides comprehensive



Having introduced the four traditional schools of Islamic legal thought, it is important to state in this context that Muslims attribute an equal value to all four schools. The differences between them are in the domain of the application of the law and not in the principles of the law.

Apart from the establishment of Baitul-mal, historical evidence confirms the existence of the bill of exchange and cheques in the early days of Islam.



guidelines towards the economics activities i.e. production, distribution, and consumption.

- **Trade and Business:** Islam permits and encourages trade. However, it provides a few conditions to protect the interest of the parties involved in the trade and in the interest of the society.
- **Role and Nature of Money:** Contrary to the prevailing system, Islam views money as Only a Medium of Exchange and a measure of Value. It does not consider it to be a Commodity in itself.
- **Debt in Islam:** Generally, Islam discourages one's involvement in debt. It permits the same only when borrowing money becomes a necessity. The person getting into debt must be aware of his ability, both actual and potential, to repay the debt even before entering the transaction.
- **Zakat and Charity:** Zakat means purifying or increase. Allah (SWT) has made it obligatory for every able individual to pay a portion of the surplus earned to the poor and the needy as their share in the form of Zakat. In addition to the legal obligation (Zakat) Islam also encourages individuals to spend in the optional charity (Sadaqah) for social welfare.
- **Savings in Islam:** Islam also encourages saving a portion of wealth for future uncertainties and requirement.
- **Reward:** Islam considers the worldly profit, self satisfaction and material rewards, but not to the extent that it accords to the life hereafter. Islam states that by following the divine guidance individuals can have a successful life here in this world and more importantly a successful life in the hereafter.
- **Prohibition of Riba:** Riba (Interest or Usury) is any excess or premium charged on money lent. Involving and trading in interest is considered as a major sin in Islam and strictly prohibited in the Quran and Ahadith.
- **Prohibition of Gharar:** Gharar refers to uncertainty. The Prophet Muhammad (Peace be upon him) has prohibited any business transaction that involves Gharar.
- **Prohibition of Maysir:** Maysir (gambling or speculation) is a zero sum game which creates no additional value in the society. It is prohibited in the Quran and Ahadith.
- **Unlawful Goods and Services:** The goods and services that are directly prohibited in the Quran such as pork, intoxicating drinks, etc.
- **Justice and equity based:** The prohibition of Riba, Gharar and other goods and services is not just to clean the financial system. In fact the main objective is to establish justice and equity in the society.
- **Islamic Economics and Finance during 650 A.D. - 750 A.D.:** During the time of Holy Prophet Muhammad (Peace be upon him); During the time of Holy Companions (Ra) and Khulfa -e-Rashideen; After the period of Companions (Ra). Biatul-Maal, Zakat, Jizyah, Kharaj, Warik, Bills and Cheques.
- **Islamic Economics and Finance during 750 A.D. - 1900 A.D.:** International Trade spread over Rome, Tunisia, Turkey, India and Sumatra; Musharaka contracts, Sukuk, Saftija, Bay al-Wafa, Bay al-Nuqud, etc, were practiced.
- **Islamic Economics and Finance during 1900 A.D. - 2000 A.D.:** Demand for interest free banking system; Theoretical works by scholars; Establishment of first-generation institutions such as societies, banks and funds in Egypt, India, Pakistan, Malaysia, Dubai, Saudi Arabia, Iran, Sudan, etc.
- **Islamic Economics and Finance from 2000 A.D. till date:** Growth and expansion of Islamic financial institutions; Establishment of the various Islamic Finance Institutions such as IIFM, AAOIFIF, IASB, IFSB and so on.



ISLAMIC FINANCE STRUCTURES

Learning Objectives:

After completing this module the reader should be able to:

- Understand the definition, meaning and Shariah prerequisites of a Contract.
- Understand the different types of Islamic Finance Structures such as Musharaka, Mudaraba, Murabaha, etc.
- Know the origin, legitimacy, Shariah principles, structure, mechanisms and flows of each of the Islamic Finance Structures.
- Know the applications of these structures or contracts in the Islamic Finance industry.





INTRODUCTION

A contract is deemed legal and lawful in Islam only if it fulfills the requirements prescribed by Shariah. Islamic finance contracts have been evolving throughout the development of Islamic civilization based on the requirements of society.

Prior to the advent of Islam in Arabia, several types of contracts were commonly used by the Arabs to meet their financial and business needs. After its emergence, however, rather than abolishing those contracts altogether, Islam looked into their subject matter and practices. Any contract which was found contradictory to Islamic principles, such as the practice of Riba, was dissolved and declared forbidden. A few other contracts that were inconsistent with the principles of Islam, but were alterable or modifiable, had gone through the process of modification, by which the contradictory elements were removed and declared lawful, and considered part and parcel of Islamic trade and finance practices.

Some contracts, such as a sale concluded by merely touching an article without the right of option after seeing it; a transaction which was determined by throwing stones; a sale of a commodity which had not been possessed and so on, were declared to be illegitimate by the Prophet Muhammad (Peace be upon Him). On the other hand, some contracts like Bay' al-Salam, after undergoing a process of modification by eliminating all unjust elements, was declared valid and applicable to Islamic law.

This is a brief history of contracts practised during the time of Prophet Muhammad (Peace be upon Him). Let us now explore the different Islamic finance contracts, their structure and applications.

ISLAMIC CONTRACT

Let us begin with the concept of Islamic Contract.

In the Quran Allah says:

**“O you who believe! Fulfill (your) commitments”
(Al Quran 05:01).**

This verse of the Quran forms the legal basis for a contract in Islam. A contract is known as Aqd in Arabic which means ‘to tie’ or ‘to knot’ or ‘to join’. Legally, a contract binds all the parties involved in it. Due to the fact that a contract expresses the intention of the parties and establishes their rights and liabilities, it also clearly defines the nature, parties, processes, means and duration of a transaction or business. Islamic commercial law gives special importance to contracts. All contracts in Islamic finance are structured in the light of Shariah principles.

We now look into the prerequisites of Shariah contracts.

Prerequisites of Shariah contracts

- **Statement of contract:** Muslim jurists give remarkable importance to the statement of the contract. Few of them opine that it is the only pillar of contract, as all other aspects will automatically follow the statement. A statement of contract constitutes the offer and the acceptance. An ‘offer’ is a statement of intention expressed by one of the parties inviting the other party to accept a proposal, whereas the ‘acceptance’ is an expression of approving a proposal by the offeror with regard to the same details as expressed in the offer. Jurists

prefer the use of the past tense for verbal expression for forming an offer and an acceptance. For instance, 'I sold you' is written in the statement even before the contract is signed or commodities are sold. It is necessary to confirm the acceptance of an offer. The confirmation has to be explicit.

There must be clarity in offer and acceptance. The words and terminologies used must be in conformance with the words and terms that are normally used in the customs of the parties to indicate a particular type of contract. Another important condition for offer and acceptance is that both should be in the same session, i.e., within the agreed time frame between the parties.

- **Contracting Parties:** There are at least two parties in a contract. These are the offeror and the offeree. The offeror is the one who makes an offer and the offeree is the one to whom the offer is made. These two parties should have legal capacity to enter into a contract. Legal capacity means that they must attain puberty, maturity and must be sane. According to jurists, maturity means good and proper dealing with wealth from a worldly viewpoint. An immature person is not allowed to deal with his wealth independently. Anyone who has no legal capacity is not eligible to enter into a contract independently.

- **Subject matter of contract:** The subject matter of a contract can either be a tangible thing, or a usufruct, or work. It should be in compliance with Shariah. Commodities or goods that are prohibited in Shariah cannot be the subject matter of an Islamic contract. It should also be in the ownership of the seller. If the subject matter is not owned by any of the parties, then it cannot be a subject matter. It should be known to both the parties. The subject matter can be identified through physical viewing or viewing a similar object. It can also be identified by the description of the genus, type and amount in the case where the subject matter is commonly known to people. It should be in the capability of being handed over at the conclusion of contract. Thus, a contract cannot be concluded for subject matters such as stray animals, which the seller cannot hand over to the buyer. It should normally be present at the time of contract if it is a tangible thing. On the other hand, if the subject matter is a utility or work, then its presence is not required. What is rather required is an ascertainment of its occurrence. However, there is an exception to this general rule as in the case of contracts such as Salam and Istisna.

Among all the contracts that have evolved into various forms as human civilisation progressed, the contract of sale is considered the most fundamental contract. This is clearly remarkable, especially when classical Islamic law is considered. Before the formalization of the Islamic theory of contracts, almost all classical writings of Fiqh began with a sale contract where all the legal pillars and conditions were articulated and discussed in detail.

After having gone through the prerequisites of Shariah contract, let us now discuss one by one the different types of Islamic contracts along with their definition, legitimacy, principle, structure, mechanism and their applications in detail.

TYPES OF CONTRACTS

Barter Trading (Bay al-Muqayada)

It can be considered as the first contract of sale in which goods were

The offeror is the one who makes an offer and the offeree is the one to whom the offer is made. These two parties should have legal capacity to enter into a contract. Legal capacity means that they must attain puberty, maturity and must be sane

Among all the contracts that have evolved into various forms as human civilisation progressed, the contract of sale is considered the most fundamental contract. This is clearly remarkable, especially when classical Islamic law is considered.



exchanged for other goods. This contract was commonly practised in the early periods of human history. During the time of Prophet Muhammad (Peace be upon Him), this was the general practice. There is no specific prohibition found in the Quran or Sunnah about the practice of this type of contract. However, Shariah does not encourage the practice of this contract to avoid any element of unfairness in exchange of goods.

General Sale (Bay' al-mutlaq)

This is a sale of goods for money and was developed when the problem of exchange arose in the barter system. It is the most preferred mode of trading as it can fairly value and determine the price of goods. The importance of sale of goods for money can be understood from the Hadith in which the Prophet (Peace be upon Him) prohibited the exchange of inferior quality of dates for superior quality and advised to sell the mixed dates of inferior quality for money and buy superior quality with that money.

In a Hadith the Prophet Muhammad (Peace be upon Him) said: Narrated Abu Said Al-Khudri and Abu Huraira (May Allah be pleased with them): "Allah's Apostle appointed somebody as a governor of Khaibar. That governor brought to him an excellent kind of dates (from Khaibar). The Prophet asked, "Are all the dates of Khaibar like this?" He replied, "By Allah, no, O Allah's Apostle! But we barter one Sa' (around 3 kilograms) of this (type of dates) for two Sa's of dates of ours and two Sa's of it for three of ours." Allah's Apostle said, "Do not do so (as that is a kind of usury) but sell the mixed dates (of inferior quality) for money, and then buy good dates with that money." (Al Bukhari, Book #34, Hadith #405).

Exchange Sale (Bay' al-Sarf)

Bay' al-Sarf is the exchange of one monetary form for another in the same or different type or category, i.e., gold for gold coins, silver for silver, gold for silver, silver for gold, etc., whether it is in the form of jewellery or mintage. According to AAOIFI, it is permissible to trade in currency as it falls under the general Islamic provisions regarding the permissibility of selling gold, silver and money as this is one of the means of earning profit. However, such trading must be done in compliance with the following Shariah rules and precepts:

- Both parties must take possession of the counter values before dispersing, such possession being either actual or constructive.
- The counter values of the same currency must be equal in amount, even if one of them is in paper money and the other is in coin of the same country, like a note of one pound for a coin of one pound.
- The contract shall not contain any conditional option or deferment clause regarding the delivery of one or both counter values.
- The dealing in currencies shall not aim at establishing a monopoly position, nor should it entail any evil consequences to the interest of individuals or societies.
- Currency transactions shall not be carried out on the forward or future market.

Markup-Sale (Murabaha)

The word Murabaha is derived from the word 'Ribh', denoting profit or gain. Murabaha is selling a commodity as per the purchasing price with a defined and agreed profit markup. This markup may be a percentage of the selling price or a lump sum. This transaction may be concluded either

without a prior promise to buy, an ordinary Murabaha, or with a prior promise to buy, submitted by the person interested in acquiring goods i.e. Murabaha to purchase orderer (the customer). This transaction is one of the trust based contracts as the seller explicitly discloses the purchasing price and profit margin to the buyer.

The legitimacy and permissibility of the Murabaha sale is derived from the verses of the Quran in which Allah, Most High, says, "Those who eat Riba (usury) will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitan (Satan) leading him to insanity. That is because they say: "Trading is only like Riba (usury)," whereas Allah has permitted trading and forbidden Riba (usury). So, whosoever receives an admonition from his Lord and stops eating Riba (usury) shall not be punished for the past; his case is for Allah (to judge); but whoever returns [to Riba (usury)], such are the dwellers of the Fire - they will abide therein (02:275), and "O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent...."(04:29).

Important principles of a Murabaha:

a. Procedures prior to the contract: It is necessary that the purchaser should express their wish to acquire an item through the seller prior to the contract. But the expression of the customer does not constitute a promise or commitment except when it has been expressed in due form. The seller can purchase the items on its own behalf but only in response to its customer's wish and application. The promise to buy is not the integral part of a Murabaha transaction, but is intended to provide assurance unilaterally by the purchaser (customer). A bilateral promise is not permissible except if there is an option to cancel the promise, which may be exercised either by both promisors or by either one of them. The seller, in case of a binding promise, can take a sum of money as security deposit (Hamish Jiddiyah). In case of the customer's breach of its binding promise, the seller is entitled only to an amount equal to the actual loss from the security deposit (Hamish Jiddiyah).

b. Contracting parties: The parties who are involved in a Murabaha contract are the seller as the financier and the buyer as the customer

c. Subject matter: The subject matter of a Murabaha contract involves the asset and the selling price. The asset shall be clearly defined including its type, quantity and other descriptions and must be permissible from Shariah perspective. The seller must assume the risk of the ownership in the asset it intends to sell. Hence, it has to acquire the physical or constructive possession of the asset before entering into the Murabaha Sale Contract with the purchaser. Receipt of Bill of Lading by the seller or its agent, when purchasing goods on the international market, is considered as constructive possession. The selling price of Murabaha asset including its cost and profit margin must be disclosed to the purchaser clearly. The selling price and the seller's profit are required to be fixed and known at the time of signing the contract. Payment of the price of the item can either be short term or long term installments. The seller cannot receive any commitment fee or a fee for providing the credit period from the purchase.

d. Conclusion of a Murabaha: The contract of Murabaha consists of the offer by one party and the acceptance by another party. The Murabaha contract can be concluded by means of meeting or exchanging the offer and acceptance in any customary form of modern communication. It cannot be concluded automatically or by force, if the purchaser refuses to conclude the Murabaha. The forms of taking delivery or possession of items differ according to



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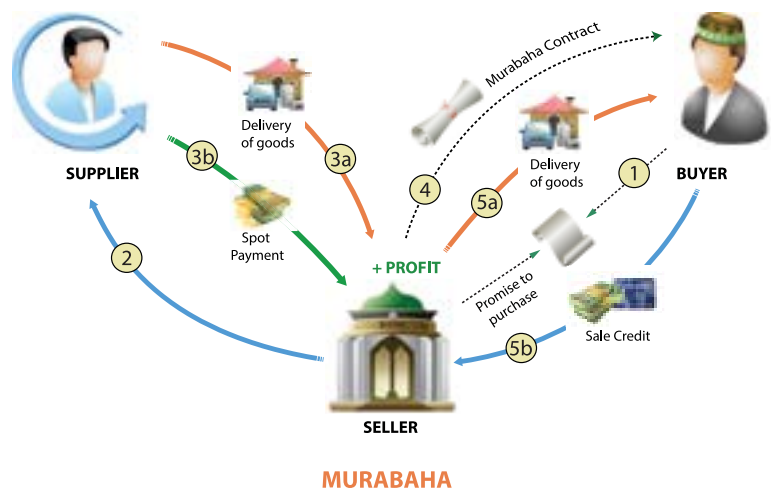
According to AAOIFI, it is permissible to trade in currency as it falls under the general Islamic provisions regarding the permissibility of selling gold, silver and money as this is one of the means of earning profit.



their nature and different trade customs. In case of the purchaser's breach of contract, the seller is entitled to receive compensation for actual damage it has incurred as a result of the breach.

e. **Guarantees and treatments:** The seller may ask the purchaser to provide lawful security like a pledge or third party guarantee or cheques or promissory notes, etc., against failure of purchaser in installment payments. However, it cannot be stipulated that the ownership of the item will not be transferred to the purchaser until full payment of the selling price. The seller may on its absolute discretion give up a part of the selling price if the purchaser pays early, but the date for payment cannot be extended in exchange for an additional charge or payment.

STRUCTURE OF A MURABAHA TRANSACTION:



Mechanism of a Murabaha Finance Transaction:

1. A customer needs certain goods and promises the Islamic bank to purchase the goods if the Islamic bank buys these goods from the supplier and takes the possession.
2. The Islamic bank purchases the goods on spot payment basis from the supplier and takes the possession (either constructive or physical).
3. The Islamic bank sells the goods to the customer after adding its profit markup, generally on deferred payment basis for an agreed period.
4. The customer makes the deferred payment to the Islamic bank during the agreed period.

Applications of Murabaha Contract in Islamic Finance:

Murabaha is one of the most widely used contracts at present in Islamic Banking and the investment sector. The various products where Murabaha is applied are as follows:

- Home financing
- Vehicle financing
- Working capital financing
- Project financing
- Goods financing
- Trade financing - LC based on Murabaha
- Murabaha based Sukuk
- Profit rate swaps
- Islamic fund
- Credit card

There are a few types of Islamic sale contracts that are technically different from Murabaha but appear similar to it. To avoid confusion,

we are mentioning them here.

- **Tawliyyah:** Tawliyyah is sale on which the commodity is sold at purchase price without making profit. It is supported by the tradition of the Prophet Muhammad (Peace be upon Him).

Here is a Hadith for reference: Narrated Aisha (May Allah be pleased with her): Rarely did the Prophet (Peace be upon Him) fail to visit Abu Bakr's house every day, either in the morning or in the evening. When the permission for migration to Medina was granted, all of a sudden the Prophet came to us at noon and Abu Bakr was informed, who said, "Certainly the Prophet has come for some urgent matter." The Prophet said to Abu Bakr, when the latter entered, "Let nobody stay in your home." Abu Bakr said, "O Allah's Apostle! There are only my two daughters (namely 'Aisha and Asma') present." The Prophet said, "I feel (am informed) that I have been granted the permission for migration." Abu Bakr said, "I will accompany you, O Allah's Apostle!" The Prophet said, "You will accompany me." Abu Bakr then said, "O Allah's Apostle! I have two she-camels I have prepared specially for migration, so I offer you one of them. The Prophet said, "I have accepted it on the condition that I will pay its price." (Al Bukhari, Book #34, Hadith #348).

- The main distinguishing feature between Murabaha and Tawliyyah is that in Murabaha there is an identified profit over the cost whereas in Tawliyyah the sale is at cost (no profit).
- **Wadhia:** Wadhia is a sale in which the commodity is sold at a discounted price, typically less than the cost price or purchase price, making a loss. The main distinguishing feature between Murabaha and Wadhia is that in Murabaha there is an identified profit over the cost whereas in Wadhia the sale is less than the cost (loss).
- **Musawama:** Musawama is the negotiation of a selling price between two parties without reference by the seller to either costs or asking price. It is a sale on cost plus basis, but the cost and profit margin are not disclosed to the customer. The main distinguishing feature between Murabaha and Musawama is that in Murabaha the cost and profit margin must be disclosed to the customer whereas in Musawama it is not necessary to disclose the cost and profit margin to the customer

DEFERRED PAYMENT SALE (Bay' Bi thaman A'ajil - BBA):

BBA is a sale contract in which the payment of the price is deferred and payable at a particular time in the future. The distinguishing feature of BBA is that in BBA the payment is always deferred.

The legitimacy of BBA is supported by the Hadith narrated by 'Aisha (May Allah be pleased with her): The Prophet Muhammad (Peace be upon Him) purchased food grains from a Jew on credit and mortgaged his iron armor to him. (Al Bukhari Book #34, Hadith #282).

Important principles of BBA:

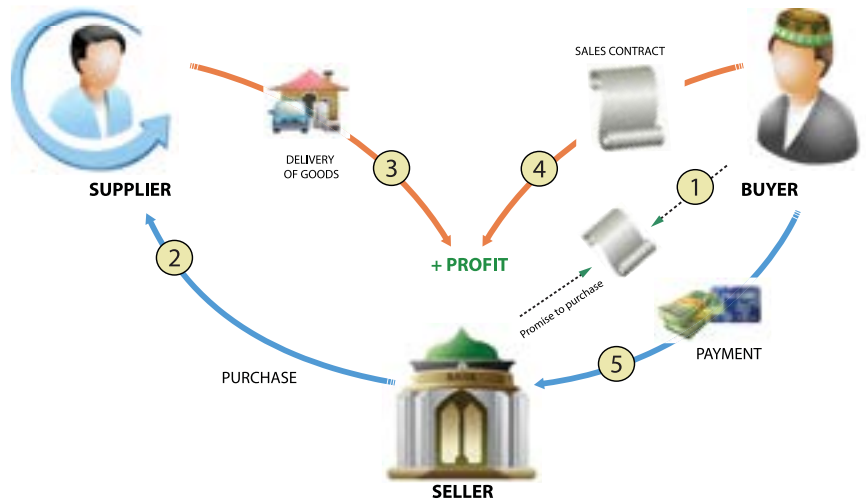
- a. Contracting parties: The parties who are involved in a BBA contract are the seller and the purchaser
- b. Subject matter: The subject matter can be assets or goods and commodities. The subject matter must be Shari'ah compliant. As the BBA is a sale contract, it is essential for the seller to have the ownership and physical or constructive possession of the goods before selling it to the purchaser.



The selling price of Murabaha asset including its cost and profit margin must be disclosed to the purchaser clearly. The selling price and the seller's profit are required to be fixed and known at the time of signing the contract.

c. Payment: There will always be a deferred payment of the purchases. The purchaser (the customer) would pay the price of the asset in future dates in various installments or in a lump sum amount at maturity.

STRUCTURE OF A BBA FINANCE TRANSACTION:



BAI'BITHAMAN A'AJIL

Mechanism of a BBA Transaction:

1. The customer needs certain goods and requests the Islamic bank to finance.
2. The Islamic bank delivers the requested goods to the customer after buying the same from a supplier and taking the possession thereof.
3. The customer pays the deferred price to the Islamic bank during the agreed period either in different installments or as a lump sum at the end.

Applications of BBA in Islamic Finance:

- Home financing
- Vehicle financing
- Goods financing

MONETIZATION (Tawarruq)

Tawarruq refers to the process of purchasing a commodity for a deferred price through Musawama (Bargaining) or Murabaha (Markup), and selling it to a third party for cash or a price on the spot.

Important Principles of Tawarruq Transaction:

a. Contracting Parties: The parties who are involved in a Tawarruq contract are the seller and the purchase.

b. Subject matter: The subject matter includes the commodity and the selling price. The commodity should be a real and Shariah compliant commodity. It must be owned and in possession of the seller before selling it. It cannot be gold or silver or any type of currency. The commodity must be sold to a party other than the one from whom it was purchased on deferred payment basis.

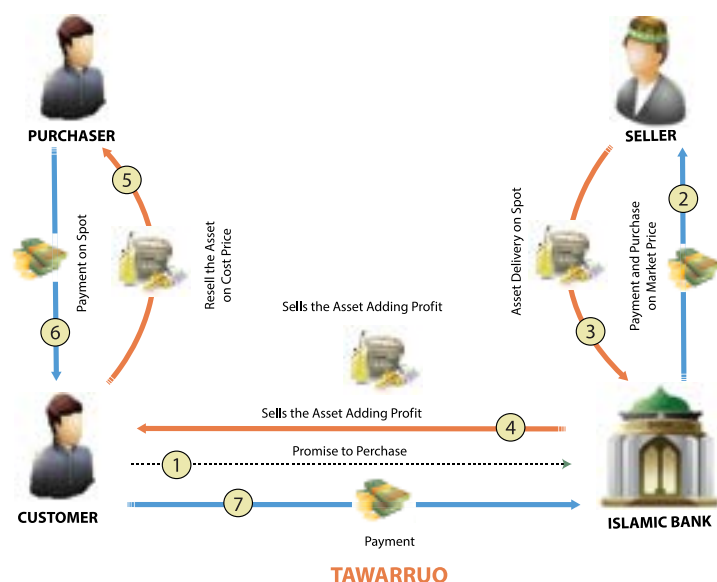
c. Conclusion of contract: A Tawarruq contract can be concluded by means of meeting or exchanging the offer and acceptance in any customary form of modern communication. However, the contract for purchasing the commodity between the purchaser and the seller on deferred payment basis should be independent of the contract of spot sale between the purchaser and the third party. In addition,

Tawarruq refers to the process of purchasing a commodity for a deferred price through Musawama (bargaining) or Murabaha (markup) and selling it to a third party for cash or a price on the spot.



neither can the purchaser delegate the seller or its agent to sell, on its behalf a commodity that it has purchased from the same seller, nor must the seller arrange proxy of a third party to sell on behalf of the purchaser, the commodity that the purchaser purchased from the seller. The seller should avoid proxy in selling a Tawarruq commodity, even if proxy is to be arranged with a third party.

STRUCTURE OF TAWARRUQ TRANSACTION:



Mechanism of Tawarruq Transactions:

1. A customer needs cash and requests the Islamic bank to finance.
2. Instead of financing in cash, the Islamic bank purchases the commodity from the seller and sells it to the customer through murabaha contract.
3. After getting the ownership and taking possession of the purchased commodity from the Islamic bank, the customer sells the commodity to a third party purchaser on spot payment basis. The price paid by the third party purchaser on the spot fulfills the need of liquid cash of the customer.
4. Later the customer pays the deferred price to the Islamic bank pursuant to the agreed upon terms.

Based on the ruling of the OIC Fiqh Academy, tawarruq can be categorized into two types: tawarruq fiqhi (or classical tawarruq) and organized tawarruq (tawarruq munazzam). The first type of tawarruq is defined as a person (mustawriq) buying merchandise at a deferred price in order to sell it at a lower price for cash. Usually, he sells the merchandise to a third party with the aim of obtaining cash. On the other hand, 'organized tawarruq' is defined in the same ruling as "when a person (mustawriq) buys merchandise from a local or international market on a deferred price basis. The financier arranges the sale of the commodity either directly or through his agent and forwards the sale proceeds to the customer.

The OIC Fiqh Academy has permitted the classical tawarruq, provided that it complies with the Shariah requirements on sale (bay), and considers the 'organized tawarruq', which is used by banks today to offer financing facility to customers for managing their short-term liquidity, to be impermissible.

There are also a few scholars who have disapproved tawarruq mainly on the aspect of intention. They argue that the intention here is to

The seller may in its absolute discretion give up a part of the selling price if the purchaser pays early, but the date for payment cannot be extended in exchange for an additional charge or payment.



procure money, which could be tantamount to the sale of money against a different amount of money, while the asset serves only as a medium; an acquisition which is not primarily intended. In addition, the principle of closing avenues (sadd al-dzarai'h - سد الذرائع) is also another important argument cited in support of the illegality of tawarruq.

However, a few other scholars from various schools of law appear to have considered Tawarruq to be legally permissible. Scholars who have upheld the permissibility of tawarruq have fundamentally relied on the general connotation of the verse permitting sale while prohibiting usury.

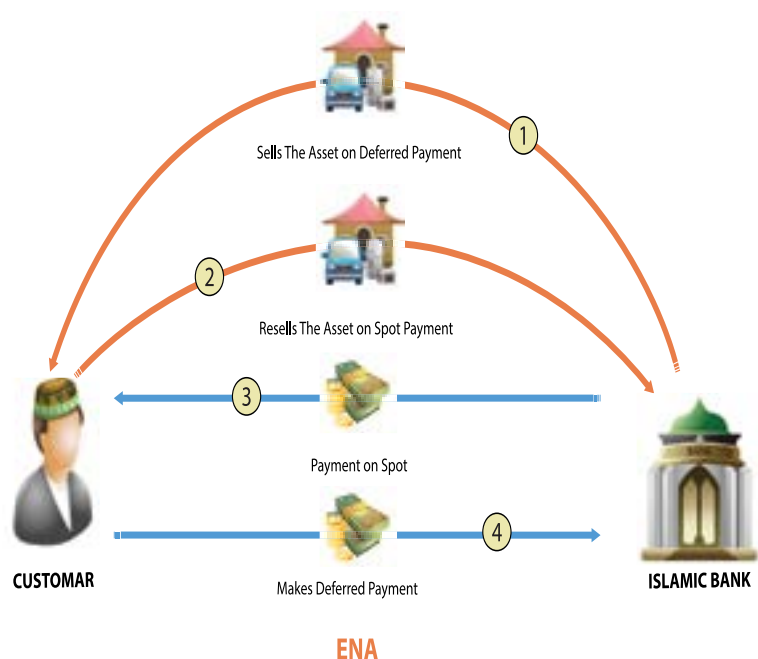
Applications of Tawarruq in Islamic Finance:

- *Working capital financing*
- *Project financing*
- *Credit Card*
- *Personal financing*

ENA:

Ena refers to the process of purchasing a commodity for a deferred price and selling it for a lower spot price to the same party from whom the commodity was purchased on deferred payment basis. It is allowed only by a few Sha'fai scholars with some specific conditions. The majority of scholars do not permit any transaction based on Ena in the Middle East and across the world.

STRUCTURE OF ENA TRANSACTION:



SALAM SALE (Bai' Al Salam):

Bai-Al Salam, also known as Bai-salaf or Bai-mafalisa is the purchase of a commodity for deferred delivery in exchange for immediate payment. It is a type of sale in which the price, known as the Salam Capital, is paid at the time of contract while the delivery of the item to be sold, known as Al-Muslam Fihi (the subject matter of a Salam Contract), is deferred. The seller and the buyer are known as Al-Muslam Ilaihi and Al-Muslim or Rab al-salam, respectively.

Tawliyyah is sale on which the commodity is sold at purchase price without making profit. It is supported by the tradition of the Prophet Muhammad (Peace be upon Him).



A contract of Salam derives its legitimacy from the Quranic verse.
In the Quran Allah says: “O you who believe! When you contract a debt for a fixed period, write it down...” (02:282).

On the level of Sunnah, here is a Hadith for reference:

Ibn Abbas (May Allah be pleased with him) narrated: Allah's Apostle (Peace be upon Him) came to Medina and the people used to pay in advance the price of fruits to be delivered within one or two years. (The sub-narrator is in doubt whether it was one to two years or two to three years.) The Prophet Muhammad (Peace be upon Him) said, “whoever pays money in advance for dates (to be delivered later) should pay it for known specified weight and measure (of the dates).” (Al Bukhari, Book #35, Hadith #441). In another version, Ibn Abbas (May Allah be pleased with him) narrated: The Prophet Muhammad (Peace be upon Him) came to Medina and the people used to pay in advance the price of dates to be delivered within two or three years. He said (to them), “whoever pays in advance the price of a thing to be delivered later should pay it for a specified measure at specified weight for a specified period.” (Al Bukhari, Book #35, Hadith #443)

Important principles of Salam:

a. Contracting Parties: The parties who are involved in a Salam contract are the seller (Muslim Ilahe) and the purchaser (the Muslim).

b. The subject matter of Salam: The subject matter of Salam includes the object and the price.

i) Object: The object of a Salam contract can be goods that may be weighed, measured or counted and not permitted to be an identified and specific thing like “this rice” or cannot be stipulated as a produce of specific piece of land. The Salam object is also not permitted to be any article which cannot be delineated in terms of their description like jewellery and antiques. It must be the kind of article for which a specification may be drawn up properly so that the seller may be held responsible for its conformity to the specifications and be commonly available under normal circumstances at the place where it should be on the delivery date. The purchaser cannot sell the subject matter before taking possession of it except through a parallel Salam contract.

ii) Price: The price for Salam goods can be in the form of goods such as wheat and other cereals, or items of material value such as livestock. It can also be in the form of a usufruct from certain assets, but it must be known to the contracting parties and must be paid in full to the seller at the time of concluding the contract.

c. Conclusion of Salam: Like other sale contracts, a Salam contract can be concluded by offer and acceptance. However, it may be concluded using the word Salam or Salaf or sale or any term that indicates sale of a prescribed commodity for deferred delivery in exchange for immediate payment of the price. It can be initiated through several agreements or can be initiated by drawing a general framework and master agreement.

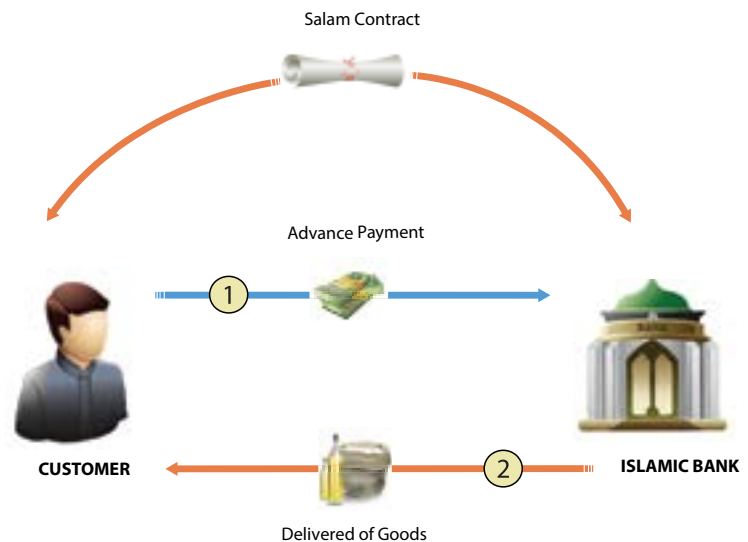
d. Delivery of the subject matter: The date of delivery for Salam goods must be specific and must be known. The seller must deliver the Salam goods to the purchaser on the due date and the purchaser must accept the goods if they meet the specifications. If the quantity and quality of the Salam goods is superior to that required by the contractual specifications, the purchaser must



The main distinguishing feature between Murabaha and Tawliyyah is that in Murabaha there is an identified profit over the cost whereas in Tawliyyah the sale is at cost (no profit).

accept the goods unless the seller seeks a higher price. If it is inferior, then the purchaser has the option to either reject or accept the goods. The delivery of Salam goods may take place before the due date. If the seller fails to perform his obligation, owing to insolvency, for instance, it can be granted an extension of time for delivery but no penalty clause shall be included in respect of delay in the delivery. In case all or part of Salam goods is not being available to the seller on the due date, the buyer may wait until availability or may cancel the contract and may also replace Salam goods by other goods.

STRUCTURE OF A SALAM TRANSACTION:



SALAM FINANCING

Mechanism of Salam Transaction:

1. A customer wants financing and approaches the Islamic Bank.
2. The customer (as seller) enters into a Salam sale contract with the Islamic Bank (as purchaser).
3. The Islamic bank pays the full purchase price in advance to the customer for the specified commodity to be delivered in future.
4. On the delivery date which is predefined, the customer delivers the commodity to the Islamic Bank.

Applications of Salam in Islamic Finance:

- *Working capital financing*
- *Financing for agriculture production*
- *Personal Finance*

MANUFACTURING FINANCE (ISTISNA):

The word Istisna is a derivative from the root word 'Sa na'a', which means to manufacture or to construct something. Istisna is a contract of sale of specified items to be manufactured or constructed with an obligation on the part of the seller to deliver them to the purchaser upon completion.

The legitimacy of Istisna is based on the Hadith narrated by Jabir (May Allah be pleased with him): A woman said, "O Allah's Apostle! Shall I get something constructed for you to sit on as I have a slave who is a carpenter?" He replied, "Yes, if you like." So she had that pulpit constructed. (Al Bukhari, Book #8, Hadith #440).

The contract for purchasing the commodity between the purchaser and the seller on deferred payment basis should be independent of the contract of spot sale between the purchaser and the third party.



Important principles of Istisna:

a. Contracting Parties: The conditions for the contracting parties for Istisna are the same as those of a regular sale contract. Thus the contracting parties must be competent by having legal capacity, i.e. they must be adults, mature and sane. Under this contract the Seller is called “San’e” while the buyer is described as “Mustasne”.

b. The subject matter: The subject matter of a contract of this type includes the object and the price.

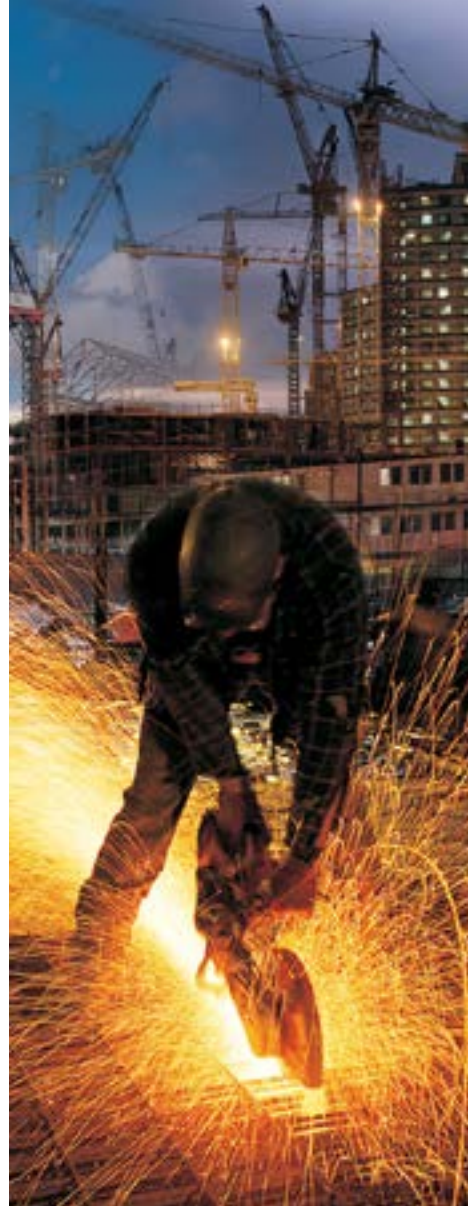
i) Object: The object for an Istisna contract must be identified raw materials that can be transformed from their natural state by a manufacturing or construction process involving labour with unique descriptions. The object of Istisna cannot be an identified existing capital asset or goods. The Istisna goods can be produced by the seller using its own resources or resources of the other manufacturer or producer, but according to the specifications and within the period agreed upon with the Mustasne (purchaser). The Istisna contract can be drawn for real estate development on designated land owned either by one of the two contracting parties or by both.

ii) Price: The price for Istisna goods must be known at the conclusion of the contract. The price could be in cash or tangible goods or the usufruct of an asset for a particular duration. Even the usufruct of Istisna goods themselves could be the price of the contract. Moreover, the price may be deferred or paid in installments within a certain period of time according to phases or stages of completion of work. The seller (San’e) can demand Urboun and guarantee from the purchaser (Mustasne) against its fulfillment of the payment obligations. In turn, the purchaser (Mustasne) may demand from the seller (San’e) to provide with the performance guarantee, or the advance payment guarantee if any amount of Istisna’s price is paid in advance.

c. Conclusion of contract: An Istisna contract can be concluded by offer and acceptance between the seller (San’e) and a purchaser (mustasne) even before the seller (San’e) assumes the title to the Istisna goods to be sold to the purchaser (mustasne). Since a contract of Istisna is binding, the parties to the contract are inevitably bound by all obligations and consequences flowing from their agreement and the contract can only be terminated by mutual agreement of the parties. If the Istisna work, however, has not commenced, either party may terminate the Istisna contract unilaterally. The seller (San’e) cannot stipulate in the contract that it is not liable for defects. After the conclusion of an Istisna contract, the seller (San’e) and the purchaser (mustasne) can mutually agree on amending and introducing new specifications and the Istisna’s price previously agreed upon. A contract of Istisna, by mutual consent of the parties, can include a clause to the effect that if any additional conditions are inserted into the contract at a later date, the extra expenses will be borne by the purchaser (mustasne).

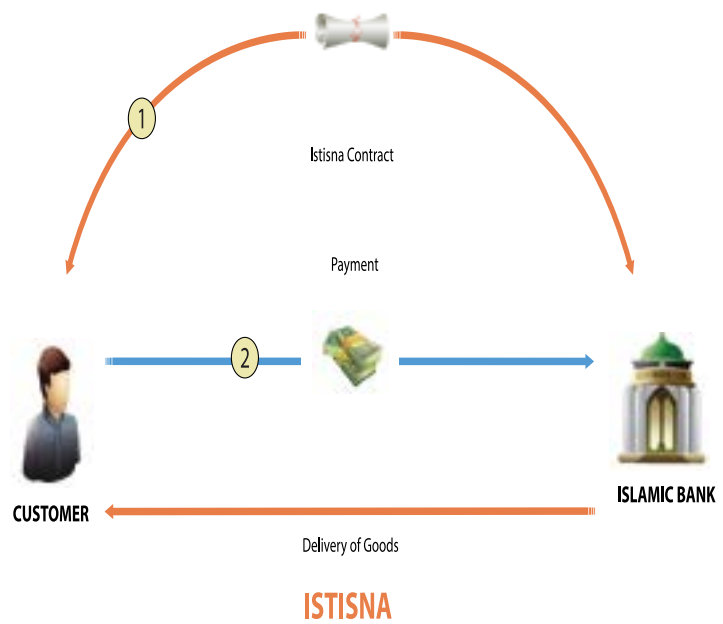
d. Supervision of the execution of contract: A technically experienced consulting firm can be appointed by the purchaser (mustasne) for ensuring whether the Istisna goods conform to the contractual specifications. The additional costs of supervision can be borne by either party as mutually agreed.

e. Delivery and disposal: Delivery of Istisna goods can take place before the due date or on the due date, or may take place through constructive possession by enabling the purchaser (mustasne) to take control over the subject matter after the completion of the production process. If the Istisna goods do not conform to the contractual specifications at the time of delivery, the purchaser (mustasne) has the right to reject them. The seller (San’e) is discharged from liability once the Istisna goods are delivered.



“For a Sale Contract the commodity should be a real and Shariah-compliant commodity. It must be owned by and in possession of the seller before selling it to the purchaser. If the sale is for a deferred price the gold or silver or any type of currency cannot become the subject matter of such sale”

STRUCTURE OF AN ISTISNA TRANSACTION:



Diminishing Musharaka (Musharaka Mutanaqisa) is a form of partnership in which one of the partners buys the equity share of the other partner gradually until the title to the equity is completely transferred to the buying partner.



Mechanism of an Istisna Transaction:

1. A customer wants to purchase certain assets to be manufactured or constructed and approaches the Islamic Bank (san'e).
2. The Islamic Bank as seller (san'e) and the customer as purchaser (mustasne) execute an Istisna contract.
3. After completion of the manufacturing process, the Islamic Bank (san'e) delivers the assets to the customer (mustasne) on agreed upon delivery date. The customer (mustasne) makes the payment to the seller (san'e) pursuant to the terms agreed upon in the Istisna contract either in various installments or, as the case may be, at the delivery of the asset.

Applications of Istisna in Islamic Finance:

- Home financing
- Project financing

PARTNERSHIP (MUSHARAKA):

The word Musharaka in Arabic is a derivative from the root word Shiraka which means to share. Musharaka (sharikatul al-inan) is a partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on condition that profit is to be distributed among the partners according to the partnership agreement and losses are to be borne by the partners in accordance with the contribution of each partner to the Musharaka capital.

Diminishing Musharaka (Musharaka Mutanaqisa) is a form of partnership in which one of the partners buys the equity share of the other partner gradually until the title to the equity is completely transferred to the buying partner. This transaction starts with the formation of the partnership, after which buying and selling of the equity take place between the two partners. It is therefore necessary that this buying and selling should not be stipulated in the partnership contract. In other words, the buying partner is allowed to give only a promise to buy. This buying and selling agreement must be independent of the partnership contract. It is not permitted to enter one contract on the condition of concluding another.

The legitimacy of the Musharaka is derived from the verse in which Allah, Glory be to Him, says,

“...And, verily, many partners oppress one another, except those who believe and do righteous good deeds, and they are few....”(Al Quran 38:24).

According to the AAOIFI standard, legitimacy of Musharaka is also supported by the Sunnah: On the day he conquered Mecca, the Prophet Muhammad (Peace be upon Him) welcomed al-Sa'ib Ibn Abi al-Sa'ib al Makhzumi, the partner of the Prophet (Peace be upon Him) in business at the beginning of Islam, by saying “my brother and my partner”.

Important principles of Musharaka:

a) Parties to Musharaka contract: In Musharaka, partnership can be concluded between two or more parties.

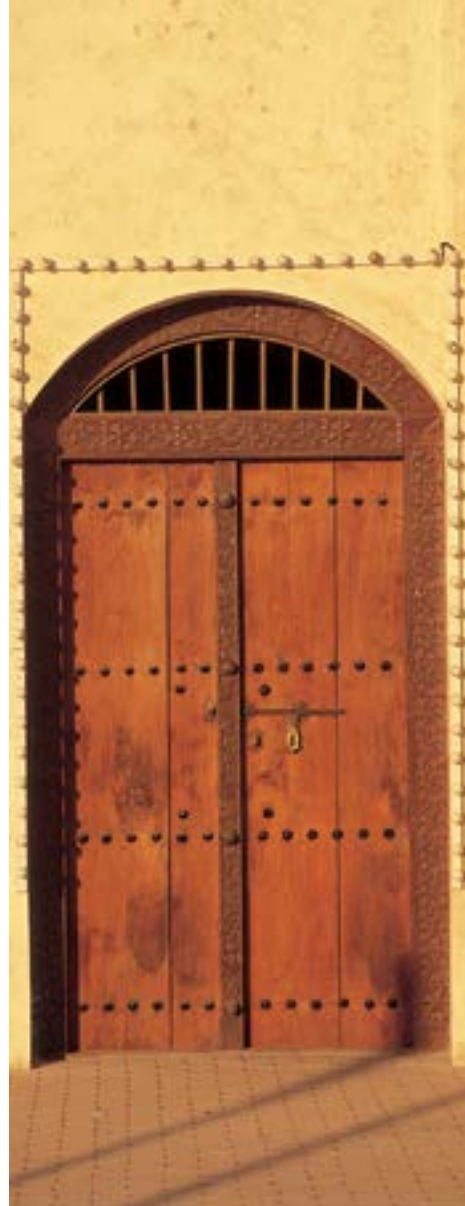
b) Capital of Musharaka: In Musharaka, the capital must be contributed by all partners. Capital can be in the form of monetary assets or in the form of tangible assets. It can be contributed in a lump sum or in various installments even in different currencies. Using debt alone as the capital to the partnership is not permitted, except to the condition when it becomes inseparable.

c) Management of Musharaka: In Musharaka, all partners have equal right to take part in its management. However, the management of partnership can be restricted to certain partners or to a single partner, in which case the other partners are not allowed to act on behalf of the partnership. Some or one of the partners can be appointed as a manager on the basis of an independent contract other than the Musharaka and can be paid remuneration. A manager other than the partners can also be appointed and can be paid a fixed remuneration.

d) Guarantee to Musharaka: All partners maintain assets of Musharaka on trust basis. Therefore, no one is liable, except in the case of misconduct, negligence or breach of contract. A partner cannot guarantee the capital of another partner except when one provides a personal guarantee to cover cases of misconduct, negligence or breach of contract. A third party can also provide a guarantee to the capital of the partners.

e) Profit Distribution: The proportion of profit to be distributed between or among partners must be agreed upon at the time of effecting the contract. The profit sharing ratio can be one other than the capital contribution ratio, but cannot be a lump sum or a percentage of capital. It is, however, not permitted to defer the determination of the profit percentage owing to each partner until the realization of profit. As for the procedure to calculate profit, partners can adopt either a permanent or varying method, for example, by agreeing that the percentage of profit shares in the first period are one set of percentages and in the second period are another set, or by using any other method for the calculation and allocation of profit. Even profit sharing can be done in a condition where the profit realised is above a certain ceiling; the profit in excess of such a ceiling will then belong to a particular partner. It is to be noted that in Musharaka, certain funds can be allocated to any of the partners on account before the final settlement of profit or Musharaka assets and it can be settled at the end.

f) Loss: Muslim jurists are unanimous on the point that proportions of losses borne by partners must be equal to the proportions of their capital contributions.



Scholars who have upheld the permissibility of tawarruq have fundamentally relied on the general connotation of the verse permitting sale while prohibiting usury.

g) Maturity and termination: Each partner has a right to terminate the Musharaka after giving due notice. Partners can enter into a binding promise to continue the partnership for a period of time. In case of maturity, assets can be distributed in a fixed proportion between or among partners. If this is not possible, then one of the partners can buy all the assets as per their market value (not on face value) and pay the proceeds to others. A Musharaka can also come to an end on the expiry date or as per the agreement of partners to terminate prematurely, or in case of death or incapacity of a partner.

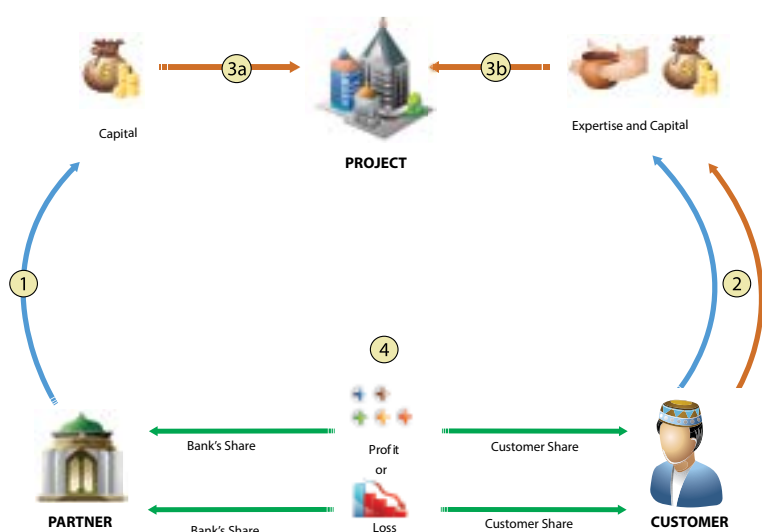
h) Diminishing Musharaka: All the general rules of a Musharaka (partnership) are applied to a Diminishing Musharaka. One partner can give a binding promise to another partner to acquire, on the basis of a sale contract, his equity share gradually, according to the market value or price to be agreed upon at the time of acquisition in case of partnership is based on Musharakatul Aqd. This promise, however, can be given by one partner to another to purchase its equity shares at their face value should the partnership is based on Musharakatul Melk.

DIFFERENT TYPES OF PARTNERSHIPS AT A GLANCE

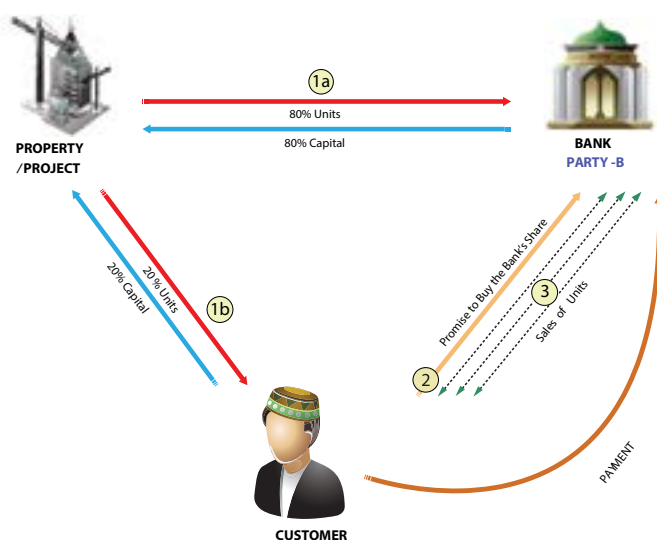
Contract Partnership (Shirkat al-aqd)	It is an agreement between two or more parties to combine their assets and liabilities with the aim of making profit.
Partnership of Ownership (Sharikat al-Melk)	It is the combination of the assets of two or more persons in a manner that creates a state of sharing the realised profits and losses.
Mufawda Partnership	It is a partnership in which the parties are equal in all respects, such as fund contribution, rights, liabilities, etc.
Sharecropping Partnership	This is a partnership in crops in which one party presents land to another for cultivation for a common defined share in the crop.
Irrigating Partnership	It is a partnership that depends on one party presenting designated plants that produce edible fruits to another in order to work on their irrigation in consideration for a common defined share in the fruits.
Agricultural Partnership	It is a partnership in which one party presents a treeless piece of land to another to plant it with trees on condition that they would share the trees and fruits in accordance with a defined percentage.



STRUCTURE OF MUSHARAKA AND DIMINISHING MUSHARAKA TRANSACTION:



MUSHARAKA



DIMINISHING MUSHARAKA

Mechanism of a Musharaka Transaction:

1. The customer and the Islamic bank are partners in a Musharaka Enterprise or project. Both the parties contribute money capital in a ratio, say, 20:80.
2. As per the agreement they decide to share the Net Profit in the ratio, say 40:60. If the Musharaka Enterprise realises any profit, then it would be shared between both the parties in the agreed profit sharing ratio i.e 40:60. The loss, if any, shall be shared only in the capital contribution ratio, which is 20:80.
3. In case of Diminishing Musharaka, one of the partners, say the customer, would buy the share of the Islamic bank over a period of time and at a certain period in future would become the complete owner of the Enterprise.

Applications of Musharaka in Islamic Finance:

A Musharaka contract is applied to many Islamic finance products. A few of them are mentioned below:

- Home financing
- Project financing
- Trade financing - Musharaka LC
- Shares and equity products

The price for Salam goods can be in the form of goods such as wheat and other cereals, or items of material value such as livestock. It can also be in the form of a usufruct from certain assets, but it must be known to the contracting parties and must be paid in full to the seller at the time of concluding the contract.

- *Islamic funds*
- *Musharaka Sukuk*

VENTURE CAPITAL (MUDARABA)

The term Mudaraba is derived from the phrase al-darb fil al-ard found in the Quran, which means to make a journey. It is called so because a worker strives and toils in the course of a business, and in most cases, making journeys is an inevitable and indispensable part of this hard work or toil.

Mudaraba is a form of partnership in profit whereby one party provides capital (rab-al-maal) and another, management skill or labour (mudarib).

The Mudaraba contract derives its legitimacy from the verse of the Quran in which Allah, Most High says,

“Others travelling through the land, seeking of Allah’s Bounty ...” (Al Quran 73:20).

According to AAOIFI standard, the proof from Sunnah on the legality of Mudaraba can be ascertained from the Hadith that says that al-Abbas Ibn Abd. al-Muttalib (May Allah be pleased with him) used to pay money for Mudaraba and to stipulate to the Mudarib that he was not to travel by sea, pass by valleys or trade in livestock, and that the Mudarib would be liable for any losses if he did so. Those conditions were brought before the Prophet Muhammad (Peace be upon Him) and he approved of them.

Important principles of Mudaraba:

a. Contracting Parties: There are two parties involved in Mudaraba, i.e. Rab al maal (capital provider) and Mudarib (who provides the management). In terms of legal capacity of the parties, rab al-maal must be competent to appoint a Mudarib, who in turn must be competent to accept this appointment.

b. Conclusion of Contract: Mudaraba is one of the trust based contracts. It can be concluded for a particular sum of money and also within a particular defined duration. The contract should define the intention of the parties, the forms of Mudaraba (i.e. unrestricted or restricted), the profit sharing ratio, the type of guarantees, etc.

c. Mudaraba Capital: Only one party contributes the capital to Mudaraba. The capital can be provided in cash or in the form of tangible assets, but in either case it should be clearly defined. The capital must also be available at the time of concluding the contract. Therefore, debt owed by the mudarib or a third party to Rab-al maal cannot be used as the capital, except in the case where the debt is due and ready for collection. The capital must be put at the disposal of the mudarib. In certain cases, Mudarib is also allowed to contribute in the Mudaraba capital.

d. Duties and Powers of Mudarib: The mudarib should employ best efforts to accomplish the objectives of the contract and investment. A Mudaraba contract can be restricted or unrestricted. If it is restricted, the capital provider can restrict the actions of the mudarib with respect to time, place, investment activities, etc. If it is unrestricted, then the Mudarib is permitted to do what entrepreneurs do in their fields of activity, like attending all permissible investments, trading and all transactions which are normally allowed in commercial usage. Regardless the type of Mudarabah be it Restricted or Unrestricted Mudarabah, the capital provider is not permitted to stipulate that he has a right to work with the entrepreneur or mudarib in management. The differentiating feature of Mudaraba is that the mudarib is not entitled to a fee or salary.

If the quantity and quality of the Salam goods is superior to that required by the contractual specifications, the purchaser must accept the goods unless the seller seeks a higher price. If it is inferior, then the purchaser has the option to either reject or accept the goods.



e. Guarantee: In principle, Mudarib is not supposed to give any guarantee to the capital provider neither for Mudaraba capital nor for any profit. The capital provider, however, can obtain certain guarantees from the mudarib that are adequate and enforceable against the Mudarib's misconduct, negligence or breach of contract.

f. Profit Distribution: Distribution of profit must be clear and must be on the basis of the sharing ratio (and not on the basis of a lump sum or a percentage of capital) and must be agreed upon when the contract is concluded. The profit sharing ratio can be fixed or can vary, subject to the performance of Mudaraba (ceiling basis). No profit can be realized or claimed unless the capital of the Mudaraba is kept invested or maintained intact. However, in the case of continuing Mudaraba, it is permissible to specify a mutually agreed accounting period for the distribution of profits, treating each period independently. There is no issue if any reserve from profits is built by the mutual consent of the parties to offset possible upcoming losses.

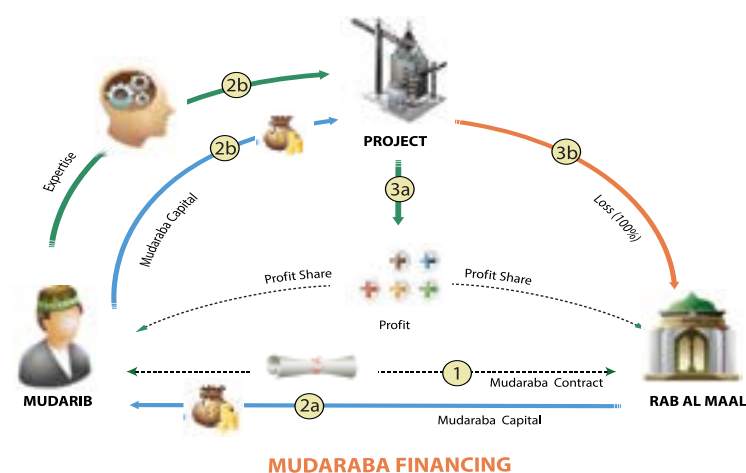
g. Mudaraba Loss: In principle, losses if any shall be borne only by Rab-al Maal and the mudarib is not liable for any loss unless there is negligence or misconduct on the Mudarib's part. Distribution of profit or loss depends on the final result of the operations. If there a loss at the time of liquidation, it must be deducted from the capital. If the parties have adopted the periodical profit distribution in continuing Mudaraba, then whenever a Mudaraba operation incurs losses, such losses stand to be compensated by the profits of future or from the reserves.

h. Maturity and Liquidation: A Mudaraba contract is not binding. Therefore, any one party may terminate the contract, except in the case when the business has commenced or the parties have already agreed on the duration of the contract. In addition, the Mudaraba can be liquidated when funds have been exhausted or suffered loss, on the death of mudarib, or on the maturity of Mudaraba or at any point in time by the mutual agreement of the parties. The valuation of assets in case of liquidation should be on actual or constructive and on the basis of fair value. The final distribution of profit should be made based on the selling price of the Mudaraba assets. The receivable shall be measured at the cash equivalent or net realizable value, i.e. after deduction of provision for bad debts. In measuring the receivables, neither the time value (interest rate) nor the discount on current value for extension of period of payment is taken into consideration.



Istisna is a contract of sale of specified items to be manufactured or constructed with an obligation on the part of the seller to deliver them to the purchaser upon completion.

STRUCTURE OF MUDARABA TRANSACTION:



MUDARABA FINANCING

Mechanism of a Mudaraba Transaction:

1. The customer and the Islamic bank initiate a Mudaraba

In Istisna price could be in cash or tangible goods or the usufruct of an asset for a particular duration. Even the usufruct of Istisna goods themselves could be the price of the contract. Moreover, the price may be deferred or paid in installments within a certain period of time according to phases or stages of completion of work.



Enterprise. As per the Mudaraba contract, the Islamic bank (as Rab-al-Maal) contributes 100% capital, whereas the customer (as the Mudarib) contributes the management or skills.

2. As per the agreement they decide to share the Net Profit in the ratio of 40:60, whereas the loss, if any, shall be borne only by the Islamic bank, the rab-al-maal.
3. In addition, if there are any direct expenses of Mudaraba, then the same shall be charged to the Mudaraba Enterprise and not to any of the parties.
4. Pursuant to the terms agreed upon in the Mudaraba contract, the Mudaraba asset is, either periodically or at the end of Mudarba, liquidated to Determine the profit or the loss.
5. As agreed earlier, 40% of the realized profit is given to the rab-al-maal and 60% is retained by the Mudarib while any loss is borne only by the rab-al-maal.
6. At the expiry of Mudaraba the Mudaraba assets are disposed off either by selling them in the market or purchased by the Mudarib on their market value.

Applications of Mudaraba in Islamic Finance:

Similar to the other contracts, the Mudaraba contract is also applied to various Islamic deposit and finance products. Few of them are mentioned below:

- *Saving account*
- *Investment account*
- *Project financing*
- *Takaful products*
- *Mudaraba Sukuk*
- *Islamic funds*

ISLAMIC LEASE (IJARAH):

The term Ijarah means leasing of property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration.

A lease contract can be concluded in different forms. They are as follows:

a) Operational Lease (Ijarah Tashgheeliyyah): In this form of lease, the lessor leases an asset for a specific period against the periodic lease rentals. The lessee utilizes the usufruct of the asset and returns the asset to the lessor at the end of the lease period.

b) Ijarah Muntahia Bittamleek (lease to own): Unlike the Operational Lease, under this lease the ownership of leased asset gets transferred to the Lessee either at the end of Lease Contract or any time during the Lease period. The ownership of the leased asset is transferred through a separate sale and purchase agreement between the parties either based on the Promise to Buy from the Lessee or Promise to Sell by the Lessor.

Apart from the above forms of Ijarah (Lease) there are two other types which are mainly related to the existence or non-existence of the Lease Asset:

c) Ijarah Muayyanah (Lease of an Identified Asset): In this form of lease, the Lease Contract is signed for an asset which can be identified by its existence and is ready to use. Based on the parties intention this type of Ijarah either may form and Operational Lease or Lease to Own.

d) Ijarah Mowsufa Fi al Dhimmah (Lease of a specified but an identified asset): In this form of lease, the Ijarah contract is concluded between the parties even before the asset is made

ready. However, an agreement is reached to make the described (according to accurate specifications) asset available on specific future date, giving the lessor the opportunity to acquire, produce or construct it.

The legitimacy of Islamic lease or Ijarah is derived from the verse of the Quran in which Allah says:

“And said one of them (the two women): “O my father! Hire him! Verily, the best of men for you to hire is the strong, the trustworthy.”(Al Quran 28:26), and “...If you had wished, surely, you could have taken wages for it!” (Al Quran 18:77).

According to AAOIFI standard, it is also supported by the saying of the Prophet Muhammad (Peace be upon Him) that, whoever hired a worker must inform him of his wages; And his saying: “give a worker his wages before his sweat (body odour) is dried”.

IMPORTANT PRINCIPLES OF IJARAH:

a. Unlike a sale contract, Ijarah contract may be executed for an asset currently not owned by the lessor. Any asset which is not permissible under Shariah to utilise cannot be leased. On the other hand, even the permissible asset cannot be leased if the purpose of lease is to perform or carry out the Shariah non-compliant activities. During the entire lease period the lessor is assumed to hold the ownership risk of the leased asset.

b. Contracting Parties: The contracting parties involved in Ijarah are the lessor and the lessee. Lessor is the one who owns the asset and lessee is the one to whom the asset is given on lease. Both parties must be of legal capacity and of sound mind and judgement.

c. Subject matter of Ijarah: The subject matter of Ijarah includes the physical asset, usufruct or benefit of the physical asset and the lease rent.

i) Usufruct or benefit: The leased asset must be capable of being used or preserved or benefitted from. The usufruct and the benefit from it must be lawful in Shariah. The lessee must use the leased asset in a suitable manner and comply with common practices. Maintenance of the leased asset is the responsibility of the lessor throughout the duration of the Ijarah, unless the lessee commits misconduct or negligence. If the benefit from the leased asset is impaired wholly or partially as a result of the lessee’s misconduct, the lessee is obliged to restore or repair. The lessor must accept responsibility for any defects of the leased asset which impair the intended use of the asset.

ii) Lease rent: The rent is what the lessee is committed to pay as consideration for the benefit enjoyed by him. The lease rental may be in cash or in kind (goods) or benefit (services), but must be specific. The total lease term can be divided into different lease periods to have different rentals for each rental period. The rentals can be fixed or floating and in the case where it is floating, it is necessary to have the minimum and maximum ceiling for the rent. It is then permissible that the rentals for the periods subsequent to the first period be determined according to certain benchmarks. The parties may agree to amend the rentals of the future by way of amendment of the Ijarah contract, but change in previous rentals which are due is not permissible if such change corresponds to the change in the payment period of the same rental. In case of Ijarah Mowsufa Fi Al Dhimmah, any amount paid by the lessee before the Ijarah commencement shall be considered as advance rental.



Since a contract of Istisna is binding, the parties to the contract are inevitably bound by all obligations and consequences flowing from their agreement and the contract can only be terminated by mutual agreement of the parties. If the Istisna’a work, however, has not commenced, either party may terminate the Istisna’a contract unilaterally.

A contract of Istisna, by mutual consent of the parties, can include a clause to the effect that if any additional conditions are inserted into the contract at a later date, the extra expenses will be borne by the purchaser (mustasne).



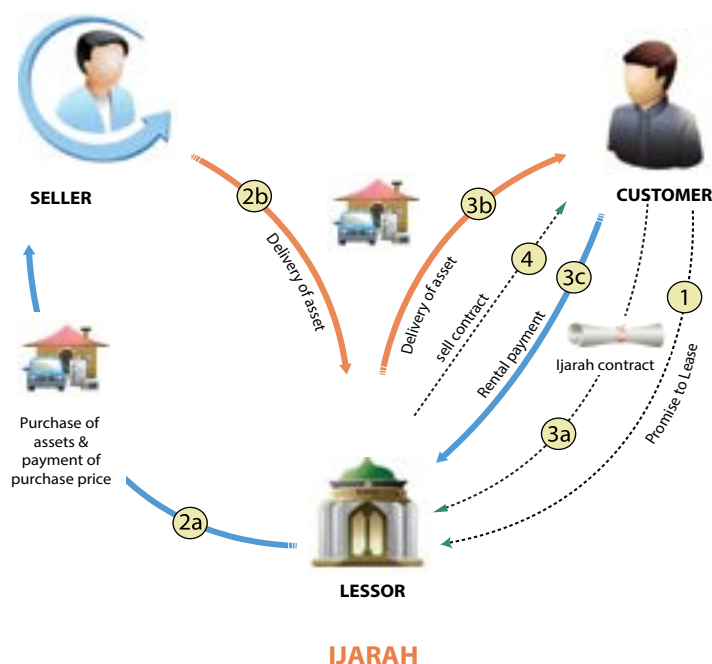
d. Concluding an Ijarah contract: Ijarah is a binding contract and is concluded through offer and acceptance. The duration of an Ijarah contract must be specified at the time of the contract. It is necessary that the asset must be delivered at the time of the contract; however, if it is delivered at a later date, then no rent is due for the period between the contract date and the actual delivery of the asset. Ijarah contracts may be executed in respect of the same asset for different periods for several lessees (successive leases). A lessee may invite a co-lessee to share with him the usufruct which he has a right to.

e. Guarantee and treatment: The lessor can ask for security to secure rental payments. No increase in the rental due may be stipulated by the lessor in case of delay in payment by the lessee. It may be provided in the contract of Ijarah that a lessee who delays payment for no good reason undertakes to donate a certain amount to a charity. In case of foreclosure of the security provided by the lessee, the lessor may deduct from such amounts only what is due.

f. Termination of Ijarah contract: An Ijarah contract may be terminated if the lessor sells the leased asset to a lessee, or if there is a total destruction of the leased asset, or with the mutual consent of both parties. It is not permissible for one party to terminate it except in case there is a defect in the leased asset or the lessee breaches the Ijarah Contract. An Ijarah contract may terminate with the death of either party; however, the heirs of the deceased have the option to continue. If the asset is sold to a third party then the title and rights and obligations under Ijarah contract are transferred to the new owner. The leased asset in the possession of the lessee is held on behalf of the lessor, therefore, the lessee will not be liable for any damage. In case of partial destruction of the leased asset in a manner that impairs the benefits expected from the asset, then the lessee may terminate the contract or may agree with the lessor to amend the rental or to replace the asset. If the lessee stops using the asset or returns it to the owner without the owner's consent, then the rental will continue to accrue. The lessor may stipulate that the Ijarah contract be terminated if the lessee does not pay the rent on time. An Ijarah can be renewed for another term and such a renewal may be made before the expiry of original term or automatically by adding a provision in the contract for such renewal when the new term starts, unless either party serves a notice on the other of its desire not to renew the contract.

g. Transfer of the ownership in Ijarah Muntahia Bittamleek: In Ijarah Muntahia Bittamleek, the asset is transferred to the lessee through a separate document from Ijarah. The document can be a sale contract for a token price or it can be a conditional gift contract. In case the Ijarah contract is combined with a gift contingent upon condition of full payment, then the ownership to leased property is transferred if the condition is fulfilled. If the leased asset is purchased from the lessee to whom this asset is leased back on Ijarah Muntahia Bittamleek, then the period between the leaseback and the transfer of the leased asset to the lessee must be long enough during which the leased property or its value is likely to change. Transfer of the ownership in the property cannot be made by executing, along with the Ijarah, a sale contract that will become effective at a future date.

STRUCTURE OF AN IJARAH TRANSACTION:



Mechanism of an Ijarah Transaction:

1. A customer who needs certain asset visits the Islamic bank and promises to lease the asset.
2. The Islamic bank purchases the asset from the supplier and pays the full amount on the spot as per the quotation.
3. Both the parties agree on the terms and conditions of Ijarah and execute the lease contract against the predefined periodic lease rent for a specific lease period.
4. In a normal lease, after the completion of the lease period, the Lessee would return the asset to the Lessor.
5. In case of 'Ijarah muntahia bittamleek', the ownership of the leased asset is transferred to the customer at the end of the lease period in which case the rental paid by the customer includes the cost of the asset as well.

Applications of Ijarah contract in Islamic Finance:

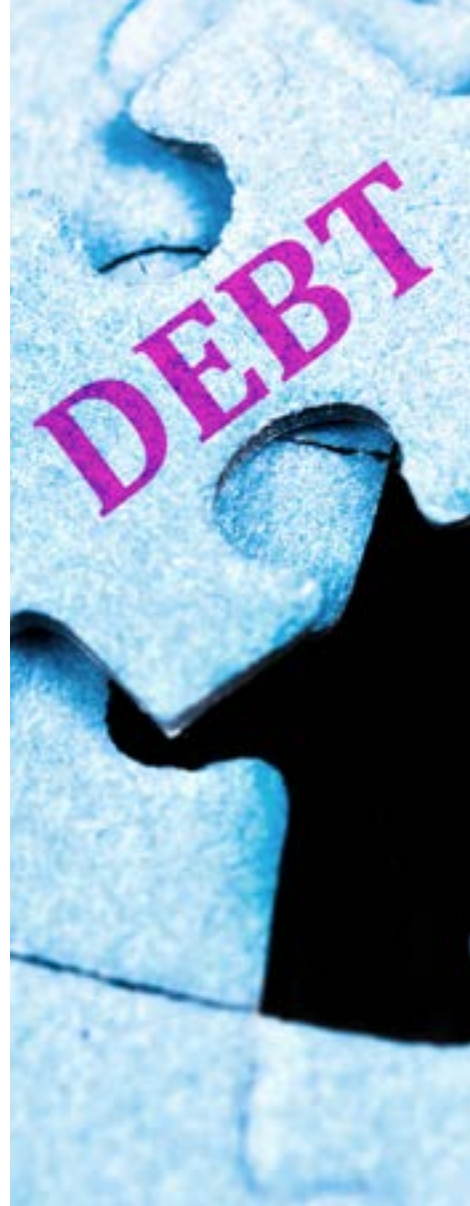
Generally, Ijarah contract is applied to the kind of products listed below:

- Home financing
- Vehicle financing
- Service financing
- Ijarah Sukuk

PLEDGE (RAHN):

The term Rahn literally means constancy, or holding and binding. Often, one uses the term Rahn to refer to the object that was pawned or pledged to insure debt. Legally, the pledging contract is defined as holding an item in lieu of a legal right that may be satisfied from an item. In other words, the contract involves holding a valuable non-fungible good as insurance against a debt, where the non-fungible good may be used to extract the value of the debt or part thereof. Rahn or pawning is one of the most practical means of insuring against default in payment of a debt.

The legitimacy of pledging is derived from the verse of the Quran in which Allah says:



If the Istisna goods do not conform to the contractual specifications at the time of delivery, the purchaser (mustasne) has the right to reject them.

“And if you are on a journey and cannot find a scribe, then let there be a pledge taken (mortgaging)...” (Al Quran 02:283).

Important principles of Pledge:

a. Contracting Parties : There are two parties to a pledge contract, i.e. the debtor and creditor. It is necessary, as is the case in all other sale contracts, that both parties must possess the legal capacity as stipulated by Shariah.

b. Underlying Debt: The underlying debt must be binding as a liability on the debtor, must be matured and must be clearly known to all the parties. It must be in nature that it is possible for the creditor to extract payment for his debt.

c. Pledged Object (asset): The pledged object is a property of the debtor held by the creditor in lieu of the underlying debt. The object must be a valuable property that can be lawfully owned and sold. It should be subjected to identification by sign, name or description and capable of being delivered to the creditor.

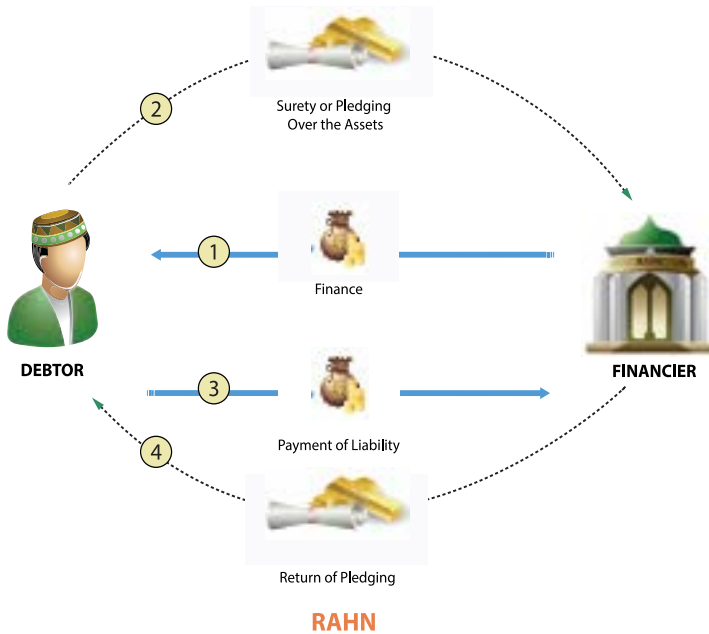
d. Possession and Ownership: The objective behind receiving in possession the pledge(d) object by creditor is to insure the realization of debt from debtor. The possession of the pledged object is permanent and final until the payment of the debt. It can be in the possession of the creditor or it can be left in the possession of the debtor or it can be kept with a third party (trustee) but the ownership right remains with the debtor so far as it continues to be the subject of pledge. The debtor can pledge an asset of a third party with the person's permission. All the actual expenses relating to tangible pledges, including the expenses incurred for the safe keeping of the pledge, are to be borne by the debtor. The creditor is entitled to retain the entire pledge for any part of the debt, unless he has agreed to a partial redemption. However, the creditor is not entitled, after the payment of the relevant debt, to retain the pledge for another unsecured debt, if this was not agreed earlier. It is permissible for the debtor to use the pledged object with the consent of the creditor. However, the creditor cannot use the pledged asset at all, even if the debtor has consented to this. A pledge asset is held by the creditor on a trust basis. Hence, its destruction, loss or damage while in the possession of the creditor does not affect the debt obligation. If it is destroyed, lost or damaged without any misconduct or negligence on the part of the creditor then the party is not liable for such destruction, loss or damage. The creditor can request the debtor to take out an insurance protection on the pledged asset and to assign the insurance benefit to creditor, so that in case the pledge asset is damaged before payment of the amount of the debt, the indemnity amount or insurance benefit shall replace the pledged asset.

e. Enforcement of pledge: A pledge object is essentially collateral to debt repayment used if a debtor does not pay his debt at maturity. Therefore, the creditor can demand the sale of pledged asset in order to recover the amount of the debt from the sale proceeds if the debtor fails to repay. However, the creditor is entitled to sale proceeds only equal to the debt and should return any surplus proceeds to the debtor. The creditor is not entitled to obtain ownership of the pledged asset in consideration of the amount owed by the debtor.

In its literal sense, Kafala means responsibility or suretyship. Legally, it can be defined as making the guaranteed person's liability a joint liability of the guaranteed and guarantor at the time of demanding compensation.



STRUCTURE OF RAHN:



Mechanism of a Rahn Transaction:

1. A person (debtor) seeks a loan (Qard) from another person (creditor).
2. The Islamic bank agrees to provide the financing using any of the Islamic structures but requests for the surety or security.
3. The debtor deposits a pledge-object (any asset or commodity) with the creditor as surety or security.
4. Once the debtor pays back the loan amount, the creditor would return the pledge-object to the debtor.

Application of Rahn in Islamic Finance

- As a security in Islamic finance contracts

GUARANTEE (KAFALA):

In its literal sense Kafala means responsibility or suretyship. Legally, it can be defined as making the guaranteed person's liability a joint liability of the guaranteed and guarantor at the time of demanding compensation. Thus, any individual, property, usurped object, or other item that can be demanded from the former can also be demanded from both parties by virtue of the guaranty.

The legitimacy of guarantee contract is derived from the Quranic verse.

In the Quran Allah says:

"...He made her grow in a good manner and put her under the care of Zakariya (Zachariah)..."(Al Quran 03:37), and, **"They said: "We have lost the (golden) bowl of the king and for him who produces it is (the reward of) a camel load; and I will be bound by it."**(Al Quran 12:72).

Here is also a Hadith for reference: Jabir Ibn Abdullah (May Allah be pleased with him) narrated: "The Apostle of Allah (Peace be upon Him) would not perform the funeral prayer over a person who died while the debt was due from him. A dead Muslim was brought to him and he asked: Is there any debt due from him? They (the



In Musharaka, all partners have equal right to take part in its management. However, the management of partnership can be restricted to certain partners or to a single partner, in which case the other partners are not allowed to act on behalf of the partnership.

A partner cannot guarantee the capital of another partner except when one provides a personal guarantee to cover cases of misconduct, negligence or breach of contract.



people) said: Yes, two Dirhams. He said: Pray yourselves over your companion. Then Abu Qatadah al-Ansari (May Allah be pleased with him) said: I shall pay them, Apostle of Allah. The Apostle of Allah (Peace be upon Him) then prayed over him. When Allah granted conquests to the Apostle of Allah (Peace be upon Him), he said: I am nearer to every believer than himself, so if anyone (dies and) leaves a debt, I shall be responsible for paying it; and if anyone leaves property, it goes to his heirs." (Abudawud, Book #22, Hadith #3337).

Important principles of Kafala:

a. Contacting Parties: The contracting parties involved in Kafala are the Guaranteed, Guarantor and Creditor. The condition for the person whose debt is to be guaranteed is that the person must be capable of repaying the debt. However, a few jurists are of the opinion that Kafala for an insolvent deceased is valid. As for the guarantor, Muslim jurists are unanimous on the requirement that he must have legal capacity to enter into a contract. The creditor should be known to the guarantor and should be present in the session of the contract directly or through a representative.

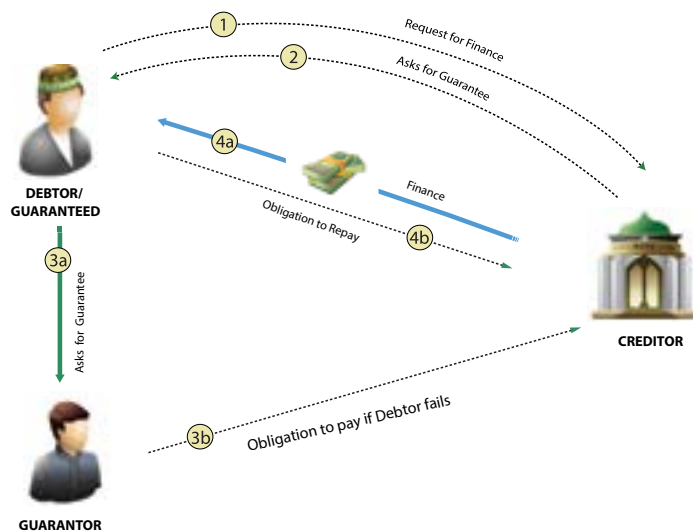
b. Object of Guarantee: Jurists are unanimous that Kafala can be effected upon all claims relating to the enforceable rights of the creditor such as the amount of debt, price of an item sold in a credit sale, rent, etc. A guarantee contract does not affect the validity of the original contract in which it is required. However, a guarantee is not permitted in trust (fiduciary) contracts, e.g., agency contracts or contracts of deposits, unless such a stipulation is intended to cover cases of misconduct, negligence, or breach of contract. The agency and personal guarantees cannot be combined in one contract at the same time.

c. Personal Guarantees: The bank can ask a customer to provide one or more guarantors to secure the amount owed by the debtor. Personal guarantees are divided into two types. One is the recourse guarantee, wherein the guarantor has a right of recourse against the debtor and the other is the non-recourse guarantee, wherein the guarantor has no right of recourse. The guarantee can be for a fixed duration. According to AAOIFI, one can neither take any remuneration for providing a personal guarantee per se, nor pay commission for obtaining such a guarantee. The guarantor is, however, entitled to claim any expenses actually incurred during the period of a personal guarantee. However, the prominent Shariah scholars are of the view that it is permissible to charge a fee for providing a guarantee in modern commercial Islamic finance practice.

d. Guaranteeing unknown and future debt: A valid guarantee may be given for debts, the exact amount of which is unknown. Similarly, a valid guarantee may be given for a debt that will arrive in the future.

e. The effect of a personal guarantee: The creditor is entitled to claim the amount due from either the debtor or the guarantor and the former has the choice of claiming his right from either of them. If the creditor discharges the debtor from the debt, the guarantor is also discharged automatically from his liability. However if the creditor discharges the guarantor from the liability, the debtor remains in debt.

STRUCTURE OF GUARANTEE



KAFALA

Mechanism of a Kafala Transaction:

1. A customer needs finance and visits the Islamic bank for the same. The Islamic bank agrees to finance but requests the customer to provide a surety.
2. The customer requests the third party or a Guarantor to guarantee the finance to the Islamic bank. The Guarantor guarantees the finance.
3. In this transaction, the Islamic bank has the right to collect the finance equally from both the customer and the Guarantor. In case of the customer's default, the guarantor is obliged to pay the amount due to the Islamic bank.

Applications of Kafala in Islamic Finance:

- Letter of Guarantee
- Documentary Letter of Credit
- Charge cards

WAKALA:

The term Wakala literally means preservation. Legally, Wakala can be defined as the delegation of one person (the principal) for another (the agent) to take his place in a known and permissible dealing. In this regard, the agent (wakil) deals in others' properties and preserves them.

There are several verses in the Quran that mention the permissibility of the contract of wakala.

In the Quran, Allah Most High says,

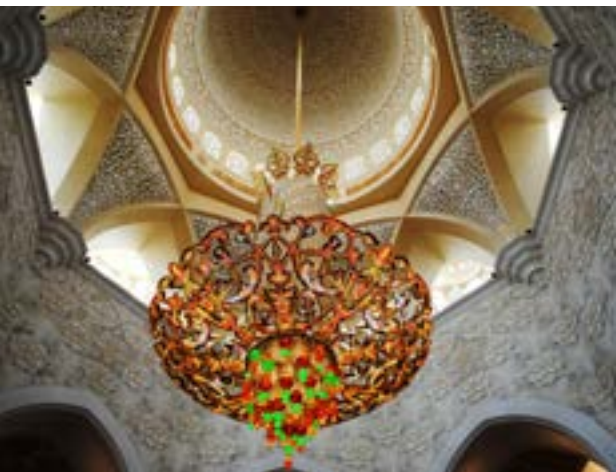
"...So send one of you with this silver coin of yours to the town, and let him find out which is the good lawful food, and bring some of that to you" (Al Quran 18:19).

There are various Hadiths that recognise and approve the legality of the practice of Wakala by the Prophet Muhammad (Peace be upon Him). One of those Hadiths is a narration by Jabir ibn Abdullah (May Allah be pleased with him): I intended to go (on expedition) to Khaybar. So I came to the Holy Prophet (Peace be upon Him), greeted him and said: I intend to go to Khaybar. He said: When you come to my agent, you should take from him fifteen Wasqs (of dates). If

In a partnership profit sharing ratio can be one other than the capital contribution ratio, but cannot be a lump sum or a percentage of capital. It is, however, not permitted to defer the determination of the profit percentage owing to each partner until the realization of profit.



Muslim jurists are unanimous on the point that proportions of losses borne by partners must be equal to the proportions of their capital contributions.



he asks you for a sign, then place your hand on his collar-bone. (Abudawud, Book #24, Hadith #3625).

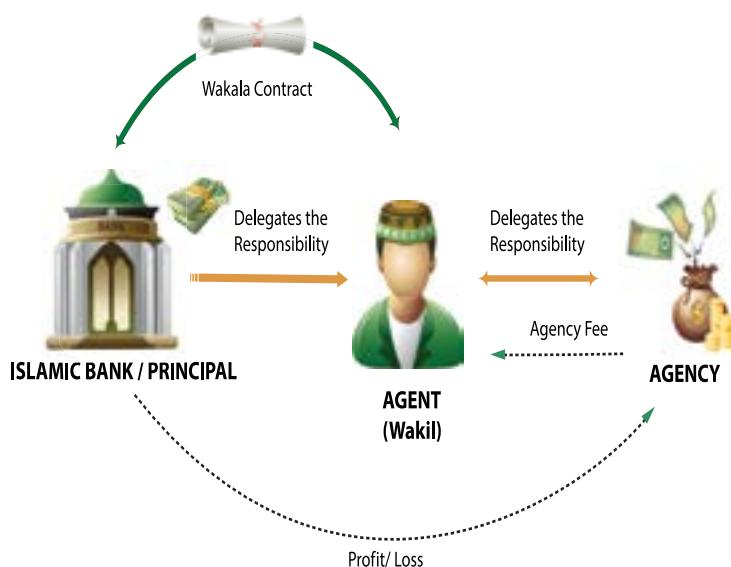
Important principles of Wakala:

a. Parties to Wakala contract: There are two parties in Wakala, namely the principal (Muwakkil), one who delegates the responsibility on his/her behalf, and the agent (Wakil), one upon whom the responsibility is delegated. Both of them should possess the legal capacity to enter into a contract. The principal should have the right to dispose of the asset in question and the agent should be aware of his status as an agent.

b. Subject matter: The subject matter of agency is for what the contract is entered into or the disposition done by the appointed agent with the authorisation of the principal. The subject matter of agency includes all types of financial contracts and dealings that a person can perform personally. It should be something that can be disposed of through the agency. It should be known to the agent and should be owned by the principal.

c. Expiry of the agency: In normal conditions, the agency contract comes to an end on the fulfillment of the agent's duties or on the expiry of the fixed period of Wakala. In addition, an agency contract expires when the principal or agent dies or loses legal capacity, or when the principal undergoes bankruptcy or liquidation except in the case of interminable agency or when the principal no longer owns the assets in question. According to AAOIFI, agency is not binding unless it involves rights of others, when it is a paid agency, when the agent commences tasks that cannot be discontinued and when the principal or the agent undertakes not to revoke the contract within a certain period.

STRUCTURE OF WAKALA:



WAKALA

Mechanism of a Wakala Transaction:

1. The customer is appointed as Islamic bank's agent (Wakil) to carry out certain activities on bank's behalf.
2. The customer as the agent of the bank is paid a Fee, i.e., a Wakala or agency fee for performing the activities.
3. The profits as well as losses solely belong to the bank (Principal or Muwakkil).

Applications of Wakala in Islamic Finance:

- *Letter of Credit*
- *Takaful products*
- *Islamic funds*
- *Islamic Syndicated financing*
- *Islamic Retail / Corporate products*

HAWALA:

Hawala is the transfer of debt from the transferor (muheel) to the payer (muhal alaihi). This involves transfer of right as well as transfer of debt. The transfer of debt differs from transfer of right in the sense that in transfer of debt a debtor is replaced by another debtor, whereas in a transfer of right a creditor is replaced by another creditor.

The legitimacy of Hawala is derived from the Hadith narrated by Abu Huraira (May Allah be pleased with him): The Prophet (Peace be upon Him) said, "Procrastination (delay) in paying debts by a wealthy person is injustice. So, if your debt is transferred from your Debtor to a rich Debtor, you should agree." (Al Bukhari, Book #37, Hadith #487)

Important principles of Hawala:

a. Parties to Hawala contract: There are three parties involved in a Hawala contract. They are the debtor (which is a transferor), the creditor and the payer (which is a transferee). As a general principle, all the three parties must possess the legal capacity stipulated by Shariah to enter into a contract. The validity of Hawala requires the consent of all parties.

b. Subject matter: The subject matter must be a debt or an obligation which is established on the obligations of the transferor and the transferor must be indebted to the creditor. Hawala can be restricted or unrestricted.

c. Conclusion of a Hawala contract: A contract of Hawala can be concluded by an offer from the transferor and acceptance from the creditor and the payer. Hawala is a binding contract and is not subject to unilateral termination. A Hawala contract consists of the release of the original obligation of the principal debtor and the transfer of a new obligation to the payer. The transfer of debt effects immediately and cannot be suspended for a period of time and also cannot to be concluded on a temporary basis or contingent on future events. However, it is permissible to defer payment of the transferred debt until a future specified date.

d. Relationship of Transferor and Creditor: In Hawala, the transferor is discharged from both debt liability and any claims in respect of it. The creditor is entitled to have a right of recourse against the transferor in situations of death, bankruptcy and liquidation of the payer.

e. Relationship of Transferor and the Payer: If the Hawala is a restricted one, then the transferor is no longer entitled to reclaim from the payer an amount transferred to the payer in respect of the debt to be settled, because the right to receive this amount has now passed to the transferee.

f. Relationship of Transferee and the Payer: The transferee is entitled to claim the amount of the debt assigned to him from the payer. The payer takes the place of the transferor in respect to all rights, legal protections and obligations. The payer may seek compensation from the transferor subject to conditions that the debt must be initiated by

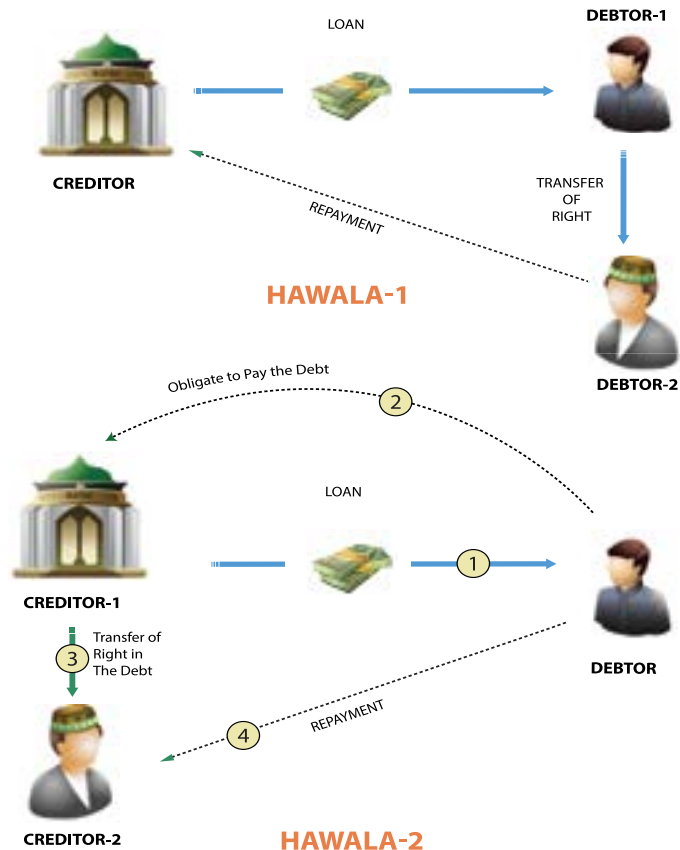


Mudaraba is a form of partnership in profit whereby one party provides capital (rab-al-maal) and another, management skill or labour (mudarib).

the transferor, the debt has been paid fully and that the payer must not be indebted to the transferor with a similar debt.

g. Termination of a Hawala liability: A Hawala liability will come to an end by settlement of the debt, or by a mutual agreement to terminate it, or by the debt being written-off by the transferee.

STRUCTURE OF HAWALA



The differentiating feature of Mudaraba is that the mudarib is not entitled to a fee or salary.



Mechanism of a Hawala-1 Transaction:

1. A customer takes finance from the Islamic bank.
2. Before the maturity of the finance, the customer transfers the finance / debt obligation owed to the Islamic bank to a third party.
3. On maturity, the third party pays the finance to the Islamic bank.
4. It is to be noted that there can be a transfer of debt collection rights from one creditor to the other in a manner similar to the transfer of debt payment .

Application of Hawala in Islamic Finance

- *Bills of Exchange*
- *Transfer of money - Remittance*

WADIAH:

The term Wadiah is derived from the verb 'Wa da'a' which means to leave, lodge or deposit. Wadiah in the legal sense signifies a thing entrusted to the care of another. The proprietor of the asset is known as Muwdi (depositor) and the person entrusted with it is known as 'Wadi' or Mustawde (custodian) and the deposited asset is Wadia.

The concept of Wadiah is not specifically mentioned in the Quran. However, as far as safekeeping which is closely related to trust is concerned, there are some indications on this concept which can be observed in the Quranic verse.

In the Quran Allah says:

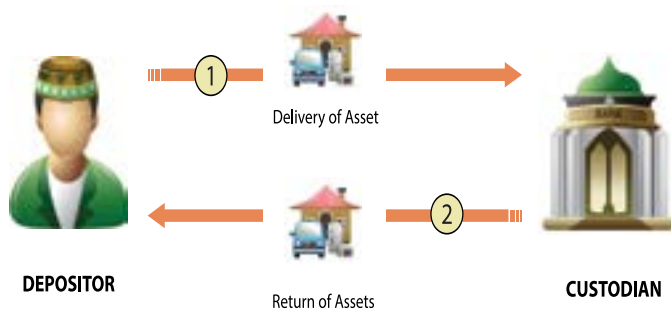
“Verily! Allah commands that you should render back the trusts to those to whom they are due...” (Al Quran 04:58) and “Those who are faithfully true to their Amanat (all the duties which Allah has ordained, honesty, moral responsibility and trusts) and to their covenants...” (Al Quran 23:08).

It is also supported by the Hadith narrated by Abu Hurayrah (May Allah be pleased with him): The Prophet (Peace be upon Him) said: Pay the deposit to him who deposited it with you, and do not betray him who betrayed you. (Abudawud, Book #23, Hadith #3528).

Important principles of Wadiah:

- a. Offer and acceptance:** Wadiah is not valid until there is mutual consent between the relevant contracting parties. This mutual consent is expressed by an offer and an acceptance.
- b. The contracting parties:** The relevant parties here are the depositor and the custodian. It is required that the depositor and the custodian must be persons who have legal capacity.
- c. The asset:** The item of deposit must be a valuable property in Islamic law. Therefore, items such as a dead animal, pork, etc., are forbidden and cannot be part of the Wadiah. The item deposited must also be a form of property that can be possessed physically.
- d. Conditions for Wadiah fund:** It is not permitted to utilise the deposit without the prior consent of the depositor. It is not permitted to travel with deposit unless all the necessary measures to safeguard the deposits are taken. The custodian is not permitted to entrust the deposit to a third party or mix it with other properties, unless there is a valid reason and in a situation where the custodian can easily identify and separate the mixed property from his own.

STRUCTURE OF WADIAH



WADIA

Applications of Wadiah in Islamic Finance:

This type of contract is applied to the following product on a very limited basis:

- *Current account*

SET-OFF (MUQASSA):

According to AAOIFI, a set-off is the discharge of a debt receivable against a debt payable. It is divided into two main forms: mandatory set-off and contractual set-off.

Important principles of Muqassa:



In principle, losses if any shall be borne only by Rab-al Maal and the Mudarib is not liable for any loss unless there is negligence or misconduct on the Mudarib's part.

The valuation of assets in case of Mudaraba liquidation should be on actual or constructive or on the basis of fair value. The final distribution of profit should be made based on the selling price of the Mudaraba assets. The receivable shall be measured at the cash equivalent or net realizable value, i.e. after deduction of provision for bad debts.



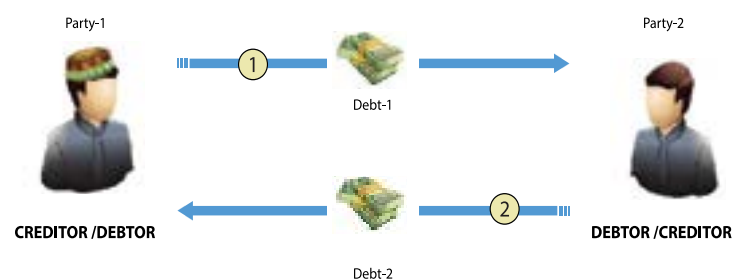
a. Conditions for Set-off: In general the Muqassa should be made with the agreement or consent of the parties.

b. Subject matter: The subject matter of the Muqassa is mainly a debt which is in the obligation of a debtor. Debts can be currency debts, commodity debts and usufruct debts.

c. Obligatory Set-off: This is the spontaneous discharge of two debts that are not contingent on the request or consent of both or either party. In this contract, each of the parties is a creditor and debtor simultaneously. The two debts of set-off in this type should be similar in kind, type, description and maturity. However, if the two debts are not equal in amount, a set-off will take place with an equivalent amount on both sides and the party that is owed the larger debt will remain a creditor for the balance. It can also be effected by a set-off on demand where the discharge of two debts at request of the creditor for the superior debt and his/her consent to forgo the excess of the amount or privilege he/she is owed over what he/she owes. The creditor for the superior debt, in terms of quality and duration, should consent to relinquish the additional right or privilege. Both debts in this type should be similar in kind, but not necessarily in quality and date of maturity .

d. Voluntary set-off: A contractual set-off is the discharge of two debts by the consent of the two parties extinguishing their obligations towards each other. The set-off should not be arranged in a manner that results in violation of a rule of Shariah such as Riba or a transaction potentially involving Riba. A contractual set-off is permissible even without the need of two debts to be similar in kind, type, description or maturity. A contractual set-off is also permissible if the two debts are not equal in terms of amount, in which case a set-off will take place of an equivalent amount on both sides, and the party that is owed the larger debt is entitled to request payment of the remaining balance.

STRUCTURE OF MUQASSA



MUQASSA

Applications of Muqassa in Islamic Finance:

- *Debit card*

URBOUN:

The term Urboun denotes an amount of money that the purchaser pays as part of total purchase price to the seller after concluding a sale contract, with the provision that if the sale is completed during a prescribed period, the amount will be counted as part of the sale price.

There has been a debate as to whether the seller can retain the amount paid by the purchaser as Urboun or should refund it in case the purchaser fails to pay the remaining sale price on time. A majority of the classical jurists, i.e., Hanafi, Maliki and Shafii opine that in Islam

it is not permitted to retain the Urboun amount, therefore, the seller must refund it. The Seller, however, is entitled to deduct any actual cost incurred to it due to the default of the purchaser. On the other hand, the Hanbalis have ruled that there is no harm in retaining the Urboun amount if the waiting period is determined upfront in the contract. The Fiqh Academy of Jeddah also agrees with the opinion of the Hanbali scholars.

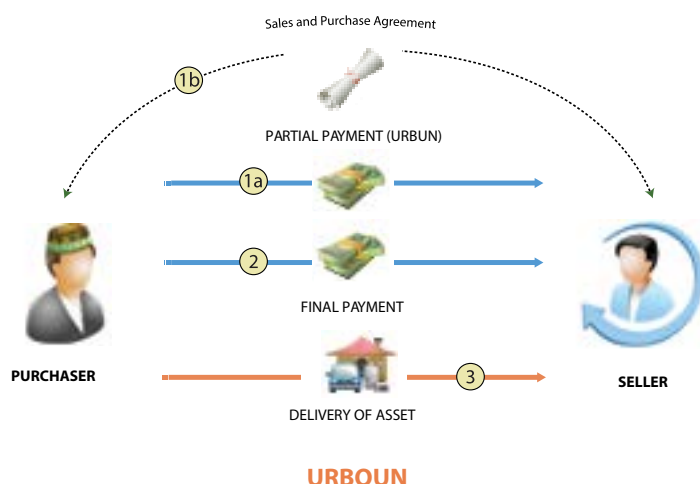
Nature of Urboun:

Urboun is considered as a conditional gift by some jurists. In this case, if the customer withdraws from the sale contract then the paid Urboun shall be considered as a gift to the seller. It is to be noted that Urboun is part of the total price of sale, and not an independent sum of money from the commodity's price.

Benefits of Urboun:

Through Urboun one can secure a right over a contract to either continue or withdraw. One can secure more time to enable oneself to acquire sufficient money to pay the price. One can utilise it as a tool to mitigate the risk. One can also use it for the purpose of making profit .

STRUCTURE OF URBOUN:



Applications of Urboun in Islamic Finance:

- *Islamic options*
- *Currency exchange*
- *Share trading*
- *Murabaha sale*

WAAD (PROMISE):

According to Islamic law, Al-Waad denotes a promise which connotes an expression of willingness of a person or a group of persons on a particular subject matter. Waad has no specific definition of its own; however, it can be explained as a commitment made by one person to another to undertake a certain actual or verbal disposal, beneficial to the second party or a verbal proposition made by someone to undertake something to the benefit of another person.

In traditional concept, Al-Waad is unilateral in nature, and binds the maker only. Islamic scholars have different views with regard to the liability imposed upon the parties of the promise.

Some schools of thought opine that a promise made by a person



Unlike a sale contract, Ijarah contract may be executed for an asset currently not owned by the lessor. Any asset which is not permissible under Shariah to utilise cannot be leased. On the other hand, even the permissible asset cannot be leased if the purpose of lease is to perform or carry out the Shariah non-compliant activities. During the entire lease period the lessor is assumed to hold the ownership risk of the leased asset.

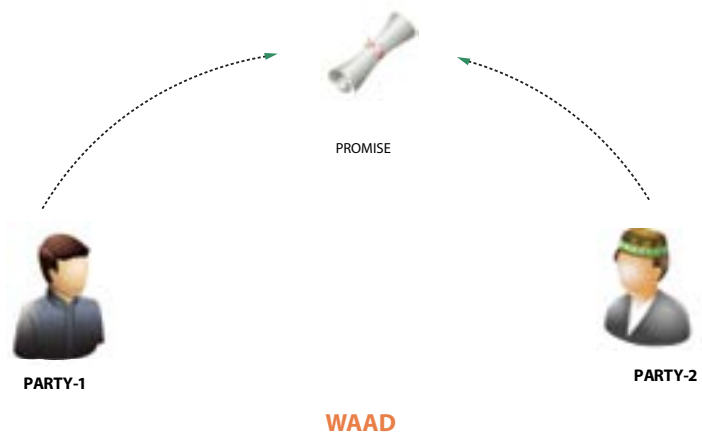
Maintenance of the leased asset is the responsibility of the lessor throughout the duration of the Ijarah, unless the lessee commits misconduct or negligence. If the benefit from the leased asset is impaired wholly or partially as a result of the lessee's misconduct, the lessee is obliged to restore or repair.



to another is religiously binding (Mulzim diyanatan) but not a legal duty (Mulzim qadha'an). This is because Al-Waad is part of a voluntarily contract (aqd tabarruat). Therefore, the judge has no way of enforcing this, because the second party has nothing more than a moral right.

In accordance with the Islamic principles, promises made must be fulfilled as a religious obligation. Therefore, it is not just a question of morality, but also a question of following the religious principles. And the scholars are in agreement on this point. A person that refuses to fulfill a promise is literally categorized as a hypocrite by the Prophet Muhammad (Peace be upon Him) Therefore, a Muslim that makes a promise of any kind to another person must fulfill the promise. Here is a Hadith for reference: Narrated Abu Huraira, the Prophet (Peace be upon Him) said: "The signs of a Hypocrite are three: 1. Whenever he speaks, he tells a lie. 2. Whenever he promises, he always breaks it (his promise). 3. If you trust him, he proves to be dishonest. (If you keep something as a trust with him, he will not return it.)" (Al Bukhari, Book #2, Hadith #32).

STRUCTURE OF WAAD



Applications of Waad in Islamic Finance

- *Musharaka Mutanaqissa*
- *Murabaha sale*
- *Ijarah*
- *Takaful*
- *FX Transaction*
- *Swaps*
- *Several other Islamic finance products*

QARD:

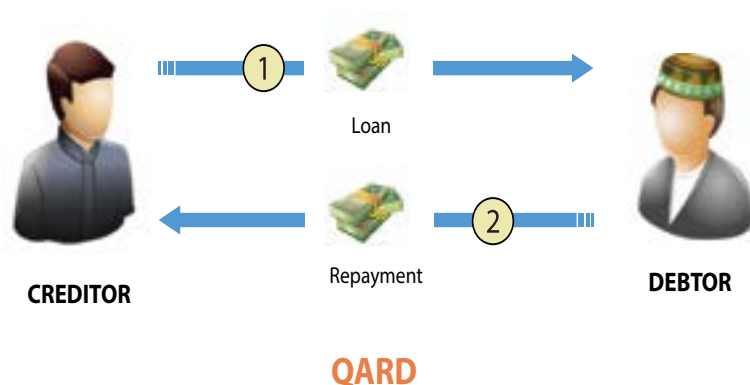
Qard is the transfer of ownership in fungible wealth to a person on whom it is binding to return wealth similar to it.

Important Principles of Qard Contract:

- a. The contract of Qard is concluded through offer and acceptance.
- b. Both the creditor and the debtor must possess legal capacity to enter into a contract.
- c. Qard can be for a specific period of time or it can be given without a specific time period stipulated for repayment.
- d. It is not permitted for a lender to stipulate or a borrower to extend, any excess in finance, irrespective of whether the excess is in terms of quality or quantity, or tangible or intangible, and whether the stipulation is at the time of contract or at a later stage during the contract.
- e. An excess over Qard is permitted at the time of its repayment

when it is not stipulated or is part of custom, irrespective of the subject matter of Qard being cash or kind. The Creditor is allowed to charge the Debtor all the actual cost it incurred to disburse the Qard amount like remittance charges.

STRUCTURE OF QARD:



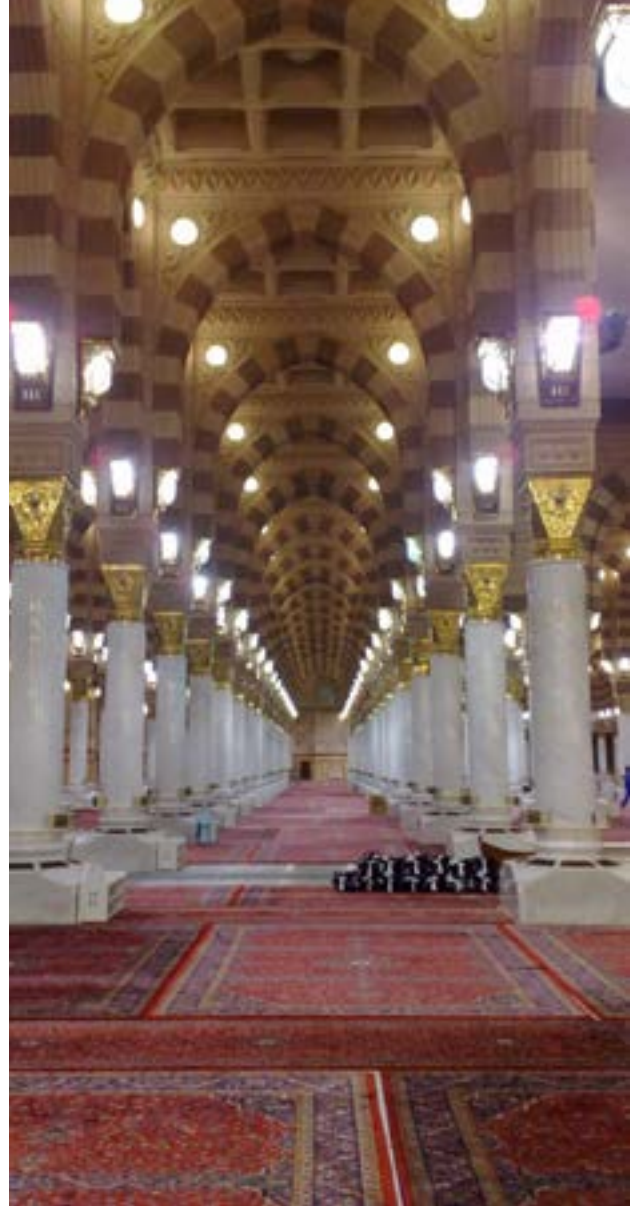
Applications of Qard in Islamic Finance:

- *Personal financing Overdraft Facility*
- *Credit Card*
- *Current account*

SNAPSHOT OF WHAT WE HAVE LEARNED

In this module we have learned about:

- **Contract:** A contract is known as Aqd in Arabic which means 'to tie', 'to knot' or 'to join'. Legally, a contract binds all the parties involved in it.
- **Statement of Contract:** The statement of a contract constitutes the Offer and Acceptance. Offer is the intention of one party inviting the other to accept a proposal, whereas acceptance is the expression of approving or agreement by the offeree to the offeror's proposal.
- **Contracting Parties:** Those who are involved in a contract as contracting parties.
- **Subject Matter of the Contract:** The subject matter of the contract is one for which the contracting parties enter into a contract. It can be a tangible thing, a usufruct or services. But it must be Shariah compliant.
- **Bay' al-Muqayada (Barter Sale):** This is a Sale contract in which goods are exchanged for other goods. For example, rice against wheat, etc.
- **Bay' al-Mutlaq (General Sale):** This is a sale contract in which goods are purchased and sold using Money or Currency as medium.
- **Bay' al-Sarf (Exchange Sale):** It is a sale contract in which one monetary form is exchanged for another in the same or different types. In a currency exchange transaction both the counter values must be delivered on spot.
- **Murabaha:** It is a sale in which the goods are sold on cost price plus defined and agreed profit.
- **Tawliyyah Contract:** It is a sale in which the asset is sold at purchase price without making any profit. It is on cost sale.
- **Wadhiah** - It is a sale in which the asset is sold at discount price typically less than the cost price. It is on loss sale.
- **Musawama** - It is a sale where the parties negotiate on the sale





price of the subject matter but neither the cost nor the profit is required to be disclosed to the buyer.

- **Bay' Bithaman A'ajil (BBA):** BBA is a sale contract in which the payment of the price is deferred and payable at a particular time in the future.
- **Tawarruq:** It refers to the process of purchasing a commodity for a deferred price and selling it to a third party for cash on the spot.
- **Ena:** Ena refers to the process of purchasing a commodity for a deferred price, and selling it at a lower spot price to the same party from whom the commodity was purchased on deferred payment basis.
- **Salam:** It is a type of sale in which the purchasing price is paid in advance at the time of contracting, while the delivery of the goods is deferred.
- **Istisna:** It is a contract of sale of specified items to be manufactured or constructed with an obligation on the part of the seller (San'e) to deliver them to the buyer (mustasne) upon completion.
- **Musharaka (sharikatul al-inan):** It is a partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on the condition that the profit is to be distributed according to the partnership agreement and losses are to be borne in accordance with the contribution of each partner to the capital.
- **Mudaraba:** It is a type of partnership in profit whereby one party provides money capital (Rab-al-maal) and another, management skill or labour (Mudarib). Profit is to be shared as per pre-agreed ratio and losses are to be borne only by the party (rab-al-mal) who contributes the money capital.
- **Ijarah:** The term Ijarah means leasing of property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration.
- **Rahn (Pledge):** Legally, the pledging contract is defined as holding an item in lieu of a legal right that may be satisfied from an item.
- **Kafala:** In its literal usage, Kafala means responsibility, or suretyship. Legally, it can be defined as making the guaranteed person's liability a joint liability of the guaranteed and guarantor at the time of demanding compensation.
- **Wakala:** Wakala can be defined as the delegation of one person (the principal) for another (the agent) to take the person's place in a known and permissible dealing.
- **Hawala:** Hawala is the transfer of debt from the transferor (Muheel) to the payer (Muh-al-alaihi). This involves transfer of right as well as transfer of debt.
- **Wadhiah:** Wadhiah means to leave, lodge or deposit. Wadhiah in the legal sense signifies a thing entrusted to the care of another.
- **Muqassa:** A set-off is the discharge of a debt receivable against a debt payable.
- **Urboun:** The term Urboun denotes an amount of money that the purchaser pays as part of total purchase price to the seller after concluding a sale contract, with the provision that if the sale is completed during a prescribed period, the amount will be counted as part of the sale price.
- **Waad:** According to Islamic law, Al-Waad denotes a promise which connotes an expression of willingness of a person or a group of persons on a particular subject matter.
- **Qard:** Qard is the transfer of ownership in fungible wealth to a person on whom it is binding to return wealth similar to it.



ISLAMIC RETAIL PRODUCTS

Learning Objectives:

After completing this module, the reader should be able to:

- Understand the six Islamic Retail Products namely Home Finance, Vehicle Finance, Personal Finance, Goods Finance, Credit Card and Bank Accounts.
- Understand the various Islamic Finance structures that are applied (in) or used to design each of the Islamic Retail Products.
- Practically calculate the financials such as Return, Profit, Installment and so on for each of the Islamic Retail Products.





INTRODUCTION

Islamic financial institutions, especially Islamic banks offer many products and services to meet the needs of customers, both on the deposit and financing sides. These products and services are important to make Islamic financial institutions competitive with conventional banks in terms of product offering. To design a successful Islamic financial product there is a need to select an appropriate and relevant contract.

Islamic financial institutions offer several categories of products and services to their clients who seek financing. The financing might be equity based or debt based. Equity based financing is equitable in character in that both parties are willing to put up the capital and work to share the future profit or loss. When financing involves the purchase or lease of an asset for any defined purpose, it creates a debt over the buyer and lessee and that's why it is referred to as debt financing or asset based financing. Upon entering into debt based financing, a customer is under an obligation to make the payment according to agreed terms and schedules.

Although various products are offered by Islamic finance institutions, in this module we will discuss only six Islamic retail products that are commonly offered in the market. The products are:

1. *Home Finance*
2. *Vehicle Finance*
3. *Personal Finance*
4. *Goods Finance*
5. *Credit Cards*
6. *Islamic Bank Accounts*

HOME FINANCE

Let us discuss how the Islamic bank would provide the financing to a customer who is seeking a house. The bank may finance the house in any of the form of contracts discussed below.

- i. *Diminishing Musharaka (Musharakah Mutanaqisa)*
- ii. *Mark-up sale (Murabaha)*
- iii. *Islamic Lease (Ijarah Muntahiya Bittamleek)*
- iv. *Manufacturing Finance (Istisna and Parallel Istisna)*

Diminishing Musharaka (Musharaka Mutanaqisa):

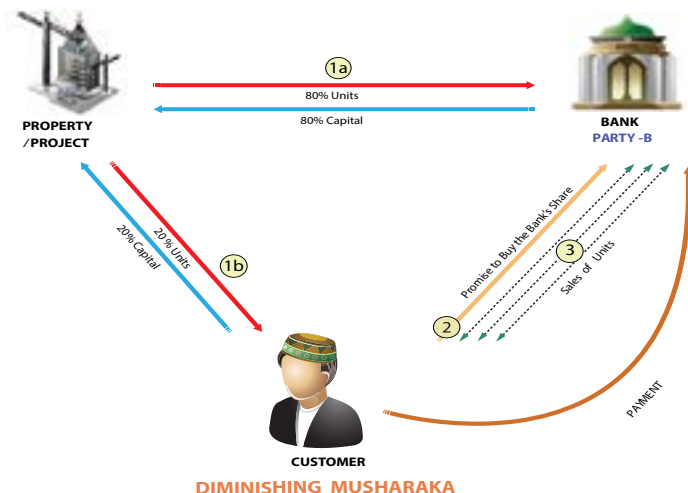
It is a form of partnership in which one partner gradually buys the equity share of the other partner at market value or a price agreed on at the time of sale, in case of Musharaka al Aqd or at any price agreed upfront, in case of Musharaka al Melk, until the title to the equity is completely transferred to him.

This transaction starts with the formation of the partnership, after which the buying and selling of the equity take place between the two partners. It is therefore necessary that this buying and selling should not be stipulated in the partnership contract. In other words, the buying partner is allowed to give only a promise to buy. This buying and selling agreement must be independent of the partnership contract. It is not permitted that one contract be entered into as a condition for concluding the other.

Both the parties, in this case, assume to have the ownership risk in the property in proportion to their capital contribution.

To earn the profit the Islamic bank leases its share in the property to the customer on a pre-defined rental whereby the rental amount is adjusted on each cycle of sale and purchase of bank's share in the property to the customer.

STRUCTURE OF HOME FINANCE BASED ON MUSHARAKA MUTANAQISA:



Operational Procedure:

1. A Customer who is in need to purchase a house approaches the Islamic Bank and applies for finance through Musharaka Mutanaqisa (Diminishing Partnership).
2. As per Customer's financing requirement Bank assesses the customer's creditworthiness and approves the request.
3. In line with the approved FTV (Finance to Value) both the Bank and the Customer purchase the property in the relevant proportion and pay the purchase price accordingly. In the common banking practice, the Customer's share is known as Down Payment.
4. The Bank seeks an undertaking from the Customer to purchase gradually the entire Bank's share in the property during the finance period. The Bank may exercise such undertaking to oblige the Customer to purchase immediately the Bank's the then share in the property in case of any default or a breach by the Customer.
5. The Customer as per given promise keeps on purchasing the Bank's share on regular intervals throughout the finance period.
6. Each time the Customer purchases the Bank's share, a separate Sale and Purchase Agreement is signed by and between the parties.
7. The Customer leases the Bank's portion in the property against the payment of specified rent for a specified period and enters into a lease contract with the Bank.
8. As per the terms of the lease agreement the Customer pays the rental amount to the bank on the due dates which coincide with the date of Bank's regular sale of its specific portion to the Customer. The rental amount for each rental period is adjusted due to a decrease in the Bank's share in the leased property.
9. Through a separate agency agreement the Customer is appointed as Bank's agent to carry out the major maintenance and obtain the Islamic property insurance for the portion of Bank's share in the property.
10. The Bank pays all the costs and expenses incurred to the Customer under the above said agency agreement. Bank also pays a fixed (generally a very nominal amount) agency fee to the Customer for his services.
11. To secure its finance, the Bank may place a mortgage over the entire property or seek some other collateral.
12. To secure his right to settle the finance early, Customer may seek an

In Diminishing Partnership (Musharaka Mutanaqisa) buying partner is allowed to give only a promise to buy. This buying and selling agreement must be independent of the partnership contract. It is not permitted that one contract be entered into as a condition for concluding the other.

Both the parties, in this case, assume to have the ownership risk in the property in proportion to their capital contribution.

undertaking from the Bank to sell its entire portion to the Customer at any point in time during the finance period.

Calculations:

One of the forms of Ijarah which is commonly used in Home financing is the Ijarah Muntahia bittamleek. This is a form of leasing contract in which the ownership of the leased property is transferred to the lessee at the end of the lease term or at any time during the lease term when the Lessee (Customer) wishes to purchase the leased asset.



HOME FINANCE BASED ON MUSHARAKA MUTANAQISA			
Basic Assumptions		Alphabetical Equations and Formulas	
Particulars	Unit	Value	
Total Cost of the House	USD	1,000,000.0	C
Customer's share (20% Down payment)	USD	200,000.0	A (Customer's Capital) i.e. (C-B)
Bank's share (80% Finance Amount)	USD	800,000.0	B (Bank's Capital) i.e. (C-A)
Total number of installments in Months	NOS	60.0	T
Monthly Share Price	USD	13,333.3	S(Monthly Sale Price) i.e.(B/T)
Monthly Rental Rate (% of Bank's finance)	%	1.0	R (Rental Rate)

1. Let us take an example of Home Finance where the total cost of a house is USD 1,000,000/- (USD 1 million).
2. The customer owns 20% share of the property and makes a down payment of USD 200,000 and the Islamic bank owns the remaining 80% and pays USD 800,000/-. In this way, the capital contribution ratio of the customer and the Islamic Bank is 20:80.
3. The customer promises to buy the share of the Islamic bank in 60 monthly installments. The payment per installment comes to USD 13,333. It is calculated by dividing the Bank's total share by the total number of installments, i.e., $800,000/60 = 13,333/-$.
4. Under a lease agreement, the customer would be paying monthly rental for occupying the Islamic bank's portion in property at 1% of the value of Islamic bank's outstanding share. The monthly rent can also be calculated using this formula: $[\text{Bank's Total Finance} - (\text{Bank's Total finance} / \text{Total No. of installments}) \times (\text{Current Month}-1)] \times (\text{Rental Rate})$.
5. The total monthly installment payment by the customer includes the share price and the monthly rental. It can also be calculated using the formula: $[(\text{Bank's Total finance} / \text{No. of installments}) + ((\text{Bank's Total Finance} - (\text{Bank's Total finance} / \text{Total No. of installments}) \times (\text{Current Month}-1)) \times (\text{Rental Rate}))]$.
6. For example, the monthly payment for the 12th month is calculated in the following way: The monthly sale price of Bank's share = $800,000 / 60 = 13,333$ /-. Rent for the 12th month = $(800,000 - (800,000/60) \times (12-1)) \times (1\%) = (800,000 - (13,333 \times 11)) \times (1\%) = (800,000 - 146,663) \times (1\%) = 6,533$. So the monthly rent for the 12th month is USD 6,533. Hence the customer has to pay USD 19866 i.e. $(13,333 + 6,533)$ as the total monthly installment payment.

Mark-Up Sale (Murabaha)

The word Murabaha is derived from the word 'Ribh', which means profit or gain. Murabaha is the sale of a commodity as per the purchasing price with a defined and agreed profit markup. This markup may be a percentage of the selling price or a lump sum amount. This transaction may be concluded without a prior promise to buy, in which case it is called an ordinary murabaha, or

MONTHLY PAYMENTS FOR DIMINISHING MUSHARAKA				
Months (t)	Bank's Finance	Monthly		
		Rent (R)	Share Price(s)	Payment (M)
0				-8,00,000.0
1	8,00,000	8,000.0	13,333.3	21,333.3
2	7,86,667	7,866.7	13,333.3	21,200.0
3	7,73,333	7,733.3	13,333.3	21,066.7
4	7,60,000	7,600.0	13,333.3	20,933.3
5	7,46,667	7,466.7	13,333.3	20,800.0
6	7,33,333	7,333.3	13,333.3	20,666.7
7	7,20,000	7,200.0	13,333.3	20,533.3
8	7,06,667	7,066.7	13,333.3	20,400.0
9	6,93,333	6,933.3	13,333.3	20,266.7
10	6,80,000	6,800.0	13,333.3	20,133.3
11	6,66,667	6,666.7	13,333.3	20,000.0
12	6,53,333	6,533.3	13,333.3	19,866.7
13	6,40,000	6,400.0	13,333.3	19,733.3
14	6,26,667	6,266.7	13,333.3	19,600.0
15	6,13,333	6,133.3	13,333.3	19,466.7
16	6,00,000	6,000.0	13,333.3	19,333.3
17	5,86,667	5,866.7	13,333.3	19,200.0
18	5,73,333	5,733.3	13,333.3	19,066.7
19	5,60,000	5,600.0	13,333.3	18,933.3
20	5,46,667	5,466.7	13,333.3	18,800.0
21	5,33,333	5,333.3	13,333.3	18,666.7
22	5,20,000	5,200.0	13,333.3	18,533.3
23	5,06,667	5,066.7	13,333.3	18,400.0
24	4,93,333	4,933.3	13,333.3	18,266.7
25	4,80,000	4,800.0	13,333.3	18,133.3
26	4,66,667	4,666.7	13,333.3	18,000.0
27	4,53,333	4,533.3	13,333.3	17,866.7
28	4,40,000	4,400.0	13,333.3	17,733.3
29	4,26,667	4,266.7	13,333.3	17,600.0
30	4,13,333	4,133.3	13,333.3	17,466.7
31	4,00,000	4,000.0	13,333.3	17,333.3
32	3,86,667	3,866.7	13,333.3	17,200.0
33	3,73,333	3,733.3	13,333.3	17,066.7
34	3,60,000	3,600.0	13,333.3	16,933.3
35	3,46,667	3,466.7	13,333.3	16,800.0
36	3,33,333	3,333.3	13,333.3	16,666.7
37	3,20,000	3,200.0	13,333.3	16,533.3
38	3,06,667	3,066.7	13,333.3	16,400.0
39	2,93,333	2,933.3	13,333.3	16,266.7
40	2,80,000	2,800.0	13,333.3	16,133.3
41	2,66,667	2,666.7	13,333.3	16,000.0
42	2,53,333	2,533.3	13,333.3	15,866.7
43	2,40,000	2,400.0	13,333.3	15,733.3
44	2,26,667	2,266.7	13,333.3	15,600.0
45	2,13,333	2,133.3	13,333.3	15,466.7
46	2,00,000	2,000.0	13,333.3	15,333.3
47	1,86,667	1,866.7	13,333.3	15,200.0
48	1,73,333	1,733.3	13,333.3	15,066.7
49	1,60,000	1,600.0	13,333.3	14,933.3
50	1,46,667	1,466.7	13,333.3	14,800.0
51	1,33,333	1,333.3	13,333.3	14,666.7
52	1,20,000	1,200.0	13,333.3	14,533.3
53	1,06,667	1,066.7	13,333.3	14,400.0
54	93,333	933.3	13,333.3	14,266.7
55	80,000	800.0	13,333.3	14,133.3
56	66,667	666.7	13,333.3	14,000.0
57	53,333	533.3	13,333.3	13,866.7
58	40,000	400.0	13,333.3	13,733.3
59	26,667	266.7	13,333.3	13,600.0
60	13,333	133.3	13,333.3	13,466.7
TOTAL		2,44,000.0	8,00,000.0	10,44,000.0



Any Top Up request by the Customer over the existing Ijarah finance cannot be entertained by an Islamic Bank if it has purchased 100% of the property unless the existing finance facility is settled and a new finance is entered into.

with a prior promise to buy submitted by the customer interested in acquiring goods through the Islamic bank, in which case it is called murabaha to purchase orderer or banking Murabaha. This transaction is one of the trust based contracts because the seller explicitly discloses the purchasing price and profit margin to the buyer.

It must be noted that the Bank assumes the responsibility of the owner and accordingly bears the ownership risk once it purchases the house from the property owner. It doesn't merely play a role of a financier. If the property is destroyed or damaged in between the bank's purchase and its sale to the customer the Bank has to bear the loss.

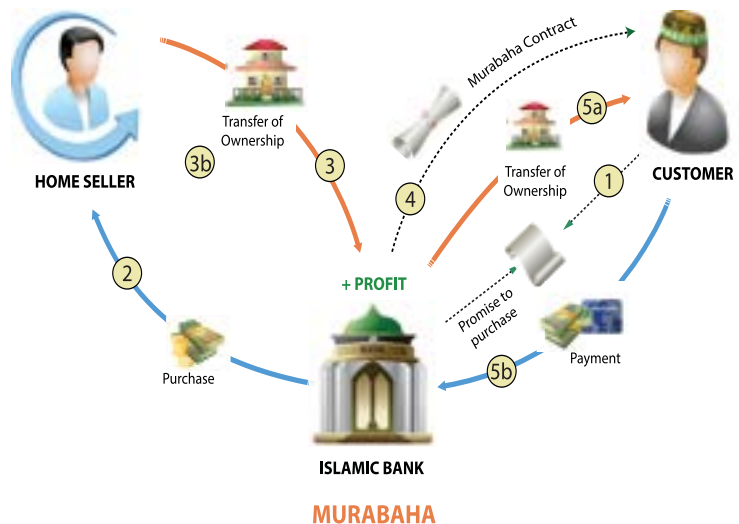
Under Murabaha based financing structure it is essential for the Bank to buy the asset on fair market value from the Supplier. Hence, it is not permissible for an Islamic Bank to finance the Customer more than the value of the asset.

Murabaha is the sale of a commodity as per the purchasing price with a defined and agreed profit markup.

As opposed to the conventional financing, under Murabaha the agreed upon Murabaha Sale Price cannot be changed even if any deferral in payment is granted to the Customer. It is important to note that if something is sold for a deferred price it becomes a debt over the purchaser which remains unchanged in both the cases of early and late payment.

Moreover, after getting into the Murabaha contract, if the Bank receives any rebate or discount over the purchased property from the property seller, this amount is either given to the Customer or adjusted in the Murabaha Sale Price.

STRUCTURE OF HOME FINANCE BASED ON MURABAHA:



Operational Procedure:

1. A Customer who is in need to acquire a house approaches the Islamic Bank and applies for finance through Murabaha (Mark-up Sale) transaction.
2. As per Customer's financing requirement Bank assesses the customer's creditworthiness and approves the request.
3. The Bank seeks an undertaking from the Customer to buy the house from the Bank once latter purchases the same and takes the possession thereof. Along with other details the Bank's profit is also stipulated in such undertaking.
4. If the financing is not approved for the 100% value of the property the Bank asks the Customer to pay certain amount as Hamish

Jiddiyyah which is turned into Down Payment at the time of signing the Murabaha Sale Contract.

5. The Bank enters into a property purchase agreement with the property owner and buys the house required by the Customer on the fair market value. The Bank pays the purchase price to the property owner as per agreed term.
6. After getting the possession of the purchased house the Bank sells it to the Customer through a Murabaha Sale Contract after adding its profit (mark-up) to the cost.
7. In accordance with the requirement of Murabaha, the Murabaha Sale Contract clearly stipulates the Murabaha Sale Price which consists of the cost of purchase and the Bank's profit. The payment term of the sale price is also agreed between the Customer and the Bank in this contract.
8. The Bank hand overs the house to the Customer.
9. The customer pays the Murabaha Sale Price to the Bank as per agreed upon terms and conditions.
10. The Customer may settle his finance early by paying the full outstanding. It is, however, allowed under Shariah for Murabaha Seller (Islamic Bank) to forgo any part of the Murabaha Sale Price at the time of early settlement and grant some rebate in its sole discretion.

Calculations:

HOME FINANCE BASED ON MURABAHA			
Basic Assumptions		Alphabetical Equations & Formulas	
Particulars	Unit	Value	
Cost of the House	USD	1,000,000	C
Down Payment from customer	USD	0	D
Amount Financed (100%)	USD	1,000,000	F=C-D
Profit Margin (Fixed Rate) % p.a.)	%	5%	R
Term of Financing	Months	60	T
Total Profit Amount	USD	250,000	$P = F * R * (T/12)$
Total Murabaha Sale Price	USD	1,250,000	$SP = F + P$
Monthly Installment	USD	20,833	$I = SP/T$
Cost portion of Installment	USD	16,667	$IC = F/T$
Profit portion of Installment	USD	4,167	$IP = P/T$

1. Let us look at an example of Murabaha Home Finance transaction. The total cost of a house is USD 1 million.
2. The customer makes no down payment (Hamish Jiddiyyah) and requires 100% financing.
3. The bank agrees to finance 100% cost of the house which is USD 1 million.
4. The bank purchases the house and sells it to the customer on Murabaha (deferred payment basis payable in 5 years, i.e., 60 months).
5. The total Murabaha Sale Price will be USD 1.25 million; this is made up of amount financed by the bank, which is USD 1million plus the bank's total profit margin which is USD 0.25 million.
6. The profit amount of USD 0.25 is arrived at as shown below:
 $\text{Profit} = [\text{Amount Financed (F)} * \text{Profit Rate (R)} * \text{Term of financing}]$
 $\text{Profit} = [1,000,000 * 5\% * 60/12] = 250,000$
7. The monthly installment of USD 20,833 is arrived at as shown below':
 $\text{Monthly Installment} = [(\text{Amount Financed (F)} + \text{Profit Amount (P)}) / \text{Term of financing (in months)}]$
 $\text{Installment} = (1,000,000 + 250,000) / 60 = 20,833$ - Installment is rounded off for ease of calculation
8. In case of an early payment, the customer may get a rebate.



As most of the Islamic Banks are not involved directly in contracting business they adopt the structure of Parallel Istisna to satisfy their customers' need who seek the home finance through Istisna contract. It is a duty of the Islamic bank to ensure that the purpose of Istisna is not repugnant to Shariah principles.



But as per the current market practice, the decision on the rate of rebate is solely at the discretion of the bank and different approaches may be applied. It is worth noting that the customer is contractually obliged to pay the full cost and profit amount.

9. Using the above example, if the customer chooses to close the financing at the end of 4 years, the customer will have an outstanding cost balance of USD 199,984 and outstanding profit balance of USD 50,000. The bank legally has the right to collect the full profit amount i.e. USD 50,000. However, as per the current market practices, a rebate at the bank's discretion is offered on the outstanding profit portion. This means that the customer will end up paying much less than USD 50,000, depending on the rebate % offered. If 50% rebate is offered, the customer will end up paying USD 25,000 of outstanding profit along with outstanding costs of USD 199,984.



ISLAMIC LEASE (IJARAH MUNTAHIA BITTAMLEEK):

The term Ijarah means leasing of property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration.

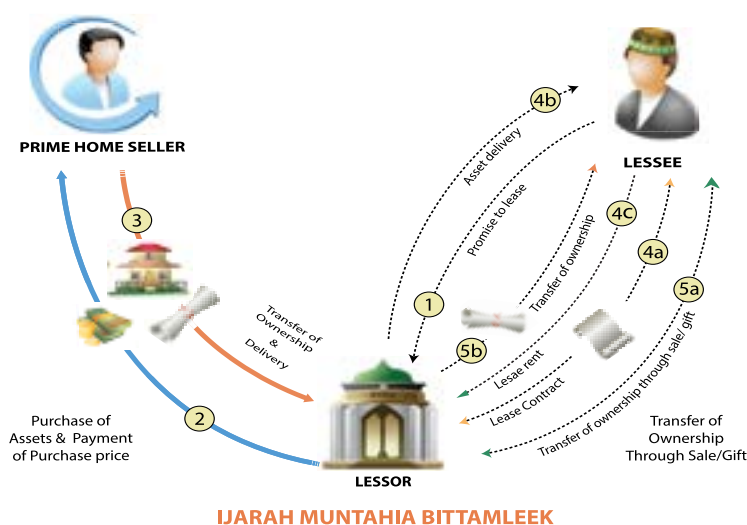
One of the forms of Ijarah which is commonly used in Home financing is the Ijarah Muntahia bittamleek. This is a form of leasing contract in which the ownership of the leased property is transferred to the lessee at the end of the lease term or at any time during the lease term when the Lessee (Customer) wishes to purchase the leased asset.

Depending upon the scenarios, the Bank may purchase the property either from the same Customer who seeks the Home Financing through Ijarah Muntahia Bittamleek or can make it available by purchasing from the market. If the property is ready and in usable form then Ijarah Muntahia Bittamleek contract is signed while in case of under construction property Ijarah Mowsufa Fi Al Dhimmah contract is executed.

It is worth mentioning that the Islamic Bank takes all the due diligence to ensure that the property subject of lease is intended to be utilised only for the Shariah-compliant activities. The Islamic Bank also terminates any on-going tenancy contract on the property before leasing it to its Customer because the same property cannot be leased twice for any single period.

Any Top Up request by the Customer over the existing Ijarah finance cannot be entertained by an Islamic Bank if it has purchased 100% of the property unless the existing finance facility is settled and a new finance is entered into.

STRUCTURE OF HOME FINANCE BASED ON IJARAH MUNTAHIA BITTAMLEEK:



Operational Procedure:

1. A Customer who is in need to acquire a house approaches the Islamic Bank and applies for finance through Ijarah Muntahia Bittamleek (Lease to own) transaction.
2. As per Customer's financing requirement Bank assesses the customer's creditworthiness, analyses the real estate market condition, evaluates the subject property and approves the request.
3. The Bank seeks an undertaking from the Customer to lease the house from the Bank once latter purchases the same and takes the possession thereof. Along with other details the Bank's Rental Rate is also stipulated in such undertaking.
4. If the financing is not approved for the 100% value of the property the Bank asks the Customer to pay certain amount as Advance Rental which is adjusted under the first rental period's rental amount when the Ijarah contract is executed. If the lease, however, has not commenced the Islamic Bank returns the Advance Rental received from the Customer.
5. The Islamic Bank purchases the required property from the property owner, pays the full purchase price, takes the possession thereof and executes the Ijarah Contract with the Customer.
6. The Islamic Bank delivers the property in inhabitable form to its Customer with full access to it in order to start the lease.
7. Under a separate agency agreement the Islamic Bank appoints its customer (Lessee) as its agent to carry out the major maintenance and obtain the property insurance (Islamic Insurance) policy on its behalf. Along with a fixed fee for these services the Islamic Bank being the Muwakkil (Principal) pays all the costs and expenses incurred under this agency agreement to the Customer (Agent).
8. The Islamic Bank may seek a purchase undertaking from the Customer (Lessee) to purchase the house during the lease term in case of any default or breach by the Customer to the Ijarah terms and conditions.
9. In return, the Customer may also ask the Bank to give a sale undertaking to sell the leased property to the customer at the end of the Ijarah term or any time during the lease in order to secure his right to settle the finance early.
10. The rental comprises of two main components, the fixed and variable representing the cost of the property and the Bank's profit respectively which is paid in accordance with the agreed upon terms and conditions in the Ijarah contract.
11. At the end of the lease term both the parties (Lessor and Lessee)

Installment Schedule

Period Months (t)	Date	EMI
0		-1,000,000.0
1	01.01.2012	20,833
2	01.02.2012	20,833
3	01.03.2012	20,833
4	01.04.2012	20,833
5	01.05.2012	20,833
6	01.06.2012	20,833
7	01.07.2012	20,833
8	01.08.2012	20,833
9	01.09.2012	20,833
10	01.10.2012	20,833
11	01.11.2012	20,833
12	01.12.2012	20,833
13	01.01.2013	20,833
14	01.02.2013	20,833
15	01.03.2013	20,833
16	01.04.2013	20,833
17	01.05.2013	20,833
18	01.06.2013	20,833
19	01.07.2013	20,833
20	01.08.2013	20,833
21	01.09.2013	20,833
22	01.10.2013	20,833
23	01.11.2013	20,833
24	01.12.2013	20,833
25	01.01.2014	20,833
26	01.02.2014	20,833
27	01.03.2014	20,833
28	01.04.2014	20,833
29	01.05.2014	20,833
30	01.06.2014	20,833
31	01.07.2014	20,833
32	01.08.2014	20,833
33	01.09.2014	20,833
34	01.10.2014	20,833
35	01.11.2014	20,833
36	01.12.2014	20,833
37	01.01.2015	20,833
38	01.02.2015	20,833
39	01.03.2015	20,833
40	01.04.2015	20,833
41	01.05.2015	20,833
42	01.06.2015	20,833
43	01.07.2015	20,833
44	01.08.2015	20,833
45	01.09.2015	20,833
46	01.10.2015	20,833
47	01.11.2015	20,833
48	01.12.2015	20,833
49	01.01.2016	20,833
50	01.02.2016	20,833
51	01.03.2016	20,833
52	01.04.2016	20,833
53	01.05.2016	20,833
54	01.06.2016	20,833
55	01.07.2016	20,833
56	01.08.2016	20,833
57	01.09.2016	20,833
58	01.10.2016	20,833
59	01.11.2016	20,833
60	01.12.2016	20,833
TOTAL PAYMENT TO BANK		1,250,000

execute a sale and purchase contract to transfer the ownership of the leased asset to the Lessee (Customer). Instead of taking a sale undertaking from the Bank, the parties may execute a Conditional Gift Contract in the beginning of the Ijarah for the transfer of the ownership of the leased asset.

Calculations:

HOME FINANCE BASED ON IJARAH MUNTAHIA BITTAMLEEK			
Basic Assumptions		Alphabetical Equations and Formulas	
Particulars	Unit	Value	
Total Cost of the Asset	USD	12,00,000.0	C
Lease Deposit (Advance Rent)	USD	2,00,000.0	D
Bank's Share (Finance Approved)	USD	10,00,000.0	F = (C-D)
Total Lease Period in Months	NOS	60.0	T
Bank's Profit Rate (fixed % p.a. on finance)	%	5.00	R
Bank's Total Profit	USD	2,50,000	$P = (F \times R \times T) / 12$
Bank's Monthly Profit	USD	4,167	$M = P / T$
Monthly Lease Rent / EMI	USD	20,833	$R = (F + P) / T$



1. Let us take an example of Home finance where the total cost of the asset is USD 1.2 Million or USD 1,200,000/-.
2. The customer makes the down payment (Advance Rent) of USD 200,000 and the Islamic bank finances the balance which is USD 1,000,000.
3. It is agreed between the customer and the Islamic bank that the Islamic bank would lease the asset to the customer for a period of 5 years or 60 months against the monthly rental, which includes the rent against usufruct and the payment towards the bank's finance. The rent is calculated on the Net Asset Value of the leased asset which includes the profit margin of 5% p.a. of the Islamic bank. The formula for rent is: $[\text{Bank's finance on the Asset} \times \text{Bank's Profit Margin} \times (\text{Total Lease period} / 12) + \text{Bank's Finance}] / \text{Total Lease Period}$, which is $[1,000,000 \times 5\% \times (60 / 12) + 1,000,000] / 60 = [1,250,000] / 60 = 20,833$. The rent has a profit component of USD 4,167 and the payment towards principal of USD 16,666.
4. After paying the total Lease Rent or EMIs i.e. $\text{USD } 20,833 \times 60 = 1,250,000$, the Islamic bank would transfer the ownership of the asset to the customer.

For an easy understanding we have used fixed rental formula for one term. But in the overall lease financing there are two components, fixed rental and variable rental. Fixed Rent is the financing amount and the Variable Rental is the floating profit amount.

It is worth mentioning that the Variable Rent, almost in all the Islamic Banks and Islamic financial institutions, is linked to the certain benchmark for each rental period. In this case the Rental Rate varies from one rental period to another based on the change in the referred benchmark. Once the rent is fixed for any rental period based on the benchmark, however, all the installments of that rental period remain unchanged even though there is a change in the benchmark.

As the Variable Rent is calculated on the outstanding Fixed Rent it keeps on decreasing every month due to the payment of the Fixed Rent. Accordingly, the Fixed and Variable Rents are adjusted to achieve the EMI.

MANUFACTURING FINANCE (ISTISNA AND PARALLEL ISTISNA):

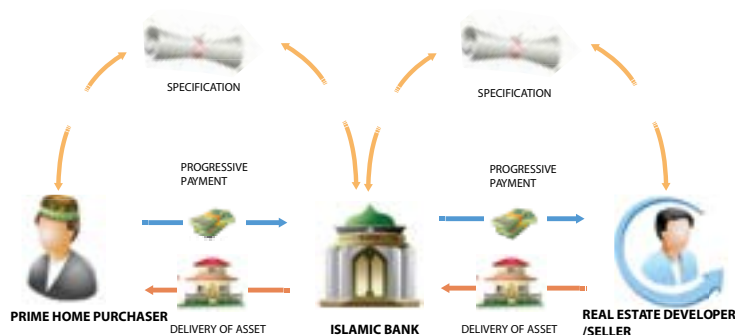
The word Istisna is a derivative from the root word ‘Sana’a which means to manufacture or to construct or to build something. Istisna is a contract of sale of specified items to be manufactured or constructed with an obligation on the part of seller (San’e) to deliver them to the buyer (Mustasne) upon completion.

Another way in which an Istisna is conducted is known in modern custom as Parallel Istisna “al-Istisna al-Muwazi”. It takes effect through two separate contracts. In the first contract, the Islamic Bank acts in the capacity of Seller (San’e) and concludes the contract with the customer who is the buyer (Mustasne). In the second contract, the Bank acts in the capacity of a buyer (Mustasne) and concludes the contract with a seller (San’e) in order to fulfill its contractual obligations towards the customer in the first contract. By this process, a profit is realised through the difference in price between the two contracts.

As most of the Islamic Banks are not involved directly in contracting business they adopt the structure of “Parallel Istisna” to satisfy their customers’ need who seek the home finance through Istisna contract. It is a duty of the Islamic bank to ensure that the purpose of Istisna is not repugnant to Shariah principles.

Since the Istisna is a kind of Sale contract, no penalty or extra amount over the Istisna purchase price shall be charged to the customer (purchaser / mustasne) in case of any delay in the payment or for any deferral in the payment granted by the Bank (seller / San’e) to the Customer. Contrary to this the Customer (mustasne), however, may impose specific penalty against the Bank (San’e) for any delay in the delivery of the property.

STRUCTURE OF HOME FINANCING BASED ON ISTISNA AND PARALLEL ISTISNA:



PARALLEL ISTISNA

Operational Procedure:

1. A Customer who is in need to build a house approaches the Islamic Bank and applies for finance through Istisna based finance transaction.
2. As per Customer's financing requirement Bank assesses the customer's creditworthiness, analyses the real estate market condition, evaluates the price of the materials of subject property and approves the request.
3. The Bank as San'e (seller) and the Customer as Mustasne (purchaser) execute the Istisna contract whereby the specification of the subject of Istisna, Istisna price, the mode of payment and the delivery of the property are stipulated in a very clear form.
4. If the financing is not approved for the 100% value of the Istisna cost the Bank asks the Customer to pay certain amount as Advance Payment which is adjusted in the Istisna purchase price.



Monetisation refers to the purchase of a commodity for a deferred price determined through bargaining (Musawama) or markup sale (Murabaha), and selling it to a third party for a spot price so as to obtain cash.

The Musawama transaction differs from Murabaha in that in Murabaha the seller explicitly discloses the purchasing price and profit margin to the buyer, whereas in Musawama the sale is concluded after negotiations on the sale price and not referring to the cost and profit of the commodity.



5. The Bank, in return, executes another Istisna contract (parallel Istisna) being purchaser (Mustasne) with any contractor (San'e) on the same terms and conditions of the Istisna agreement signed with the Customer except the Istisna price. In the parallel Istisna contract, the Bank may ask the contractor to provide with a Performance Guarantee and in case of any advance payment, the Advance Payment Guarantee.
6. Under the Parallel Istisna contract, the Bank as Mustasne pays the Istisna price to the contractor i.e. San'e, as per agreed upon terms in the agreement. The payment is generally linked to the progress of construction.
7. A consultant is appointed either on the cost of the contractor or the customer to supervise the construction works.
8. The Contractor as a San'e delivers the property on the delivery date to the Bank (mustasne) under the parallel Istisna contract.
9. The Bank being San'e delivers the property under the first Istisna contract to the Customer (mustasne) on the relevant delivery date.
10. The Customer pays the Istisna purchase price to the Bank as per agreed upon terms in the contract which generally starts after the delivery of the property to the Customer in the form of Equated Monthly Installment (EMI).

VEHICLE FINANCE

After understanding the different modes and contracts through which the Islamic bank can finance the housing projects, let us now discuss how the Islamic bank would provide the financing to a customer who is seeking a vehicle or car. The bank may finance the car in any of the form of contracts discussed below.

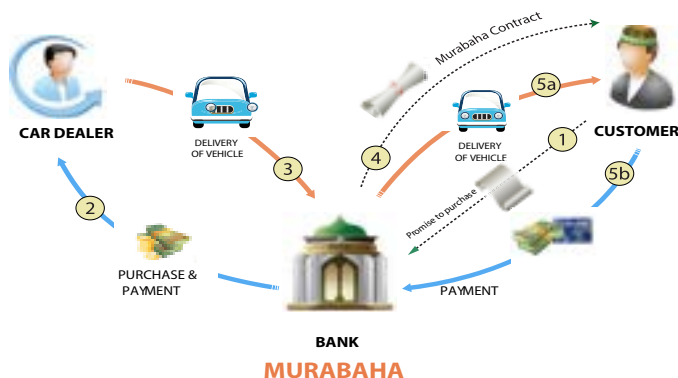
i. Mark-up sale (Murabaha)

ii. Lease to Own (Ijarah Muntahia Bittamleek)

Mark-Up Sale (Murabaha)

The word Murabaha is derived from the word 'Ribh', which means profit or gain. Murabaha is the sale of a commodity as per the purchasing price with a defined and agreed profit markup. This markup may be a percentage of the selling price or a lump sum amount. This transaction may be concluded without a prior promise to buy, in which case it is called an ordinary murabaha, or with a prior promise to buy submitted by the customer interested in acquiring goods through the Islamic bank, in which case it is called murabaha to purchase orderer or banking Murabaha. This transaction is one of the trust based contracts because the seller explicitly discloses the purchasing price and profit margin to the buyer.

STRUCTURE OF VEHICLE FINANCING BASED ON MURABAHA:



Operational Procedure:

1. A Customer who is in need to acquire a vehicle approaches the Islamic Bank and applies for finance through Murabaha (Mark-up Sale) transaction.
2. As per Customer's financing requirement Bank assesses the Customer's creditworthiness and approves the request.

3. The Bank seeks an undertaking from the Customer to buy the vehicle from the Bank once latter purchases the same and takes the possession thereof. Along with other details the Bank's profit is also stipulated in such undertaking.
4. If the financing is not approved for the 100% value of the vehicle the Bank asks the Customer to pay certain amount as security money (Hamish Jiddiyyah) which is converted into Down Payment at the time of signing the Murabaha Sale Contract.
5. The vehicle supplier submits a quotation to the Bank with the detailed specifications of the vehicle and its sale price.
6. The Bank issues the Local Purchase Order (LPO) to the vendor and purchases the vehicle on its fair market price. The sale and purchase agreement between the Bank and the vendor is envisaged by accepting the vendor to the above LPO.
7. After getting the possession of the purchased vehicle the Bank sells it to the Customer through a Murabaha Sale Contract after adding its profit (mark-up) to the cost of purchase.
8. In accordance with the requirement of Murabaha, the Murabaha Sale Contract clearly stipulates the Murabaha Sale Price which consists of the cost of purchase and the Bank's profit. The payment term of the sale price is also agreed between the Customer and the Bank in this contract.
9. The Bank hands over a Delivery Order to its Customer enabling him to receive the vehicle from the vendor after which the ownership risk in the vehicle gets transferred from the Bank to the Customer.
10. To secure its finance the Bank generally mortgages the vehicle in its favor. In accordance with the Bank's risk appetite it may require from the Customer some other securities like salary transfer.
11. The insurance is arranged by the Customer on its own the proceeds of which are assigned to the Bank. In case of any accident which results into a total loss of the vehicle the relevant insurance company pays the claim amount to the Bank.
12. If Customer requires the insurance to be financed as well, the Bank obtains the insurance policy only from the Islamic Insurance (Takaful) company and then sells the insured vehicle to the customer. In no case any Islamic Bank can finance the takaful policy separately.
13. After getting all the documents along with the original invoice from the vendor, Bank releases the payment for the cost of purchase.
14. Customer starts paying the Murabaha Sale Price generally in EMI.

Calculations:

VEHICLE FINANCE BASED ON MURABAHA			
Basic Assumptions		Alphabetical Equations and Formulas	
Particulars	Unit	Value	
Cost of the House	USD	500,000	C
Down Payment from customer	USD	0	D
Amount Financed (100%)	USD	500,000	$F = C - D$
Profit Margin (Fixed Rate) % p.a.)	%	5%	R
Term of Financing	Months	60	T
Total Profit Amount	USD	125,000	$P = F * R * (T/12)$
Total Murabaha Sale Price	USD	625,000	$SP = F + P$
Monthly Installment	USD	10,416	$I = SP/T$
Cost portion of Installment	USD	8,333	$IC = F/T$
Profit portion of Installment	USD	2,083	$IP = P/T$

1. Let us look at an example of Murabaha Vehicle Finance transaction. The total cost of a car is USD 500,000.
2. The customer makes zero down-payment and requires 100% financing.



There are three main categories of accounts, namely Islamic current account, Islamic savings account and Islamic investment account.

And a Qard contract is an interest-free loan given by the depositor to the bank. In this case also the bank can utilise the monies lent by the customer as creditor, but the bank is obliged to return the principal on demand or as per the contract.



3. The bank agrees to finance 100% cost of the car which is USD 500,000.
4. The bank purchases the car and sells it to the customer on Murabaha (deferred sale) basis payable in 5 years, i.e., 60 months.
5. The total Murabaha Sale Price will be USD 625,000; this is made up of the amount financed by bank, which is USD 500,000, plus the bank's total profit margin, which is USD 125,000.
6. The profit amount of USD 125,000 is arrived at as shown below:

Profit = [Amount Financed (F) * Profit Rate(R) * Term of financing]

$$\text{Profit} = [500,000 * 5\% * 60 / 12] = 125,000$$

7. The monthly installment of USD 10,416 is arrived at as shown below:
Monthly Installment = [(Amount Financed (F) + Profit Amount (P))] / Term of financing

$$\text{Installment} = (500,000 + 125,000) / 60 = 10,416.$$

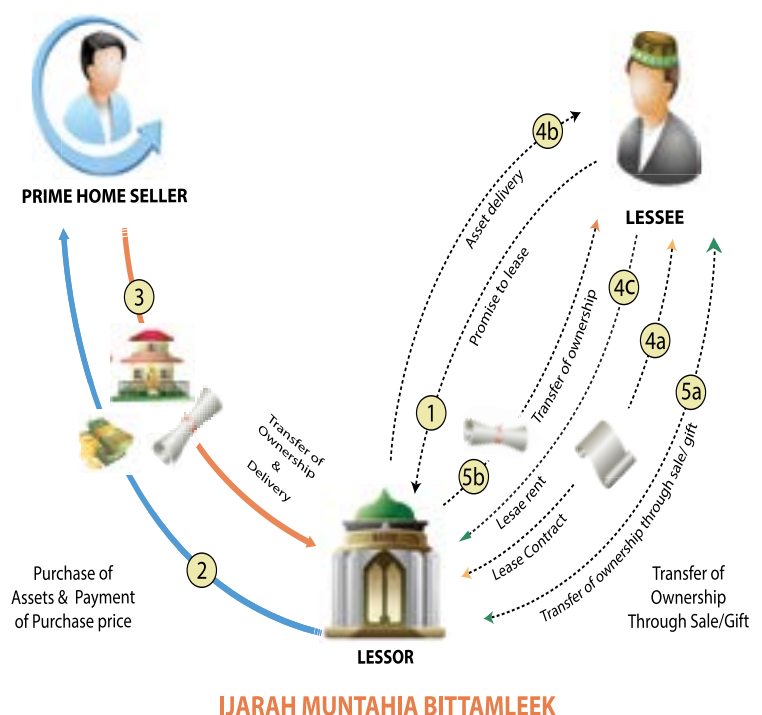
8. The customer would pay the total amount of USD 625,000 (i.e. 10,416 * 60) in 60 installments
9. In case of an early payment, i.e., prepayment by the customer as per the current market practice, the decision on the level of rebate is solely at the discretion of the bank and different approaches may be applied. It is worth noting that the customer is contractually obliged to pay the full cost and profit amount.

ISLAMIC LEASE (IJARAH MUNTAHIA BITTAMLEEK):

The term Ijarah means leasing of property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration.

One of the forms of Ijarah which is commonly used in Vehicle financing is the Ijarah Muntahia Bittamleek. This is a form of leasing contract in which the ownership of the leased property is transferred to the lessee.

STRUCTURE OF VEHICLE FINANCING BASED ON IJARAH MUNTAHIA BITTAMLEEK:



Calculations:

VEHICLE FINANCE BASED ON IJARAH MUNTAHIA BITTAMLEEK			
Basic Assumptions	Alphabetical Equations and Formulas		
Particulars	Unit	Value	
Total Cost of the Car	USD	5,00,000.0	C
Lease Deposit (down payment)	USD	50,000.0	D
Bank's Share (Finance Approved)	USD	4,50,000.0	F = C-D
Total Lease Period in Months	NOS	60.0	T
Bank's Profit Rate (fixed % p.a. on finance)	%	5.00	r
Bank's Total Profit	USD	1,12,500	$P = F \times r \times T / 12$
Bank's Monthly Profit	USD	1,875	$M = P / T$
Monthly Lease Rent/EMI	USD	9,375	$R = (F + P) / T$

1. Let us take an example of Vehicle finance where the total cost of the asset is USD 500,000.
2. The customer pays the advance rental of USD 50,000 and the Islamic bank finances the balance, which is USD 450,000.
3. It is agreed between the customer and the Islamic bank that the bank would lease the asset to the customer for a period of 5 years or 60 months/ against the monthly rental, which includes both the bank's profit as well as the cost of purchase. The rent is calculated on the Net Asset Value of the leased asset which includes the profit margin of 5% p.a. of the Islamic bank. The formula for rent is: [Bank's finance on the Asset*Bank's Profit Margin*(Total Lease period/12) + Bank's Finance]/Total Lease Period, which is $[450,000 \times 5\% \times (60/12) + 450,000] / 60 = [562,500] / 60 = 9,375$. The rent has a profit component of USD 1,875 and the payment towards principal of USD 7,500.
4. After paying the total Lease Rent or EMIs, i.e., $USD\ 9,375 \times 60 = 562,500$, the Islamic bank would transfer the ownership of the asset to the customer.

PERSONAL FINANCING

After having understood how the Islamic bank provides vehicle finance, let us now understand the techniques by which the Islamic bank facilitates personal finance. Generally, personal finance can be provided by following contracts.

i. Service Ijarah (Ijarah)

ii. Monetisation (Tawarruq)

Service Ijarah (Ijarah):

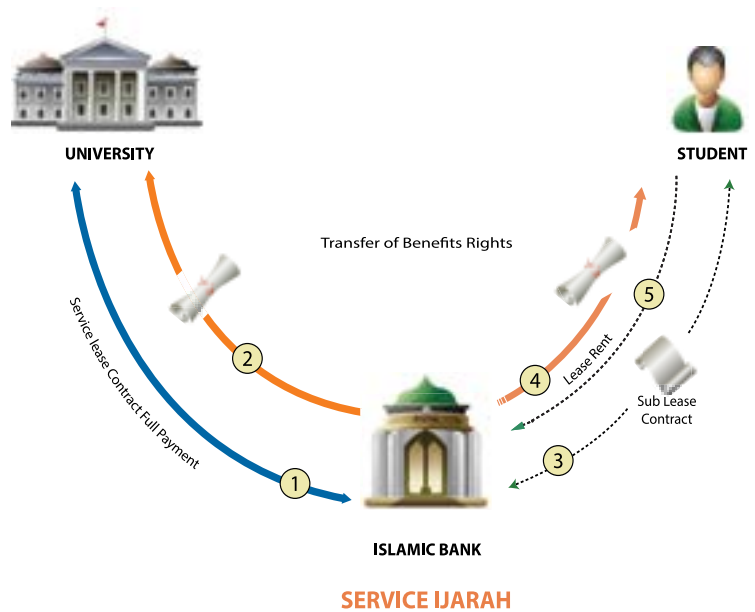
The term Ijarah means leasing of property pursuant to a contract under which a specified permissible in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration.

Islamic finance has developed a scheme of personal financing based on the concept of Ijarah or Service Ijarah or Hire contract to finance the Medical, Educational, wedding services ect. In this case, two hire contracts exist - one between the service provider and the Islamic Bank, and another between the Islamic Bank and its Customer. The second contract is known as sub-hire or sub-lease contract.

Though both the above contracts comprise on the same specifications of the services, they are totally independent and separate from each other whereby the execution of one contract shall not be contingent on the other.



STRUCTURE OF PERSONAL FINANCING BASED ON SERVICE IJARAH



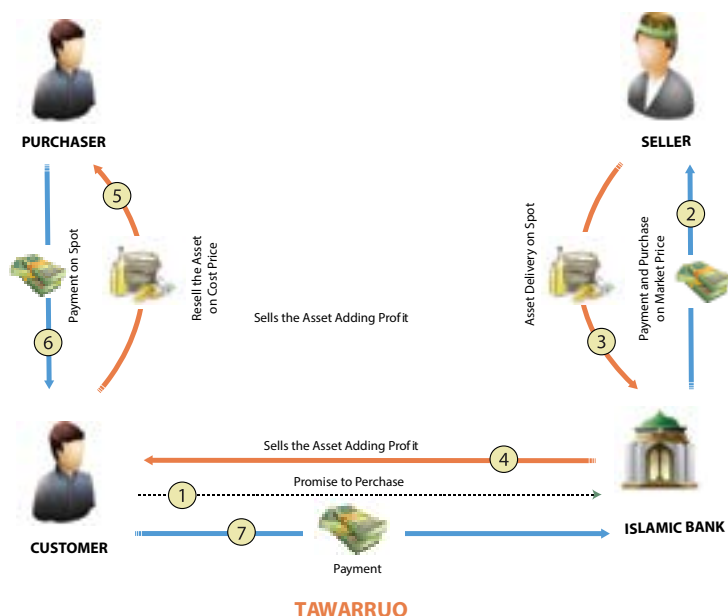
Operational Procedure:

1. A Customer who is in need to hire any specific service like education, medical or travelling approaches the Islamic Bank and applies for finance.
2. As per Customer's financing requirement Bank assesses the customer's creditworthiness, checks if the required service is a Shariah compliant service and approves the request.
3. The Bank seeks an undertaking from the Customer to hire the required service from the Bank once latter hires the same from the actual service provider.
4. If the financing is not approved for the 100% value of the service the Bank asks the Customer to pay certain amount in advance which is deducted from the service cost later on.
5. The service provider submits a quotation to the Bank with the detailed specifications of the service, its cost of purchase and the way of delivery.
6. The Bank issues the Local Purchase Order (LPO) to the service provider and hires the service. The sale and purchase agreement between the Bank and the service provider is envisaged by accepting the vendor to the above LPO.
7. The Bank executes the Service Ijarah agreement with its Customer which stipulates the details of the service, its delivery, the total sale price and the payment details.
8. The Bank releases the payment to the vendor for the purchase of the service.
9. The Customer gets a service delivery order from the Bank and avails the service directly from the service provider.
10. The Customer pays the service sale price to the Bank as per agreed upon terms in the Service Ijarah Agreement.
11. To secure its finance, Bank may ask the Customer to furnish the required securities.

MONETISATION (TAWARRUQ):

Monetisation refers to the purchase of a commodity for a deferred price determined through bargaining (Musawama) or markup sale (Murabaha), and selling it to a third party for a spot price so as to obtain cash.

STRUCTURE OF PERSONAL FINANCING BASED ON TAWARRUQ:



Operational Procedure:

1. A Customer who is in need to have cash approaches an Islamic Bank and requests for financing.
2. As per Customer's financing requirement Bank assesses the customer's credit worthiness and approves the request.
3. The Bank seeks an undertaking from the Customer to buy the commodity from the Bank once latter purchases the same and takes the possession thereof. Along with other details the Bank's profit is also stipulated in such undertaking.
4. The Islamic Bank purchases any commodity available in the market from the vendor and takes the possession thereof.
5. The Bank executes the Commodity Murabaha Agreement with its Customer which stipulates the details of the commodity, cost price, Bank's profit and the mode of Murabaha Sale Price payment.
6. The Customer, further, sells the same commodity on the cost price to a party other than the one from whom the Bank has purchased the commodity.
7. The sale proceeds of the above sale (under point No. 6) fulfills the cash requirement of the Customer.
8. The Customer pays the Murabaha Sale Price to the Bank as per agreed terms in the Murabaha agreement which is generally in the form of EMI.

ISLAMIC GOODS FINANCING

After exploring how the Islamic bank provides personal finance, let us now understand the techniques by which the Islamic bank facilitates the goods finance. Generally goods finance can be provided by using two contracts.

i. Mark-up sale (Murabaha)

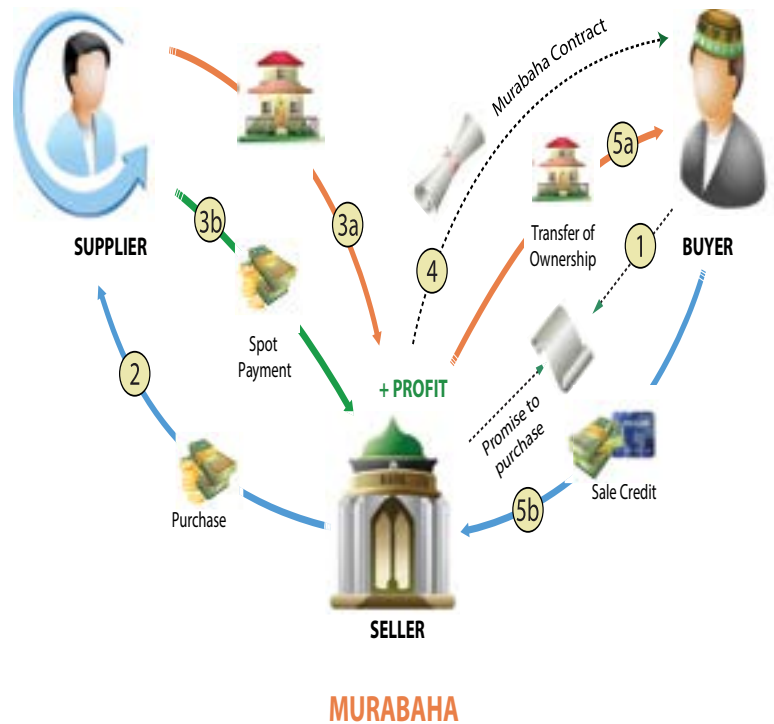
ii. Sale on negotiation (Mussawama)

Markup-Sale (Murabaha):

Murabaha is selling a commodity as per the purchasing price with a defined and agreed profit markup. This markup may be a percentage of the selling price or lump sum. This transaction is one of the trust based contracts, because the seller explicitly discloses the purchasing price and profit margin to the buyer.



STRUCTURE OF GOODS FINANCE BASED ON MURABAHA:



Calculations:

GOODS FINANCE BASED ON MURABAHA			
Basic Assumptions	Alphabetical Equations and Formulas		
Particulars	Unit	Value	
Cost of the Goods	USD	200,000	C
Down Payment from customer	USD	0	D
Amount Financed (100%)	USD	200,000	F=C-D
Profit Margin (Fixed Rate) % p.a.)	%	10%	R
Term of Financing	Months	36	T
Total Profit Amount	USD	60,000	P=F*R*(T/12)
Total Murabaha Sale Price	USD	260,000	SP = F+P
Monthly Installment	USD	7,222	I=SP/T
Cost portion of Installment	USD	5,555	IC=F/T
Profit portion of Installment	USD	1,666	IP=P/T

- Let us look at an example of Goods Murabaha Finance transaction. Total cost of the goods is USD 200,000.
- The customer makes zero down-payment and requires 100% financing.
- The bank agrees to finance 100% cost of the goods which is USD 200,000.
- Bank purchases the goods and sells it to the customer on Murabaha (deferred sale) basis repayable in 3 years, i.e., 36 months.
- The total Murabaha Sale Price will be USD 260,000; this is made up of the amount financed by the bank, which is USD 200,000 plus the bank's total Profit Margin which is USD 60,000.
- The profit amount of USD 60,000 is arrived at as shown below:

$$\text{Profit} = [\text{Amount Financed (F)} * \text{Profit Rate (R)} * \text{Term of financing}]$$

$$\text{Profit} = [200,000 * 10\% * 36/12] = 60,000$$
- The monthly Installment of USD 7,222 is arrived at as shown below:

$$\text{Monthly Installment} = [(\text{Amount Financed (F)} + \text{Profit Amount (P)}) / \text{Term of financing}]$$

$$\text{Installment} = (200,000 + 60,000) / 36 = 7,222. - \text{Installment}$$

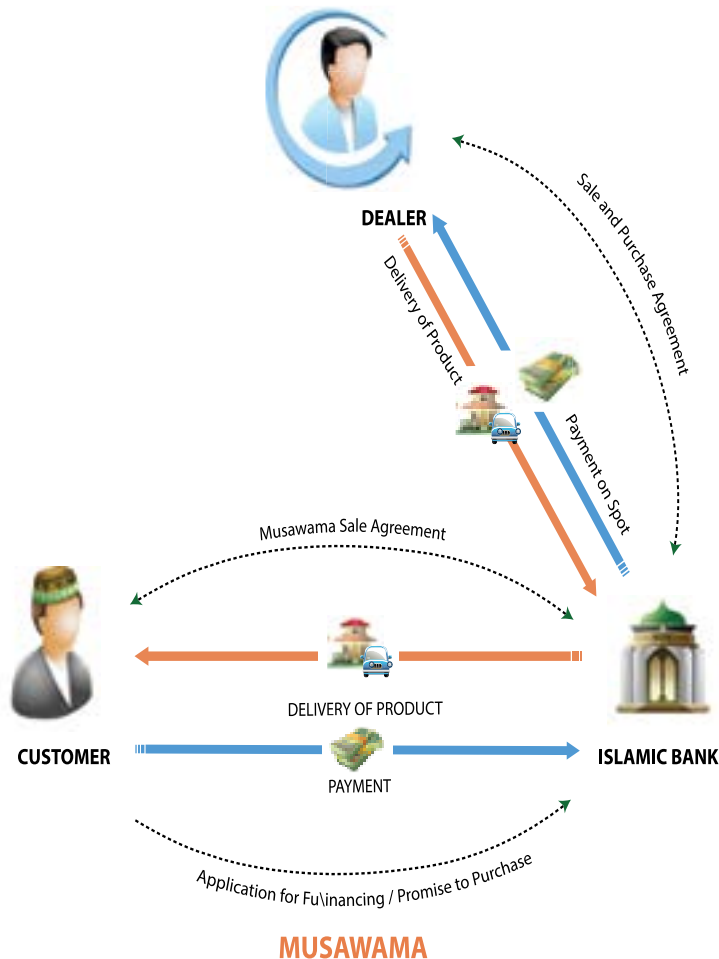
is rounded off for ease of calculation.

8. The customer would pay the total amount of USD 260,000 (i.e. $7,222 \times 36$) in 36 installments.
9. In case of an early payment, i.e., prepayment by the customer as per the current market practice, the decision on the level of rebate is solely at the discretion of the bank and different approaches may be applied. It is worth noting that the customer is contractually obliged to pay the full cost and profit amount.
10. Using the above example, if the customer chooses to close the financing at the end of 2 years, the customer will have an outstanding cost balance of USD 66,680 and outstanding profit balance of USD 20,016. The bank has the legal right to collect the full profit amount i.e., USD 20,016. However, as per the current market practices, a rebate at the bank's discretion is granted on the outstanding profit portion. This means that the customer will end up paying much lesser amount than 20,016 depending on the rebate % granted. If 50% rebate is granted, the customer will pay USD 10,008 of the outstanding profit along with outstanding costs of USD 66,680.

Negotiation Markup-Sale (Musawama):

Musawama is the sale of a commodity as per the purchasing price with a profit markup. This markup may be a percentage of the selling price or lump sum. This transaction differs from Murabaha in that in Murabaha the seller explicitly discloses the purchasing price and profit margin to the buyer, whereas in Musawama the sale is concluded after negotiations on the sale price and not referring to the cost and profit of the commodity.

STRUCTURE OF GOODS FINANCING BASED ON MUSAWAMA:



Calculations:

GOODS FINANCE BASED ON MUSAWAMA			
Basic Assumptions	Alphabetical Equations and Formulas		
Particulars	Unit	Value	
Cost of the Goods	USD	200,000	C
Down Payment from customer	USD	0	D
Amount Financed (100%)	USD	200,000	F=C-D
Profit Margin (Fixed Rate) % p.a.)	%	10%	R
Term of Financing	Months	36	T
Total Profit Amount	USD	60,000	P=F*R*(T/12)
Total Murabaha Sale Price	USD	260,000	SP = F+P
Monthly Installment	USD	7,222	I=SP/T

The Ujrah Card is based on the Islamic principle of “Qardh Al Hasan” or benevolent loans and a bunch of services are made available to the customer.



1. Let us look at an example of Musawama Goods Finance transaction. Total cost of the goods is USD 200,000.
2. The customer makes zero down-payment and requires 100% financing.
3. The bank agrees to finance 100% cost of the Goods which is USD 200,000.
4. Bank purchases the Goods and sells it to the customer on Murabaha (deferred sale) basis repayable in 3 years i.e. 36 months.
5. The total Murabaha Sale Price will be USD 260,000; this is made up of amount financed by bank which is USD 200,000 plus Bank's total Profit Margin which is USD 60,000.
6. The profit amount of USD 60,000 is arrived at as shown below':

$$\text{Profit} = [\text{Amount Financed (F)} * \text{Profit Rate (R)} * \text{Term of financing}]$$

$$\text{Profit} = [200,000 * 10\% * 36/12] = 60,000$$
7. The monthly Installment of USD 7,222 is arrived at as shown below':

$$\text{Monthly Installment} = [(\text{Amount Financed (F)} + \text{Profit Amount (P)}) / \text{Term of financing}]$$

$$\text{Installment} = (200,000 + 60,000) / 36 = 7,222. - \text{Installment is rounded off for ease of calculation.}$$
8. The customer would pay the total amount of USD 260,000 (i.e. 7,222 * 36) in 36 installments.
9. However, it is to be noted that in Musawama, the Islamic bank would not disclose the actual cost or the profit margin to the customer.

CREDIT CARDS

A credit card authorises the holder to buy goods and services on credit without having to use cash. The issuer of the card grants a line of credit to the consumer from which the user can withdraw cash money and can pay to the merchant for the purchases. The introduction of Islamic credit cards happened to be one of the most challenging tasks, as the mechanism of modern credit card facility works on the principle of Interest which is clearly prohibited in Islam. This is where the Islamic product development was required to create something as flexible as the conventional credit card without involving interest. The Islamic finance institutions have adopted two structures to develop Islamic credit cards. They are as follows:

- i. Ujrah based Credit Card
- ii. Tawarruq based Credit Card

Ujrah-based Credit Card:

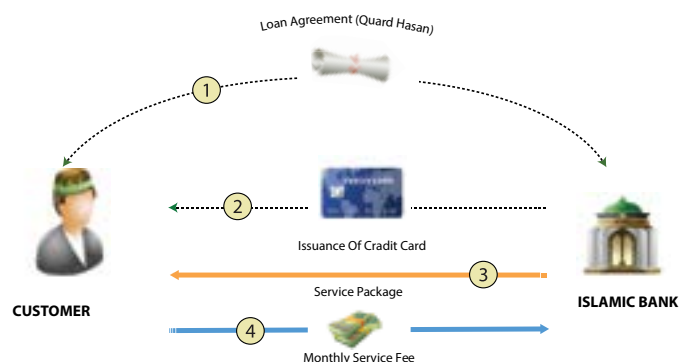
Ujrah (Ajr) means payment for services rendered. A person or an institution can render services for a wage.

The Ujrah Card is based on the Islamic principle of “Qardh Al Hasan” or benevolent loans and a bunch of services are made available to the customer. Under this structure the credit amount lent as Qardh to the customer is repaid by the customer in installments without any premium.

The bank charges a flat monthly fee which is for the services which it provides along with the Ujrah Card such as vehicle recovery services, discounts at restaurants as well as access to airport lounges etc. In the event of a delay in payment of the Qardh amount, the bank cannot charge the customer any extra amount. Also in the event of a default the customer will still be able to avail the services that are provided with the Ujrah Card and therefore the flat monthly fee can continue to be charged.

The monthly fixed fee cannot be applicable differently on different categories of the card due to the difference in their credit limits unless the services package tagged on to any category of the card is different from the other.

STRUCTURE OF UJRAH BASED CREDIT CARD:



UJRAH BASED CREDIT CARD

Transaction Procedure and Calculations:

1. The Islamic Bank makes the credit amount USD 10,000 available as Qard to the customer.
2. The Islamic bank issues the plastic card where the relevant services are made accessible to the cardholder under the Service Ijarah agreement.
3. The customer pays a fixed monthly fee, say, USD 100 towards the services rendered by the Islamic bank.
4. The customer repays in full or a part of the utilized credit amount or Qardh on monthly basis to the Islamic bank.

TAWARRUQ BASED CREDIT CARD:

Monetisation (Tawarruq) refers to purchase of a commodity for a deferred price determined through bargaining (Musawama) or markup sale (Murabaha), and selling it to a third party for a spot price so as to obtain cash.

After the credit assessment the Islamic bank approves the credit limit for its customer which is made available to the customer through Commodity Murabaha (Tawarruq) transaction.

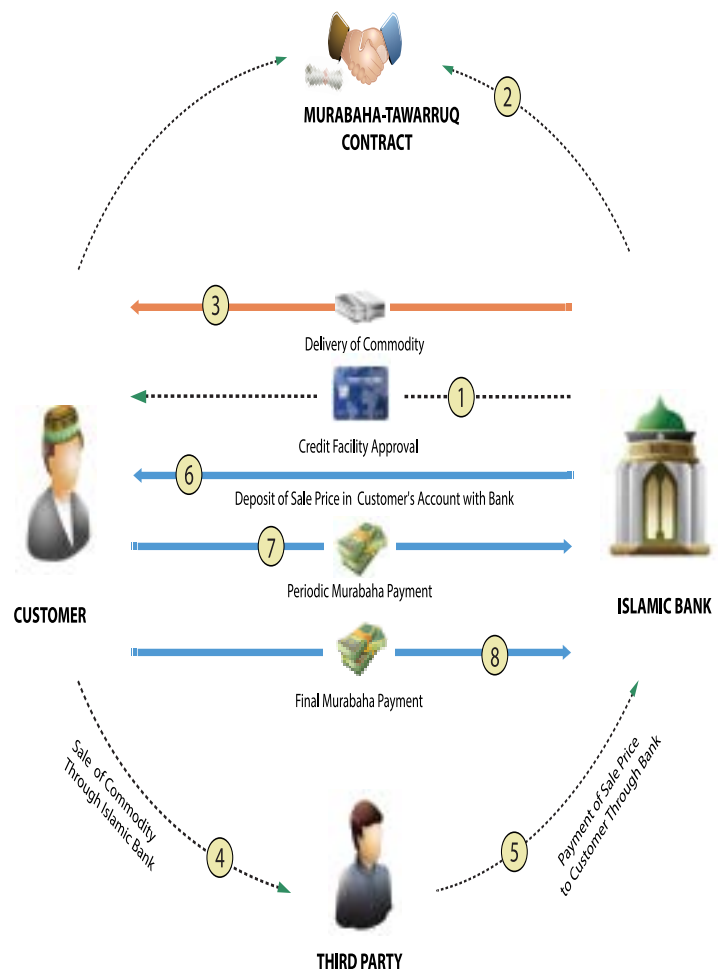
In Tawarruq based credit card the amount equal to the total Murabaha profit paid by the customer is spread over the period of the Murabaha Agreement tenor on a monthly basis. The amount of the Cost Price is paid by the customer to the bank at the end of the Murabaha Agreement period which coincides with the expiry of the Credit Card.



The sale proceeds generated through Tawarruq is placed in a special Mudaraba account as a security against the deferred sale price of above mentioned commodity Murabaha and thus earns a profit for the customer on the monthly average or minimum balance available in that account. The Bank at its own discretion may pay a certain profit amount as a gift to the customer on monthly basis. This way bank satisfies the customer's requirement not to be charged the higher profit under the Murabaha sale on an unutilised amount.

It is to be noted that in order the card holders should not use the Islamic Credit Card for Shariah non-compliant products and services, the Islamic Banks block all the MMCs (Merchant Category Codes) which are assigned to those products and services not in compliance with Shariah principles. Moreover, the general terms and conditions of the Islamic card should explicitly state that using this card for any Shariah non-compliant product and services is not allowed otherwise bank will have the right to cancel the card.

STRUCTURE OF TAWARRUQ BASED CREDIT CARD:



MURABAHA-TAWARRUQ BASED CREDIT CARD

Transaction Procedure and Calculations:

1. An Islamic bank buys bulk commodities (Metals) from the Market and takes the constructive possession.
2. A customer wishes to apply for a Credit Card and requires USD 10,000 amount as a credit limit along with 24 months validity

approaches the Islamic Bank.

3. The Islamic bank assesses the Customer's credit credibility for approval and sells the commodity to the customer at cost price plus profit ("Total Murabaha Amount") which is USD 12,000 (10,000 +10% p.a profit margin) for deferred payment for two years.
4. After executing the commodity Murabaha agreement, the customer sells the purchased commodity to a third party and collects the sale proceeds which is equal to the initial Cost price of the commodity.
5. The sale proceeds which is USD 10,000 is credited to the customer's Mudarba account with the Islamic bank.
6. The Customer is allowed, to withdraw and use the money only through a credit card issued by the Bank with a condition that he/she has to pay back certain amount, say at least 5% of the utilised amount, every month.
7. The total Murabaha profit which is USD 2,000 will be paid by the customer over the tenor on a monthly basis which comes to USD 83.33. While the cost price which is USD 10,000 will be paid at the end.
8. Along with the normal mudaraba profit in the mudaraba savings account the Islamic bank, at its own discretion may give the customer some additional profit as a gift on monthly basis.
9. Suppose the customer has utilised USD 5,000 through the card then he is obliged to pay an amount approximately equal to 292 which consists of 5% of the utilised credit amount plus the Murabaha profit.

The break up of this calculation is as under:

(a) 5% of 5,000 (utilized amount) = 250/-; plus

(b) Monthly installment of profit = 83.33; Minus

(c) Monthly Mudharabah Profit and Bank's gift = 41.66

(250 + 83.33) - (41.66) = 291.66 (rounded upward as 292/-)

ISLAMIC BANK ACCOUNTS

Having given a brief introduction to the mechanism of Islamic credit cards, let us now discuss the Islamic bank accounts. There are three main categories of accounts, namely Islamic current account, Islamic savings account and Islamic investment account.

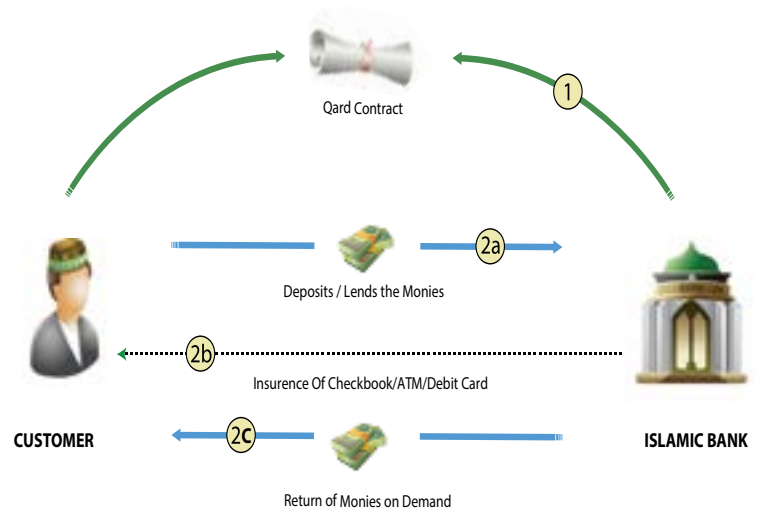
Current Account:

An Islamic current account provides the account holder with a guarantee on the principal amount deposited. The account holders are not entitled to receive any profits, but do not bear any losses either. This type of account is designed specifically to meet the needs of customers who want to deposit or withdraw funds by cheques, through cash tellers at bank branches or through the ATM machines.

The Islamic current account is structured using the wadia or Qard contract. Wadia in the legal sense signifies a thing entrusted to the care of another. The proprietor of the item is known as Mudi (depositor), the person entrusted with it is known as 'Wadi' or Mustawda (custodian) and the deposited asset is Wadia. A depositor, by depositing its money with a bank for safe custody purposes, has entered into a Wadiah contract. In this case, the bank will give its undertaking to be liable for any loss to the deposited item as a custodian. And a Qard contract is an interest-free loan given by the depositor to the bank. In this case the bank can utilise the monies lent by the customer as creditor, but the bank is obliged to return the deposits on demand or as per the contract.



STRUCTURE OF ISLAMIC CURRENT ACCOUNT:



ISLAMIC CURRENT ACCOUNT BASED ON QARD

Calculations:

CURRENT ACCOUNT BASED ON QARD			
Basic Assumptions	Alphabetical Equations and Formulas		
Particulars	Unit	Value	
Total Amount Deposited by Depositor	USD	100,000	D
Profit Rate allotted fixed % of)	%	Nil	
Amount available on demand or maturity	USD	100,000.0	D

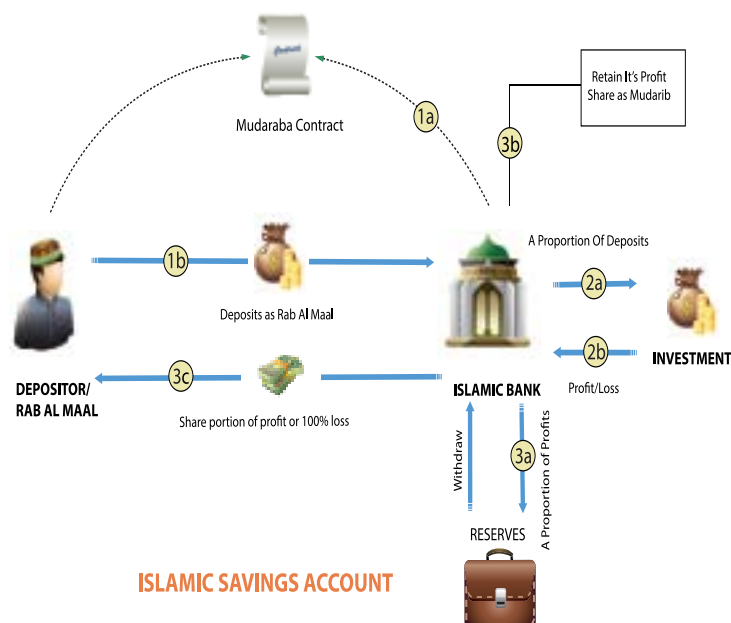
1. Let us take an example of Current Account where the total deposits from the depositor is USD 100,000/-.
2. The customer deposits the amount with the Islamic bank on Qard basis. Therefore, there will be no profit or loss sharing between the depositor and Islamic Bank.
3. The amount available to the depositor on demand or on maturity is USD 100,000.

Islamic Savings Account:

Islamic Savings account is offered to depositors primarily to fulfill their precautionary motives of holding money, as well as to meet some of their transactionary and investment needs where relevant. Savings accounts are designed specifically to meet the needs and requirements of customers who authorise the bank to invest their deposited money. Customers can deposit or withdraw funds at any time. The actual profits received are shared monthly at the ratio agreed between the bank and depositors.

The contract that could facilitate this purpose would be Mudaraba (profit sharing). Mudaraba is a partnership in profit whereby one party provides capital (rab-al-maal) and the other party provides labour (mudarib). In this contract, the depositors act as rab-al-maal and the bank as mudarib. Therefore, a portion of the deposits would be invested in various projects and the profit shared on the basis of the agreement. In case of loss, the rab-al-maal, i.e., the depositors would bear all the losses.

STRUCTURE OF ISLAMIC SAVINGS ACCOUNT:



Calculations:

SAVINGS ACCOUNT BASED ON MUDARABA			
Basic Assumptions	Alphabetical Equations and Formulas		
Particulars	Unit	Value	
Depositor's Capital (Savings Account)	USD	200,000.0	C
Mudaraba Profit Sharing ratio	%	30:70 x:y	
Deposits Invested in Bank's Assets(Financed)	USD	200,000.0	A
Net profit (Yield) from Banks assets	%	10.0	R
Profit earned from assets - Available for Distribution	USD	20,000	$P=A \times R$
Bank's Share of profit (30%)	USD	6,000	$BP=P \times x$
Customer's Share of Profit (70%)	USD	14,000	$CP=P \times y$
Customer's final return from Mudaraba Deposits	%	7%	$NR=CP/C$

Note the loss, if any shall be borne only by the Capital provider.

- Let us take an example of a Savings Account where the total deposits from the client is USD 200,000/-.
- The customer deposits the amount with the Islamic bank on Mudaraba basis as a Rab-al-Maal and the Islamic bank acts as the Mudarib managing the deposits. The depositor and Islamic Bank agreed to a profit sharing ratio of 70:30. Profits are shared as per the pre-agreed ratio; however, losses if any shall be borne by the depositor.
- As per the current practice, funds raised from Mudaraba deposits/savings accounts are invested in the bank's assets and the underlying profits generated from these assets are shared between the Bank and the depositors. The assets are earmarked against the deposits and their performance is tracked and profits calculated accordingly. The final profits paid out are based on the actual return generated from the underlying assets.
- In this example, the Mudaraba deposits of USD 200,000 will be used for financing/investing in Shariah compliant assets.
- For example, the underlying assets generate a net return of 10%,



Islamic investment account can be considered a substitute for conventional fixed time deposits. This account enables customers to deposit specific sums of money with the bank throughout the year for specific periods of time (1 month, 3 months, 6 months, 9 months or 12 months) with the option to withdraw profits at specific times.



which means a profit of USD 20,000. Profit = Deposit Amount * Rate of Return = USD 200,000 * 10% = USD 20,000

6. As per the profit distribution ratio, the profit of USD 20,000 is shared between the bank and the depositors as: Bank's share of profit (30%) = $20,000 \times 30\% = \text{USD } 6,000$. Customer share of profit (70%) = $20,000 \times 70\% = \text{USD } 14,000$
7. The customer's Net return from the Mudaraba deposits will equal to 7%, working as follows: Customer's share of profit/Mudaraba Deposits = $\text{USD } 14,000 / \text{USD } 200,000 = 7\%$.

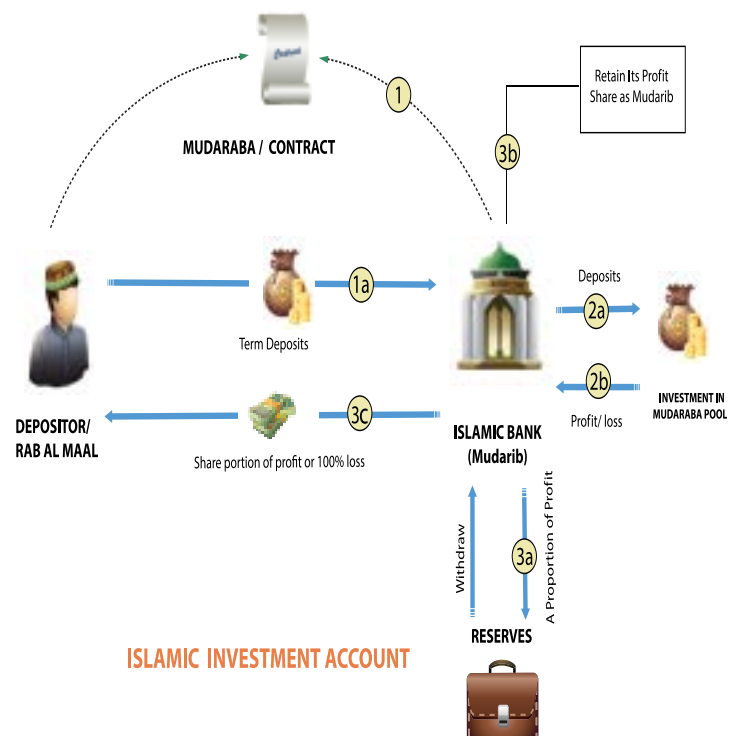
INVESTMENT ACCOUNT:

Islamic investment account can be considered a substitute for conventional fixed time deposits. This account enables customers to deposit specific sums of money with the bank throughout the year for specific periods of time (1 month, 3 months, 6 months, 9 months or 12 months) with the option to withdraw profits at specific times. It also enables banks to hold some money for depositors and invest on the basis of pre-agreed deposit tenure. Islamic investment account is structured using the Mudaraba and Wakala contracts.

A Mudaraba is a partnership in profit whereby one party provides capital (rab-al-maal) and the other party provides labor (mudarib). In this contract, the depositors act as rab-al-maal and the bank as mudarib. Therefore, a portion of the deposits would be invested in various projects and the profit is shared in ratios as agreed upon between the parties. In case, a loss is incurred, then the rab-al-maal, i.e. the depositors would bear all the losses.

The term Wakala literally means preservation. Legally, Wakala can be defined as the delegation of one person (the principal) for another (the agent) to take principal's place in a known and permissible dealing. In this regard, the agent (wakil) deals in others' properties and preserves them in return for a specific fee known as Wakala fee.

STRUCTURE OF ISLAMIC INVESTMENT ACCOUNT:



Calculations:

INVESTMENT ACCOUNT BASED ON MUDARABA			
Basic Assumptions	Alphabetical Equations and Formulas		
Particulars	Unit	Value	
Depositor's Capital (Investment Account)	USD	500,000.0	C
Mudaraba Profit Sharing ratio	%	30:70	x:y
Deposits Invested in Bank's Assets(Financed)	USD	500,000.0	A
Net profit (Yield) from Banks assets p.a.	%	10.0	R
Maturity Period	YEARS	5	T
Profit earned from assets - Available for Distribution on maturity	USD	250,000	$P=A*R*T$
Bank's Share of profit (30%)	USD	75,000	$BP=P*x$
Customer's Share of Profit (70%)	USD	175,000	$CP=P*y$
Customer's final return p.a. from Mudaraba Deposits	%	7%	$NR=CP/C/T$

Note: The loss, if any, shall be borne only by the Capital provider.

1. Let us take an example of Investment Account where the Total deposits from the client is USD 500,000/-.
2. The customer deposits the amount with the Islamic bank on Mudaraba basis as a Rab-al-Maal and the Islamic bank acts as the Mudarib managing the deposits. The depositor and Islamic Bank agree to a profit sharing ratio of 70:30. It is agreed that the amount remains with the Islamic bank for a period of 5 years. Profits are shared as per the pre-agreed ratio; however, losses if any shall be borne by the depositor.
3. As per the current practice, funds raised from Mudaraba deposits/savings accounts are invested in the bank's assets and the underlying profits generated from these assets are shared between the bank and the depositors. The assets are earmarked against the deposits and their performance is tracked and profits calculated accordingly. The bank provides an indicative profit rate and profit sharing ratio to the customers at the time of investment, whilst the final profits paid out are based on the actual return generated from the underlying assets.
4. In this example, the Mudaraba deposits of USD 500,000 will be used for financing/investing in Shariah compliant products which are booked in the Bank's balance sheet.
5. For example, the underlying assets generate a net return of 10% p.a. for 5 years, which means a profit of USD 250,000. Profit = Deposit Amount * Rate of Return * Maturity Period = USD 500,000 * 10% * 5 = USD 250,000
6. As per the profit distribution ratio, the profit of USD 250,000 is shared between the bank and the depositors as: Bank's share of profit (30%) = 250,000 * 30% = USD 75,000. Customer share of profit (70%) = 250,000 * 70% = USD 175,000
7. The customer's Net return from the Mudaraba deposits will equal to 7%, working as below: [Customer's share of profit/Mudaraba Deposits]/Total Maturity Period = [(175,000/500,000)/5] = 7%.

SNAPSHOT OF WHAT WE HAVE LEARNED:

In this module we have learned about:

- Islamic Retail Products that include Home Finance, Vehicle Finance, Personal Finance, Goods Finance, Credit Cards and Bank Accounts.
- Application of Musharaka (Partnership), Murabaha (Mark-up Sale), Ijarah (Islamic Lease) and Istisna (Manufacturing Contract) in

Home Finance Product. We have seen the structure, mechanism and calculations with respect to each Islamic Finance structure applied in Home Finance Product.

- Application of Murabaha (Mark-up Sale) and Ijarah Muntahia Bittamleek (Lease to Own) in Vehicle Finance Product. We have seen the structure, mechanism and calculations with respect to each Islamic Finance structure applied in Vehicle Finance Product.
- Application of Service Ijarah (Islamic Lease), Tawarruq (Monetization) in Personal Finance Product. We have seen the structure, mechanism and calculations with respect to each Islamic Finance structure applied in Personal Finance Product.
- Application of Murabaha (Mark-up Sale) and Musawama (Negotiations Markup Sale) in Goods Finance Product. We have seen the structure, mechanism and calculations with respect to each Islamic Finance structure applied in Goods Finance Product.
- Application of Ujrah and Tawarruq in Credit Cards. We have seen the structure, mechanism and calculations with respect to each Islamic Finance structure applied in Credit Cards.
- Application of Qard in Current Account, Mudaraba in Saving Account and Mudaraba & Wakala in Investment Account. We have seen the structure, mechanism and calculations with respect to each Islamic Finance structure applied in Bank Accounts.
- Calculation of Monthly installment in a Diminishing Musharaka i.e. $\text{Monthly Installment} = [(\text{Bank's Total finance} / \text{No. of instalments}) + ((\text{Bank's Total Finance} - (\text{Bank's Total finance} / \text{Total No. of instalments}) \times (\text{Current Month}-1)) \times (\text{Rental Rate}))]$.
- Calculation of Profit in Mudaraba i.e. $\text{Profit} = \text{Deposit Amount} \times \text{Rate of Return}$
- Calculation of Profit in Murabaha i.e. $\text{Profit} = [\text{Amount Financed (F)} \times \text{Profit Rate (R)} \times \text{Term of financing}]$
- Calculation of Monthly Installment in a Murabaha i.e. $\text{Monthly Installment} = [(\text{Amount Financed (F)} + \text{Profit Amount (P)}) / \text{Term of financing}]$.
- Calculation of Rent in a Normal Ijarah i.e. $\text{Rent} = \text{Finance Value} \times \text{Lease Rent Rate}$.
- Calculation of Rent in Ijarah Muntahia Bittamleek i.e. $\text{Rent} = [\text{Bank's finance on the Asset} \times \text{Bank's Profit Margin} \times (\text{Total Lease period} / 12) + \text{Bank's Finance}] / \text{Total Lease Period}$.
- Calculation of Installment in Istisna, i.e., $\text{Each Instalment Amount} = [\text{Total Selling Price or Cost} / \text{No. of Instalments}]$.





ISLAMIC

CORPORATE PRODUCTS

Learning Objectives:

After completing this module the reader should be able to:

- Identify the corporate and Investment banking products offered by Islamic Financial Institutions and Islamic banks.
- Understand the corporate and Investment banking products such as Islamic Bank Guarantee, Islamic Letter of Credit, Islamic Corporate Finance, Islamic Working Capital Finance, and Islamic Syndicate Finance with respect to their structures and mechanism.
- Practically calculate the financials such as Profit, Return, Share of the parties, etc, for each of the Islamic Corporate and Investment banking Products.







INTRODUCTION

Finance is the lifeblood of any business. It assists in the formation, operations and development. It allows a company to take advantage of opportunities to grow and expand. A company cannot survive without finance. The strategic use of financial services such as loans, investments, financial instruments and financial products is the key to the success of every company and business. Today financial institutions, such as intermediaries, play a key role in providing the financial services to corporate companies and businesses to match their expectations through various products and instruments.

There have been significant developments in the product line of Islamic financial institutions in terms of Islamic corporate products. Various innovative products have evolved and been developed to meet the requirement of modern local, international and multinational businesses. In this module we will discuss a few important corporate products that are commonly available in the Islamic financial market. The products are as listed below:

1. *Islamic Bank Guarantee*
2. *Islamic Letter of Credit*
3. *Islamic Corporate Finance*
4. *Working Capital Finance*
5. *Syndicate Finance*
6. *Islamic Current Account*

ISLAMIC BANK GUARANTEE

In Shariah, the debtor has the prime responsibility for the payment of the debt to which the person is obliged. However, an individual or an institution (the Islamic bank) is also allowed to provide a guarantee of the payment if the debtor fails to pay the debt to the creditor. The guarantee provided by the individual or an institution shall serve as an additional security, wherein the guarantor undertakes to pay an agreed sum if the debtor fails or defaults in fulfilling any assigned obligation under the terms and conditions of the relevant agreement.

A bank guarantee is a written undertaking issued by the bank to pay the beneficiary or the creditor if the customer of the bank, who is the debtor or applicant, defaults on payment or any obligation to the beneficiary or creditor. The bank guarantee can be conditional or unconditional based on the mutual agreement between the parties. However, once the bank issues a guarantee, it means it has assumed the responsibility for the payment to the beneficiary upon default by its customer who is primarily responsible to the beneficiary of the guarantee.

An Islamic bank guarantee is designed using the Kafala or Wakala structures of Islamic finance. In its literal usage, Kafala means responsibility, or suretyship. In a bank guarantee based on the Kafala structure, the Islamic bank acts as a guarantor for its client. The guarantee from the Islamic bank to the client is conditional in case the client fails to pay the agreed financial obligation to its creditor on agreed date or perform any of the agreed upon duties under the relevant contract, then the Islamic bank would step in and fulfill the financial obligation of its client towards the creditor / beneficiary.

On the other hand, the term Wakala literally means preservation. Legally, Wakala can be defined as the delegation of one person (the principal) for another (the agent) to take his/her place in a known and permissible dealing. In this regard, the agent (wakil) deals in others' properties and preserves them. In a bank guarantee based on

If the consignment arrives at the destination before the shipping documents are received, which is common in case of local L/C, the Islamic bank must inspect the goods and take the physical possession thereof before selling them to the customer under Murabaha. The Murabaha Sales price (deferred amount) shall be paid on a deferred payment date (s) to the Islamic bank by the customer.



the Wakala structure, the Islamic bank acts as the agent (Wakil) of the customer. It is to be noted that under this type of bank guarantee, the Islamic bank should have 100% margin against the guarantee when it holds the responsibility of Agent (Wakil).

Parties involved in letters of guarantee:

There are three parties primarily involved in a guarantee contract. They are as follows:

- **Guarantor:** The party that assumes responsibility for the default of another is known as a guarantor. In common business practices, banks play the role of a guarantor in bank guarantee.
- **Applicant/Debtor:** The party primarily responsible for the fulfillment of the obligation or discharge of the debt is the applicant or debtor.
- **Beneficiary/Creditor:** The party who will be reimbursed by the guarantor in the event that the applicant or the debtor defaults on the loan or fails to fulfill the terms of the underlying contract signed between the Applicant/Debtor and the Beneficiary/Creditor is known as a beneficiary or creditor.

Types of Islamic Guarantees

There are several types of Bank guarantees. Some of the common types of guarantees are listed below:

Financial Guarantee:

A financial guarantee is a written undertaking issued by the Islamic bank on behalf of its customer, guaranteeing that if the customer (applicant) fails to comply with their obligations to an underlying Shariah-compliant transaction, then the Islamic bank will financially re-compensate the beneficiary or the creditor in accordance with the terms of the guarantee. The guarantee issued by the Islamic bank can be either conditional or unconditional based on the agreement between the parties. In case of claiming the financial re-compensation, the beneficiary has to present a written demand or any other document as the evidence that the bank's customer (debtor/ applicant) has failed to fulfill its obligations under the underlying transaction. It is to be noted that the Islamic bank cannot issue any financial guarantee for a conventional loan.

Tender Guarantee (Bid bond):

A guarantee issued by the Islamic bank guaranteeing against default by its customer in taking up a specific tender which is to be awarded to the person. These types of guarantees are issued by the Islamic bank to customers (applicants) who are professional contractors. For the avoidance of doubt, such guarantees cannot be issued by an Islamic bank if the tender is going to be awarded for any non-Shariah compliant project or activity.

Performance Guarantee (Performance Bond):

As the name indicates, a performance guarantee is issued by the Islamic bank guaranteeing against default by its customer in performing certain responsibilities in a project as per the terms and conditions of the contract, e.g., to complete properly or deliver the goods on time and in good condition. These types of guarantees are also issued by the Islamic bank to the customers (applicants) who are professional contractors.

Advance Payment Guarantee:

In some cases the customer (contractor) requests the beneficiary (Project Owner) for an advance payment for the work or services to

be carried out. In such a case, the Project Owner asks for an advance payment guarantee, which can be issued by the Islamic bank. This type of guarantee can either be issued separately or in conjunction with a performance guarantee.

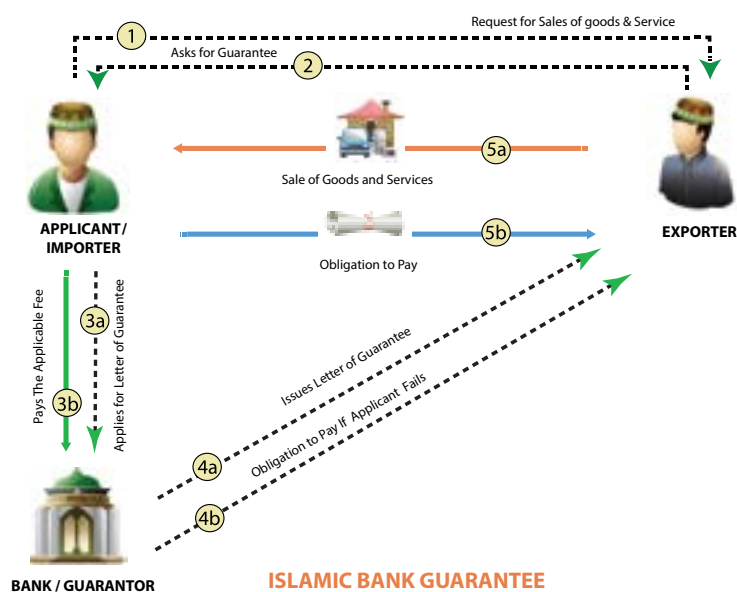
Retention Guarantee (Retention Bond):

In some cases, the beneficiary (Project Owner) withholds a part of payment of the customer to ensure the work or services have been completed satisfactorily. To allow early release of the payment by the beneficiary (Project Owner) to the customer / applicant, the Islamic bank issues a retention guarantee. A retention guarantee is issued instead of or in conjunction with a performance guarantee or advance payment guarantee.

Shipping Guarantee:

A shipping guarantee is a written undertaking issued by the Islamic bank to the ship owner or the agent or the master of a vessel to pay any claims resulting from the premature release of the goods and also to certify that the consignee is the rightful owner of the goods. It is generally issued in instances where the goods have arrived at the port prior to the arrival of the shipping documents.

STRUCTURE OF AN ISLAMIC BANK GUARANTEE:



Mechanism of an Islamic Bank Guarantee:

1. A Customer (Importer) purchases certain goods or services from a Seller (Exporter).
2. As per the sale and purchase contract the Customer (Importer) is principally obliged to make the payment to the Seller (Exporter).
3. On the Seller's (Exporter's) demand, the Customer (Importer) applies for the Letter of Guarantee to an Islamic Bank for the payment of the purchase price.
4. The Islamic bank issues the Letter of Guarantee for the Customer (Importer) in favour of the Seller (Exporter). As per the guarantee the Seller (Exporter) has the right to payment of sale price equally from the Customer (Importer) and Islamic bank (Guarantor).
5. In a case where Customer (Importer) defaults the Islamic bank (Guarantor) would make the payment to the Seller (Exporter) against the purchases.



It is important to note that, most of the jurists do not allow an Islamic bank to appoint its customer as its purchasing agent under Murabaha financing. However, to cater the needs of Sole Proprietorship, Exclusive Agency or Distribution or the specific discount in Customs Duty, the jurists allow the Wakala arrangement in some of the L/C Murabaha transactions.

It is to be noted that under Musharaka Letter of Credit the Islamic bank opens the LC in its own name and acts as a silent partner. As the customer acts as a managing partner the person may be entitled to a profit share higher than the bank's share of profit. Further, the Islamic bank is not permitted to take any guarantee of return of the principal or the profit from the customer.



Islamic Bank Guarantee and Fee:

There is a difference of opinion among Shariah scholars on whether an Islamic bank can charge a fee or commission on providing the letter of guarantee. Generally, it is not allowed to charge fees or commissions or remuneration on bank guarantees under the Kafala structure. However, jurists consider that the bank can take a fee, since the bank puts its efforts into matters like financial analysis of the applicant, credit assessment and getting required approval from the management to issue the required guarantee. Furthermore, if the guarantee is based on Wakala structure the scholars are of the opinion that the Islamic bank can charge any agreed fee under the Wakala arrangement.

ISLAMIC LETTER OF CREDIT

A letter of credit (LC) or documentary credit is a secure means of ensuring prompt payment for the export of goods in international market. The Islamic finance structures such as Musharaka, Murabaha, Wakala, etc, are applied in a letter of credit. The expectations of the exporter are met providing the confidence and mitigating the risks of non-payment.

TYPES OF ISLAMIC LETTERS OF CREDIT

There are various types of letters of credit that have been designed so far in the Islamic banking industry. A few important ones are mentioned below:

Murabaha Letter of Credit:

In this type of letter of credit, the Islamic bank will import the goods from the exporter, through establishing an LC on its own behalf, but as per the promise of the customer to purchase the imported goods from the bank under Murabaha sale contract after the bank owns the goods and gets the possession thereof. Once the Islamic bank receives the imported goods or the shipping documents including original commercial invoices and Bill of Lading in its name, which shall be considered of having the constructive possession of the imported goods, it will sell the goods to the customer on cost plus profit basis executing a Murabaha Sale agreement. In this case, the Islamic bank pays the beneficiary bank on the due date 100% of the cost of imported goods using its own funds and delivers the documents duly endorsed to the customer. If the consignment arrives at the destination before the shipping documents are received, which is common in case of local L/C, the Islamic bank must inspect the goods and take the physical possession thereof before selling them to the customer under Murabaha. The Murabaha Sales price (deferred amount) shall be paid on a deferred payment date (s) to the Islamic bank by the customer.

Wakala-Murabaha Letter of Credit:

Under Wakala-Murabaha letter of credit, the Islamic bank appoints the customer as its undisclosed agent to purchase the goods to be imported on the bank's behalf from the exporter. After having the actual or constructive possession of the goods (through its agent), the Islamic bank sells the imported goods to the customer under a Murabaha Sale agreement. All the Wakala- and Murabaha conditions will be applied to execute this type of LC. It is important to note that, most of the jurists do not allow an Islamic bank to appoint its customer as its purchasing agent under Murabaha financing. However, to cater the needs of Sole Proprietorship, Exclusive Agency or Distribution or the specific discount in Customs Duty, the jurists allow the Wakala arrangement in some of the L/C Murabaha transactions.

Musharaka Letter of Credit:

The Musharaka LC is designed using the Musharaka (Partnership) structure. The Musharaka Capital of the LC is originated from a Musharaka arrangement between the Islamic bank and the customer for a Shariah compliant transaction.

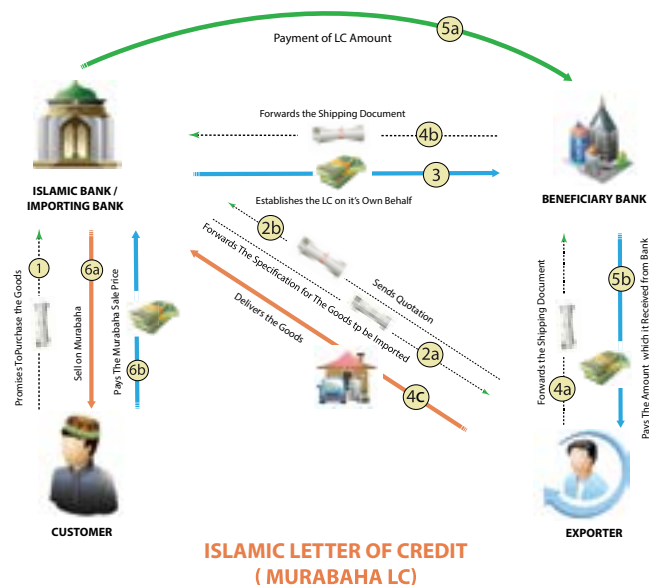
In this case, an importer applies for a Musharaka arrangement with the Islamic bank and informs the Islamic bank about its LC requirement. The importer deposits a percentage (share) of the cost of the goods to be imported as the partial Musharaka capital. The Islamic bank establishes the LC and pays the cost of the goods using both its own funds and the funds deposited by the importer to the beneficiary bank (which acts on behalf of the exporter). The Islamic bank releases the shipping documents forwarded by the beneficiary bank, to the importer. The importer, using the documents, takes possession of the imported goods and sells or disposes of the goods in a manner agreed under the Musharaka agreement. The importer and the Islamic bank share the realisation (cost plus profit) from the sale of imported goods in the mutually agreed ratio.

It is to be noted that the Islamic bank opens the LC in its own name and acts as a silent partner. As the customer acts as a managing partner the person may be entitled to a profit share higher than the bank's share of profit. Further, the Islamic bank is not permitted to take any guarantee of return of the principal or the profit from the customer.

Cash based Letter of Credit:

Under this type of letter of credit the customer will import the goods under LC against placing 100% cash margin with the Islamic bank equal to the full amount of the price of goods to be imported. The Islamic bank as the customer's agent will pay the beneficiary bank from the customer's deposit or by debiting his account. The beneficiary bank is required to present the compiled documents to receive the payment.

STRUCTURE OF AN ISLAMIC LETTER OF CREDIT (MURABAHA LC)



Mechanism of Islamic Letter of Credit (Murabaha LC):

1. The Customer promises to buy the specific goods on Murabaha





- from the Islamic Bank, if the Islamic Bank purchases the goods (to be imported) from the Supplier and takes the possession thereof.
- The Islamic Bank may ask the customer to make the payment of Hamish Jiddiyyah (Earnest Money) which is converted into Down Payment at the time of Murabaha Sale execution.
 - The Islamic Bank establishes the LC on its own behalf to the name of the Exporter and sends it to Beneficiary Bank.
 - The Supplier forwards the Shipping Documents of imported goods to the Beneficiary Bank.
 - (a): The Beneficiary Bank forwards the Shipping Documents of the imported goods to the Islamic Bank.
(b): The Exporter ships the goods to Islamic Bank.
 - After receiving the Shipping Documents or in case of local LC after receiving the consignment the Islamic Bank sells the goods to its Customer under Murabaha Sale Contract.
 - On the due date, the Islamic Bank pays the cost price to the Beneficiary Bank.
 - The Beneficiary Bank pays the amount so received from the Islamic Bank to the Exporter.
 - The Customer makes the deferred payment to the Islamic Bank in future installments towards the purchases of imported goods through Murabaha Sale.

Calculations:

MURABAHA LETTER OF CREDIT (LC)			
Basic Assumptions	Alphabetical Equations and Formulas		
Particulars	Unit	Value	
Cost of the Goods	USD	200,000	C
Down Payment from customer	USD	0	D
Amount Financed (100%)	USD	200,000	F=C-D
Profit Margin (Fixed Rate) % p.a.)	%	5%	R
Term of Financing	Months	36	T
Total Profit Amount	USD	30,000	P=F*R*(T/12)
Total Murabaha Sale Price	USD	230,000	SP = F+P
1st of last installment amount	USD	6,420	
Monthly Installment	USD	6,388	I=SP/T
Cost portion of Installment	USD	5,555	IC=F/T
Profit portion of Installment	USD	833	IP=P/T

- Let us look at an example of Murabaha Letter of Credit (LC). Total cost of the Goods to be imported is USD 200,000.
- The customer makes zero downpayment (Hamish Jiddiyyah)- and requires 100% financing.
- The bank agrees to finance 100% cost of the Goods which is USD 200,000.
- The Bank purchases the Goods and sells the same to the customer after taking the possession thereof on Murabaha basis payable in 3 years i.e. 36 monthly installments.
- The total Murabaha Sale Price will be USD 230,000; this is made up of amount the bank incurred as a cost to acquire the goods which is USD 200,000 plus the bank's total Profit Margin which is USD 30,000.
- The profit amount of USD 30,000 is arrived at as shown below:

$$\text{Profit} = [\text{Cost Price (C)} * \text{Profit Rate (R)} * \text{Term of financing}]$$

$$\text{Profit} = [200,000 * 5\% * 36/12] = 30,000$$

- The monthly Installment (EMI) of USD6,388 is arrived at as shown below: after a slight adjustment to the first or last installment amount which shall be equal to USD 6,420:

$$\text{Monthly Installment} = [(\text{Amount Financed (F)} + \text{Profit Amount (P)})] / \text{Term of financing}$$

$$\text{Installment} = (200,000 + 30,000) / 36 = 6,388.$$

8. The customer would pay the total amount of USD 230,000 in 36 installments.

9. In case of an early payment, i.e., Prepayment by the customer as per the current market practice, the decision on the level of rebate is solely at the discretion of the bank and different approaches may be applied. It is worth noting that the customer is contractually obliged to pay the full Murabaha Sale Price even in case of Early Settlement.

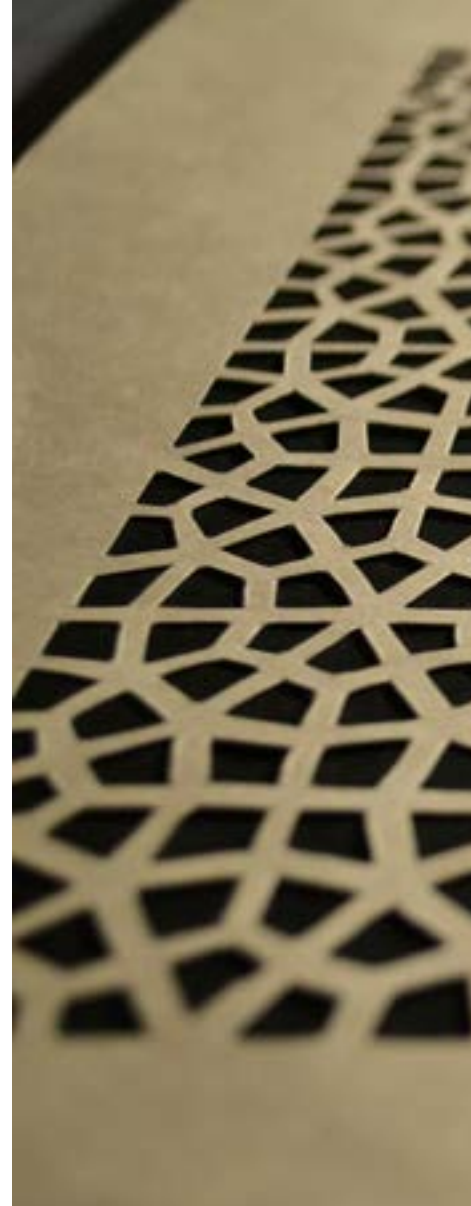
MUSHARAKA LETTER OF CREDIT			
Particulars	Unit	Value	
Customer's Importer's Investment	USD	200,000.0	a
Islamic Bank's Investment	USD	800,000.0	b
Total Investment	USD	1,000,000.0	$I = a+b$
Profit sharing Ratio	%	75:25	X:y
Total Value of Assets to be imported	USD	1,000,000.0	C
Expected Profit Margin (% p.a.)	%	10.0	r
Profit Earned by Musharaka	USD	100,000.0	$P = C * r$
Profit Share of Importer	USD	75,000.0	$X = P * x$
Profit share of the Islamic Bank	USD	25,000.0	$Y = P * y$

Note: All the losses are borne by the partners only in Capital contribution ratio.

- Let us take an example of Musharaka Letter of Credit where the total cost of the goods to be imported is USD 1 Million (USD 1,000,000/-).
- The importer contributes USD 200,000 to the Musharaka Capital whereas the Islamic bank contributes 80% of the cost which is USD 800,000/- and imports the goods from the Exporter paying the amount to the Beneficiary bank.
- The Exporter forwards the Shipping documents to Beneficiary bank, and the Beneficiary bank forwards the same to the Islamic bank. If the shipping documents are found perfect the Islamic Bank releases the LC amount (in case of sight LC) to the beneficiary bank. After getting the shipping documents endorsed by the Islamic bank the Customer seeks the delivery of goods to sell them in the market.
- It is agreed between the customer and the bank that the Net Profit realised from the sale of the imported goods shall be shared in the ratio 75:25 and the losses in proportion to capital contribution.
- Using our example, if the customer sells the Musharaka goods on the profit margin of 10%, then the profit would be USD 100,000. It can be calculated using the formula: (Total Cost of the goods*Profit Rate), which is $(1,000,000 * 10\%) = \text{USD } 100,000 /-$.
- The profit is shared between the importer and the Islamic bank in agreed ratio i.e., 75:25. Therefore, the profit share of importer is USD 25,000 i.e. $100,000 * 25\%$, whereas the profit share of the Islamic bank is USD 75,000 i.e. $100,000 * 75\%$.

ISLAMIC CORPORATE FINANCE

Trade essentially involves two different parties, namely importers and exporters in both domestic and foreign environments. The relationship between these two parties is based on trust, specifically on the terms of payment and delivery. In both international and domestic trade the importers require financing to purchase products from the exporter before selling them in the market.



In Murabaha financing, the Islamic bank purchases certain goods from the Supplier on its own behalf. After getting the constructive possession, the bank sells the purchased goods to the customer adding its profit margin. Later, the customer pays the Murabaha Sale price in various installments.

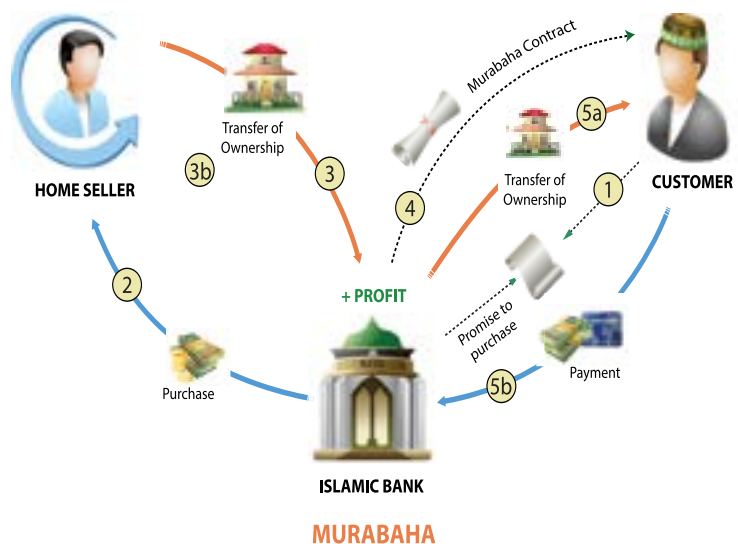
In the first Istisna contract, the Islamic bank acts as the supplier (San'e) and concludes the contract with the original Purchaser (Mustasne) to supply certain goods to be manufactured as per agreed upon specifications. In the second contract, the Islamic bank acts as the purchaser (Mustasne) and enters into a contract with the original contractor/manufacturer (San'e) to purchase certain goods to be manufactured by the contractor/manufacturer as per agreed upon specifications between the Islamic bank and the contractor/manufacturer.

On the other hand, the exporters require financing to manufacture or produce products for the export market before payment is received. To tackle these issues, the Islamic financial institutions have designed a few trade financing products such as Murabaha finance, Istisna finance and Salam finance. Let us, in this section, explore each of these products.

Murabaha financing (Markup Sale):

In corporate Goods Murabaha financing, the customer requests the Islamic bank to purchase goods from a specific supplier. The Islamic bank, after purchasing the goods and taking physical / constructive possession, sells the goods to the customer at the cost price plus a profit amount (markup) on deferred payment basis. The customer makes the payment in installments within a predetermined period. Generally, it is used when a customer needs to purchase an asset, equipment, machinery, inventories, raw materials, etc.

STRUCTURE OF CORPORATE GOODS FINANCING BASED ON MURABAHA:



Mechanism of Corporate financing based on Goods Murabaha:

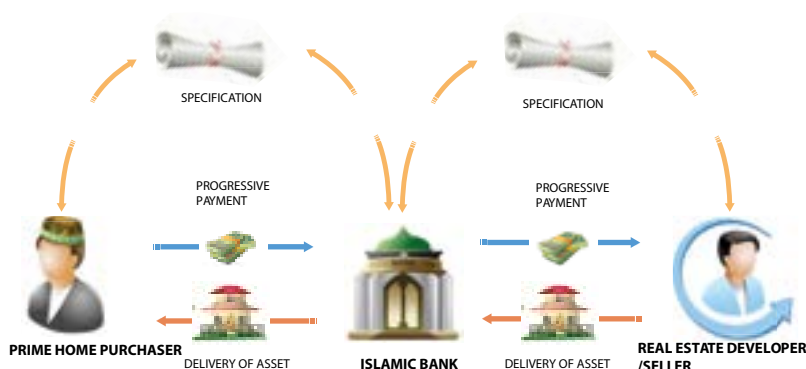
1. A Customer wants to acquire some goods, so visits the Islamic Bank and promises to purchase the goods from the Islamic Bank, if the Bank purchases the same from the Supplier.
2. The Islamic bank purchases the goods on spot payment basis and takes possession of the goods.
3. The Islamic bank then sells the goods to the customer on Murabaha for a deferred sale price disclosing its actual purchase cost and the total profit (in this case 10%) to be paid over a 3 years period. The Islamic bank delivers the goods to the Customer.
4. The Customer pays the Murabaha Sale Price in 36 monthly installments as agreed between the Customer and Islamic Bank.
5. It is to be noted that in this contract the ownership of the goods is transferred from the Islamic Bank to the Customer at the time of contract and the Customer would pay the due amount in future installments.

Manufacturing Financing (Istisna Sale):

Most often, when an Islamic bank gets involved in corporate financing through Istisna, it signs, due to certain reasons, another Istisna contract with the original contractor/manufacturer. This is known in modern custom as Parallel Istisna or "al-Istisna al-Muwazi". In the first

Istisna contract, the Islamic bank acts as contractor / manufacturer (San'e) and concludes the contract with the original customer who is the purchaser (Mustasne) to sell certain goods to be manufactured as per agreed upon specifications. In the second contract, the Islamic bank acts as the purchaser (Mustasne) and enters into a contract with the ultimate contractor/manufacturer (San'e) to purchase certain goods to be manufactured by the contractor/manufacturer as per agreed upon specifications between the Islamic bank and the contractor/manufacturer. The Islamic bank makes the payment to the contractor/manufacturer as per the agreement terms and conditions while the customer would make the payments to Islamic bank as per agreed terms in the first Istisna contract. In practice, the Islamic bank purchases the Istisna goods from the contractor/manufacturer and sells it to the customer after adding its own markup. By this process, a profit is realised through the difference in price between the two contracts and, in most cases, both the contracts are concluded at the same time. These two contracts, however, are separate from each other and run independently.

STRUCTURE OF CORPORATE FINANCE BASED ON PARALLEL ISTISNA:



PARALLEL ISTISNA

MECHANISM OF CORPORATE FINANCE BASED ON PARALLEL ISTISNA:

1. The customer expresses its desire to purchase certain goods to be manufactured or constructed. The customer sends the specifications to the Islamic bank and enters into an Istisna contract (Istisna 1) whereby both the parties agree on Istisna price as well as payment mechanism.
2. The Islamic bank enters into another Istisna contract (Parallel Istisna) with the contractor/manufacturer and agrees on the Istisna price certainly less than the one agreed with the customer for the goods to be manufactured as per the specification under Istisna-1.
3. Under parallel Istisna the Islamic bank pays the Istisna purchase price to the contractor/manufacturer progressively in installments as per the manufacturing process.
4. The customer pays the Istisna purchase price to Islamic bank in installments as per the agreed upon payment terms under Istisna 1 contract usually after the delivery of the goods.
5. The contractor/manufacturer delivers the goods to the Islamic bank as per the agreement of parallel Istisna.
6. The Islamic bank delivers the goods to the customer as per the agreement of Istisna-1.
7. The difference between the price paid to the Islamic bank by the customer and the price paid by the Islamic bank to the contractor/manufacturer would be the Profit of the Islamic bank.



Bai-Salam, also known as Bai-salaf or Bai-mafalisa is the purchase of a commodity for deferred delivery in exchange for immediate payment. It is a type of sale in which the price, known as the Salam Capital, is paid at the time of contracting while the delivery of the item to be sold, known as Al-Musalam Fihi (the subject matter of a Salam Contract), is deferred.

Supplier Financing (Salam Sale):

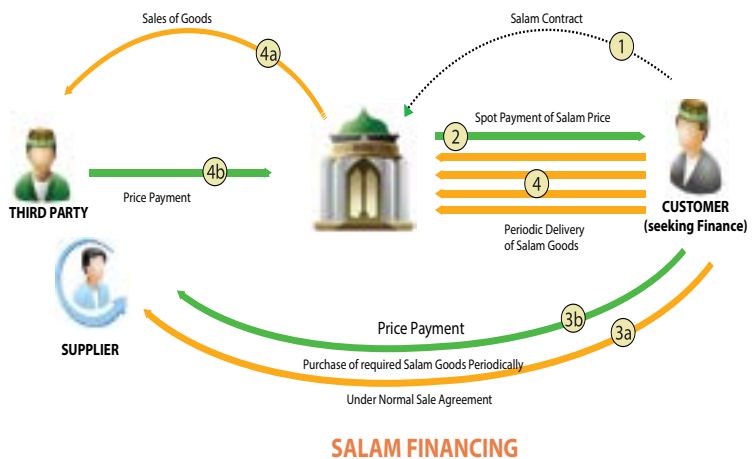
The seller and the buyer under Salam Sale are known as Al-Musalam Ilaihi and Al-Muslim or Rab al-Salam, respectively.

Most often when an Islamic bank gets involved in corporate financing through Salam, it seeks, due to certain reasons, a binding promise to purchase from a third party (the Ultimate Buyer). In the Salam contract, the Islamic bank acts as a purchaser (Al Muslim / Rab-al-Salam) and concludes the contract with the customer (Al Muslim Ilaihe) to purchase certain goods to be produced or procured as per agreed upon specifications. Simultaneously, the Islamic bank receives a binding promise to purchase from an ultimate buyer in order to sell the goods purchased from the customer. Being the purchaser in the Salam Contract the Islamic bank would make an advance payment of the full amount to the customer, which will fulfill the need of the customer of required financing. On the agreed upon delivery date the customer delivers the Salam goods to the Islamic bank which in turn, based on the promise to purchase, sells these goods to the ultimate buyer. In this process also, profit is realised through the difference in price between the two contracts.

In Salam financing difference between the price paid by the Islamic bank by the Customer and the price paid to the Islamic bank by the Third Party would be the Profit of the Islamic bank.



STRUCTURE OF CORPORATE FINANCE BASED ON SALAM:



Mechanism of Corporate finance based on Salam:

1. The Customer expresses its desire to get financing probably to meet the expenses to be incurred during manufacturing, procurement, production or processing of the goods.
2. After credit approval both the parties, the Islamic Bank and the Customer enter into a Salam Contract and agree on goods specification, delivery date and Salam Price.
3. The Islamic bank makes full payment in advance as a purchase price under the Salam Contract to the customer.
4. The Islamic Bank receives a Promise to Purchase from a third party (an ultimate buyer) in order to sell the goods to be delivered by the customer. The promise to purchase includes the specification of the goods, purchase date and the purchase price.
5. The customer delivers the goods to the Islamic bank as per the agreement either in installments or in a single consignment.
6. The Islamic bank sells the goods to the ultimate buyer exercising its promise to purchase.
7. The difference between the price paid to the Islamic bank by the ultimate buyer and the price paid by the Islamic bank to the customer would be the Profit of the Islamic bank.

Note: To make this transaction commercially viable the Islamic bank always purchases the goods under Salam Contract from its customer on discounted pricing.

Calculations:

Let us assume bank is financing 100% construction cost of a building.

CORPORATE FINANCE BASED ON ISTISNA			
Basic Assumptions	Alphabetical	Equations and	Formulas
Particulars	Unit	Value	
Actual Construction Cost of the Building (Finance Amount)	USD	1,000,000	C
Finance Period	Years	5	P
Profit Rate (p.a. on flat basis)	%	5	R
Profit Amount	USD	250,000	$PA = (C * R * P)$
Istisna Sale Price (Between Bank and the Customer)	USD	1,250,000	$SP = C + PA$
No. of Installments	Nos	60	n
Installment to be paid by the Customer (Except 1st installment which is USD 20,853/- which is USD 20,853/-	USD	20,833	SP/n

1. Let us look at an example of Istisna Corporate Finance transaction. The Total cost of the construction is USD 1 Million.
2. The Islamic bank makes 100% financing.
3. In our example, the Istisna Sale Price is USD 1,250,000 which is paid by the customer in 60 monthly installments of USD 20,833 each except the first one which is USD 20,853. The price for the second Istisna is USD 1,000,000. Therefore, the profit for Islamic bank shall be USD 250,000 (1,250,000-1,000,000).

CORPORATE FINANCE BASED ON SALAM			
Basic Assumptions	Alphabetical	Equations and	Formulas
Particulars	Unit	Value	
Total Quantity of Salam Goods (Wheat)	KG	100,000	Q
Market Unit Price (per kg)	USD	12.5	U
Total Market Price of the Salam Goods	USD	1,250,000	TM
Salam Contract Sale Price (Fin. Amnt.)	USD	1,000,000	SP
Salam Contract Unit Sale Price	USD	10	MU
Delivery Period (Finance Period)	Years	5	T
Delivery Frequency (Installment)	Months	6	D
Quantity to be delivered in each installment	KG	10,000	QD
Profit Rate (p.a. on flat basis)	%	5	$R = (TM - SP) / SP / T$
Total Profit Amount	USD	250,000	$PA = TM - SP$
Islamic Bank's Sale Price to the third party	USD	1,250,000	$SP = TM$
Half Yearly Quantity of Salam Goods Received by Islamic Bank	KG	10,000	QR
Islamic Bank (Installment Amount)	USD	125,000	$A = QR * U$

1. Let us look at an example of Salam Corporate Finance transaction. The Total market cost of the goods or commodities is USD 1.25 Million (1,250,000).
2. The Islamic Bank enters into Salam Contract to purchase 100,000 Kgs of specified wheat at the unit price of USD 10. The total Sale Price of the Salam Goods is USD (100,000*10)=1,000,000/-.
3. The Islamic bank makes 100% advance payment towards Salam Sale Price of the goods whereby the customer has to deliver the goods semi-annually within 5 years (10,000 Kgs in each 6 months).



In Murabaha Syndication, a financial institution or the Islamic bank (the lead arranger) pools the investment of different financiers into a huge pool. It acts as an agent to all the financiers and purchases certain assets on behalf of all of them. After taking possession of the purchased asset, it sells it to a customer on Murabaha basis.



4. On each delivery date the Islamic Bank sells the delivered quantity of Salam goods to the ultimate buyer in the market on market price which is USD 125,000 (10,000*12.5).
5. Thus, Islamic Bank makes a total profit of 250,000 or getting 5% return on its finance.

WORKING CAPITAL FINANCE

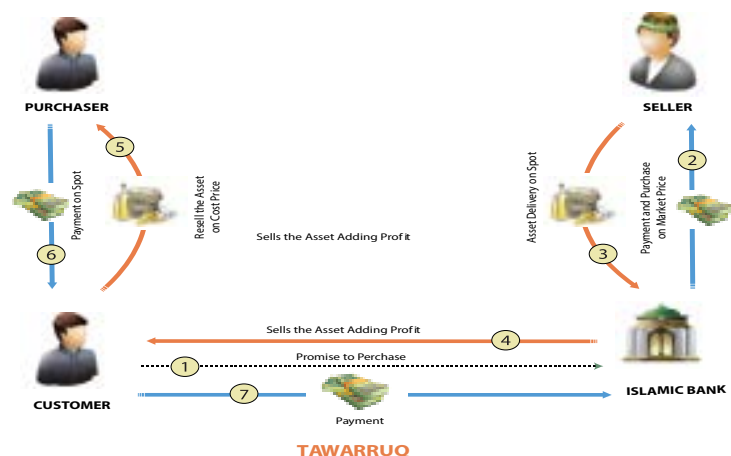
The day-to-day activities of any business or company such as purchasing, production, distribution, rent, payroll, etc., require financing. The form of financing required to meet the short term liabilities of the company or business is known as Working Capital finance. It is defined as the difference between current assets and current liabilities. It reflects a company's ability to meet current obligations. In other words, working capital financing is essential to any growing business as it helps the company and business compete in the market.

For financing working capital the Islamic way, three structures are mainly used, namely: Commodity Murabaha, Mudaraba and Wakala. Let us explore each of these in detail.

Commodity Murabaha:

Commodity Murabaha is a contract in which a party purchases certain commodities from the seller and sells it to a third party in the market to obtain cash. Under working capital financing, the Islamic bank buys a Shariah-compliant commodity from the market and sells it to the customer on deferred payment basis. However, since the customer is in need of cash, the person will sell that commodity to a third party in the market (usually through the bank that acts as the customer's messenger) and get the cash needed for working capital financing.

STRUCTURE OF WORKING CAPITAL FINANCE BASED ON COMMODITY MURABAHA:



Mechanism of Working Capital Finance based on Commodity Murabaha:

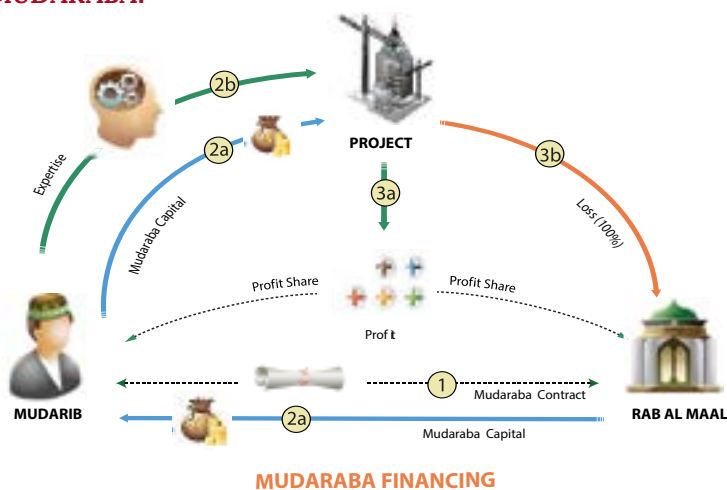
1. A Customer needs working capital (cash) so visits the Islamic bank and promises to purchase a commodity on Murabaha basis.
2. The Islamic bank purchases the commodity from the Supplier making the market price in cash.
3. The Supplier delivers the commodity to Islamic bank after receiving the price.
4. After taking delivery, the Islamic bank sells the commodity to the Customer on Murabaha usually on deferred payment basis adding its profit markup to the cost of purchase. It is to be noted that instead of giving a loan or debt in cash, the Islamic bank

- generated the asset for the Customer through a Murabaha.
- After taking delivery of the commodity from the Islamic bank, the Customer sells it to the ultimate Purchaser in the market at cost price which is paid on spot and delivers the commodity.
 - It is to be noted that the price paid by the Purchaser on spot fulfills the working capital requirement of the Customer.
 - The Customer pays the Murabaha Sale price to the Islamic bank in installments in the future.

Mudaraba (Venture Capital)

Mudaraba is a partnership in profit whereby one party provides capital (Rab-al-Maal) and the other party provides labour (Mudarib). In working capital financing, the Islamic bank provides the capital to an identified project, whereas the customer provides his skills and management. The income and profit from the project are shared as per the agreed profit sharing ratio. The losses, if any, shall be borne by only the Islamic bank.

STRUCTURE OF WORKING CAPITAL FINANCE BASED ON MUDARABA:



Mechanism of Working Capital Finance based on Mudaraba:

- The Customer approaches the Islamic bank to seek the finance (working capital) for a specific project.
- The Customer and the Islamic bank enter into a Mudaraba contract. As per the contract, the Islamic bank as Rab-al-Maal would contribute 100% capital to the project, whereas the Customer as Mudarib manages the project.
- The Profit will be shared as mutually agreed, say in 30:70 ratios. In case of loss, only the Islamic bank would bear 100% loss unless the Mudarib is found negligent, in which case the Mudaraba Capital shall be refunded by the Mudarib to the Rab-Al-Maal.
- The expenses of the Mudaraba management are borne by the Mudaraba itself.
- At the end of the Mudaraba period the Customer (Mudarib) shall dispose of the Mudaraba Assets in order to return the Mudarabah Capital and any relevant unpaid profit to the Islamic Bank (Rab-al-Maal)

Wakala based Finance:

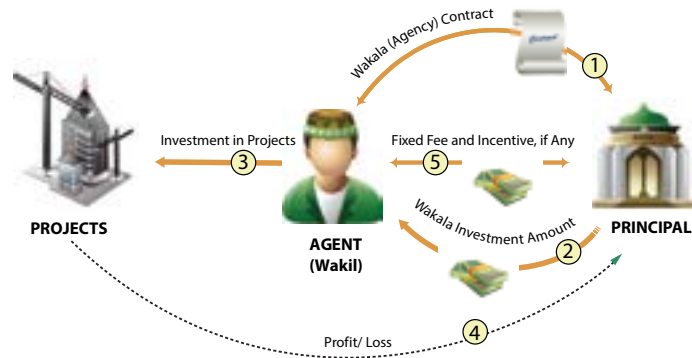
The term Wakala literally means preservation. Legally, Wakala can be defined as the delegation of one person (the Principal) for another (the agent) to take their place in a known and permissible dealing. In this regard, the agent (wakil) deals in others' properties and preserves them.



The Islamic current account is structured using Qard contract. A Qard contract is an interest-free loan given by the depositor to the Bank. In this case the bank can utilise the monies lent by the customer as creditor, but the bank is obliged to return the principal on demand or as per the contract.

In this type of arrangement, the Islamic bank appoints the customer as its agent (Wakil) to invest its money in a project. The customer is entitled to the agency fee or Wakala fee. The loss, if any, shall be borne by the bank only unless the Wakil is found negligent, in which case the Wakala Capital shall be refunded by the Wakil (Agent) to the Muwakkil (Principal).

STRUCTURE OF WORKING CAPITAL FINANCE BASED ON WAKALA:



WAKALA

Mechanism of Working Capital finance based on Wakala:

1. The Customer approaches the Islamic bank to seek finance (working capital) for a specific project.
2. They enter into a Wakala contract. As per the contract the Islamic bank as the Principal would contribute 100% capital to the project, whereas the Customer as agent (Wakil) invests the bank's money and manages the project.
3. The profit and loss belong only to the Islamic bank (Muwakkil), while the Customer is entitled to a predefined Wakala fee and/or an incentive, if there is any.
4. The expenses of the agency management are borne by the agency itself.

Calculations:

COMMODITY MURABAHA BASED WORKING CAPITAL FINANCE			
Basic Assumptions	Alphabetical Equations and Formulas		
Particulars	Unit	Value	
Cost of the Goods	USD	150,000	C
Down Payment from customer	USD	0	D
Amount Financed (100%)	USD	150,000	F=C-D
Profit Margin (Fixed Rate) % p.a.)	%	5%	R
Term of Financing	Months	24	T
Total Profit Amount	USD	15,000	P=F*R*(T/12)
Total Murabaha Sale Price	USD	165,000	SP = F+P
Monthly Installment	USD	6,875	I=SP/T
Cost portion of Installment	USD	6,250	IC=F/T
Profit portion of Installment	USD	625	IP=P/T
Cash in hand of the Customer	USD	150,000	C = F

1. Let us look at an example of Commodity Murabaha Working Capital Finance. Total cost of the Goods is USD 150,000.
2. The customer makes zero down-payment and requires 100% financing.
3. The bank agrees to finance 100% cost of the goods which is USD 150,000.
4. The bank purchases the goods and sells it to the customer on Murabaha (deferred sale) basis repayable in 2 years, i.e., 24 months.
5. The total Murabaha Sale Price will be USD 165,000; this is made up of the amount financed by the bank which is USD 150,000



plus Bank's total Profit Margin which is USD 15,000.

6. The profit amount of USD 15,000 is arrived at as shown below:

Profit= [Amount Financed (F) * Profit Rate(R) * Term of financing]

$$\text{Profit} = [150,000 * 5\% * 24/12] = 15,000$$

7. The monthly Installment of USD 6,875 is arrived at as shown below:

Monthly Installment = [(Amount Financed (F) + Profit Amount (P))/ Term of financing]

$$\text{Installment} = (150,000 + 15,000) / 24 = 6,875.$$

8. The customer would pay the total amount of USD 165,000 (i.e. 6,875 * 24) in 24 installments.
9. However, the customer immediately sells the commodity to a third party on spot at market price, which is USD 150,000. The cash payment made by the third party fulfills the working capital requirement of the customer.
10. In case of an early payment, i.e., Prepayment by the customer, as per the current market practice, the decision on the level of rebate is solely at the discretion of the bank and different approaches may be applied. It is worth noting that the customer is contractually obliged to pay the full Cost and profit amount.
11. Using the above example, if the customer chooses to close the financing at the end of 18th month, the customer will have an outstanding cost balance of USD 37,500 and outstanding profit balance of USD 3,750. The bank legally has the right to collect the full profit amount, i.e., USD 3,750. However, as per the current market practices, a rebate at the bank's discretion is offered on the outstanding profit portion. This means that the customer will end up paying much lesser than USD 3,750 depending on the rebate % offered. If 50% rebate is offered, the customer will end up paying USD 1,875 of outstanding profit along with outstanding costs of USD 37,500.

MUDARABA BASED WORKING CAPITAL			
Particulars	Unit	Value	
Customer's Capital Requirement	USD	100,000.0	C
Islamic Bank Finances (100%)	USD	100,000.0	C
Profit Sharing Ratio	%	70:30	x:y
Mudaraba Business Period	YEARS	1.0	N
Rate of Return from business	%	10%	R
Profit Generated from the business	USD	10,000	P=C*R
Islamic Bank's Share of Profit	USD	7,000	BP=P*x
Customer's Share of Profit	USD	3,000	CP=P*y
Total Capital and profit due to bank	USD	107,000	C+BP

Note: The loss, if any, shall be borne only by the capital provider.

- Let us take an example of Mudaraba based Working Capital where the Total Working Capital requirement of the customer is USD 100,000/-.
- The Islamic bank agrees to finance 100% of the capital requirement which is USD 100,000/-.
- As per Mudaraba, it is agreed that the customer would solely manage the business and profits generated from the business will be shared as per the agreed ratio of 70:30, i.e., 70% to Bank and 30% to Customer.
- The term of the business project is 1 year.
- As per the example, the business (project) generates a profit of 10%, this is equated to USD 10,000: Profit = Investment* Rate of Return = 100,000* 10%= USD 10,000.
- The profit is shared between the bank and customer in the

agreed ratio of 70:30 resulting in profit of USD 7,000 to the Bank $10,000 \times 70\%$ and USD 3,000 to the Customer $10,000 \times 30\%$.

- Upon completion of the project, the bank gets back its capital invested in the project and profit equating to USD 107,000 i.e. USD 100,000 (Capital) + USD 7,000 (Profit).

SYNDICATE FINANCE:

Islamic banks can form syndicates for huge financing requirements of corporate customers. Syndication is a financing facility granted by a group of financiers. It is a lead arranged by one or more financiers. All the terms and conditions of the financing arrangement are documented in a single financing agreement which is common to all financiers or investors. This type of financing arrangement provides a wide range of options in application and will be helpful in corporate financing, investment or acquisition financing, project financing, etc.

In this section we are discussing only two important forms of syndications. They are:

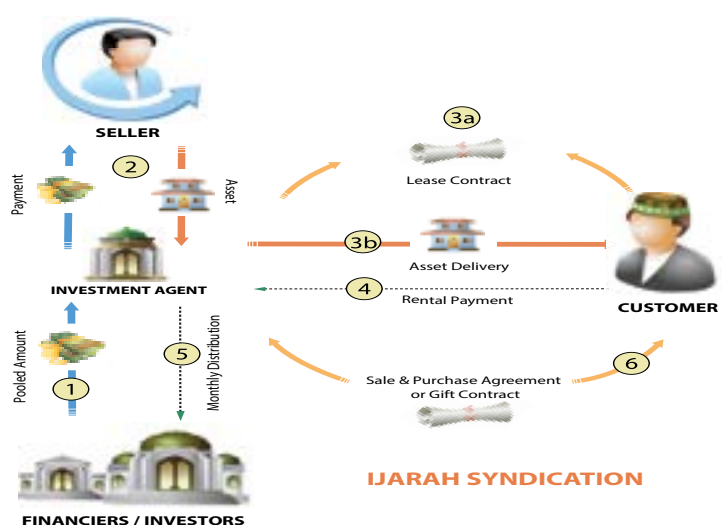
- Ijarah Syndication*
- Murabaha Syndication*

Ijarah Syndication:

Let us begin with Ijara syndication. The term Ijarah means leasing of property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration.

In Ijara syndication, a financial institution or the Islamic bank (the lead arranger) pools the investment of different financiers into a huge collection. It acts as an agent to all the financiers and purchases assets on their behalf. After taking possession, it leases out the asset to the customer (lessee) against the lease rent. The financial institution or the Islamic bank (lead arranger) collects the lease rent from the lessee and distributes it to the different financiers (investors) proportionate to their contribution in the pool.

STRUCTURE OF IJARAH SYNDICATION:



Mechanism of Ijarah Syndication:

- The Investment Agent or Islamic Bank pools the investments from the different investors (the investment agent may also be one of the investors)
- The Investment Agent, as an agent of the financiers, purchases the



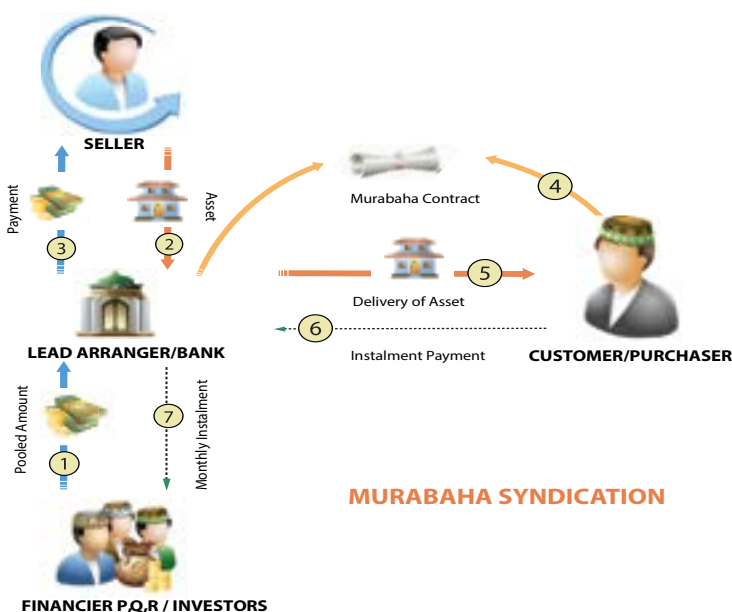
- asset from the Seller and makes the payment.
3. After receiving the payment, the Seller delivers the asset to the Investment Agent.
4. After getting the ownership of the asset and the possession thereof, the Investment Agent enters into a lease contract with the Customer and leases out the asset for a certain period against a rent to be paid on specified frequency. It is also agreed that the Investment Agent as lessor would bear all the major maintenance and insurance expenses, and the ownership of the asset remains with the Investment Agent (on behalf of the investors) until the completion of the lease contract.
5. The customer would pay the rent as per the agreement for the total lease period.
6. It is the responsibility of the Investment Agent to collect and distribute the rental income to the Investors in proportion to their investment.
7. After completion of lease, the Investment Agent would either sell the leased asset to the customer on nominal price or gift it to the customer against the fulfillment of all the obligations by the customer under the lease contract.

Murabaha Syndication:

The term Murabaha is derived from the word 'Ribh', which means profit or gain. Murabaha is the sale of a commodity as per the purchasing price with a defined and agreed profit markup. This markup may be a percentage of selling price or lump sum. This transaction is one of the trust based contracts, because the seller explicitly discloses the purchasing price and profit margin to the buyer.

In Murabaha Syndication, a financial institution or the Islamic bank (the lead arranger) pools the investment of different financiers into a huge pool. It acts as an agent to all the financiers and purchases certain assets on behalf of all of them. After taking possession of the purchased asset, it sells it to a customer on Murabaha basis. The lead arranger collects the deferred payments including the cost plus profit margin from the customer and distributes them to the different financiers (investors) proportionate to their contribution in the pool.

STRUCTURE OF MURABAHA SYNDICATION:



Mechanism of Murabaha Syndication:

1. The Investment Agent pools the investments from the investors.
2. The Investment Agent as an agent of financiers purchases the





- asset from the Supplier and makes the spot payment.
3. The Supplier delivers the asset to the Investment Agent.
4. After getting the ownership of the asset and the possessions thereof, the Investment Agent sells the asset to the Customer through a Murabaha sale usually on deferred payment basis for a sale price which includes the cost plus profit and to be made in a specified period of time.
5. The Investment Agent delivers the sold asset to the Customer.
6. The Customer would pay the Murabaha Sale price on certain frequency in different installments.
7. It is the responsibility of the Investment Agent to collect the deferred sale price from the customer and distribute the same to Investors in proportion to their investments. It is to be noted that in this contract the ownership of the asset is transferred to the Customer from Investment Agent at the time of Murabaha sale contract and the Customer would continue paying the due amount in future installments.

Calculations:

IJARAH SYNDICATION			
Basic Assumptions	Alphabetical Equations and Formulas		
Particulars	Unit	Value	
Total Cost of the Asset	USD	10,200,000.0	C
Lease Deposit	USD	200,000.0	D
Bank's Finance	USD	10,000,000.0	$F = C - D = (a + b + c)$
Investment of Bank-1	USD	2,500,000.0	a
Investment of Bank-2	USD	2,500,000.0	b
Investment of Bank-3	USD	5,000,000.0	c
Total Lease Period	Years	5	T
Bank's Profit Rate (fixed % p.a. on Finance)	%	5	Profit Rate = r
Bank's Annual Profit in Amount	USD	500,000	$P = (F * r * T)$

1. Syndication is a financing facility granted by a group of investors (Banks) to meet a huge finance requirement. In Ijarah Syndication huge capital is pooled together from the different investors (Banks) and invested in Ijarah business. The term Ijarah means leasing of property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration.
2. Let us take an example of Ijarah Syndication where the Total cost of the asset is USD 10.2 Million or USD 10,200,000/-.
3. The customer makes the down payment of USD 200,000 as lease deposit and the Islamic bank finances the balance, which is USD 10,000,000 through syndicate financing.
4. The Investment of USD 10 Million is pooled from the investors i-1, i-2 and i-3 which includes the investment of i-1 = 2,500,000/-, i-2=2,500,000 and i-3=5,000,000/- respectively.
5. It is agreed between the customer and the Islamic bank that the bank would lease the asset to the customer for a period of 5years against the fixed annual rental of 5% p.a. on the Bank's Finance i.e. USD 10,000,000. As per the agreement, the lease rent would be USD 500,000 p.a. It is calculated using the formula: Bank's Finance * Bank's Profit Rate = 10,000,000*5% = 500,000.
6. After the lease period, the customer would return the asset to the Islamic bank.

MURABAHA SYNDICATION			
Basic Assumptions		Alphabetical Equations and Formulas	
Particulars	Unit	Value	
Participating Bank1	USD	3,000,000.0	I1
Participating Bank 2	USD	3,000,000.0	I2
Participating Bank 3	USD	4,000,000.0	I3
Total Syndication	USD	10,000,000.0	I = I1+I2+I3
Profit Margin (Fixed Rate) % p.a.)	%	5%	R
Term of Financing	Months	60	T
Total Profit Amount	USD	2,500,000	$P = F * R * (T/12)$
Total Murabaha Sale Price	USD	12,500,000	$SP = F + P$
Monthly Installment	USD	208,333	$I = SP/T$
Cost portion of Installment	USD	166,666	$IC = F/T$
Profit portion of Installment	USD	41,666	$IP = P/T$

1. Syndication is a financing facility granted by a group of financiers (banks). In Murabaha syndication a financial institution or the Islamic bank (lead arranger) pools the investment of the different financiers into a huge pool. And the pool of money is invested on the basis of Murabaha. The profit or the return is distributed to the investors or the financiers.
2. Let us take an example of Murabaha Syndication where the Total Investment pooled from the three investors is USD 10 million made up of investment amounts of I1 = 3,000,000/-, I2=3,000,000 and i-3=4,000,000/- .
3. Total cost of the Goods is USD 10 million. The customer makes zero down-payment and requires 100% financing.
4. The bank agrees to finance 100% cost of the Goods which is USD 10 million.
5. Bank purchases the Goods and sells it to the customer on Murabaha (deferred sale) basis repayable in 5 years i.e. 60 months.
6. The total Murabaha Sale Price will be USD 12,500,000; this is made up of amount financed by bank which is USD 10 million plus Bank's total Profit Margin which is USD 2.5 million.
7. The profit amount of USD 2.5 million is arrived at as shown below:

$$\text{Profit} = [\text{Amount Financed (F)} * \text{Profit Rate(R)} * \text{Term of financing}]$$

$$\text{Profit} = [10,000,000 * 5\% * 60/12] = 2,500,000$$
8. The monthly Installment of USD 208,333 is arrived at as shown below:

$$\text{Monthly Installment} = [(\text{Amount Financed (F)} + \text{Profit Amount (P)}) / \text{Term of financing}]$$

$$\text{Installment} = (10,000,000 + 2,500,000) / 60 = 208,333.$$
9. The customer would pay the total amount of USD 12,500,000 (i.e. 208,333 *60) in 60 installments.
10. In case of an early payment i.e. Prepayment by the customer, as per the current market practice, the decision on the level of rebate is solely at the discretion of the bank and different approaches may be applied. It is worth noting that the customer is contractually obliged to pay the full Cost and profit amount.
11. Using the above example, if the customer chooses to close the financing at the end of 4th year, customer will have an outstanding cost balance of USD 2,000,032 and outstanding profit balance of USD 500,032. The bank legally has the right to collect the full profit amount i.e. USD 500,032, however as per the current market practices, a rebate at banks discretion is offered on the outstanding profit portion. This means that the customer will end up paying much lesser amount than 500,032 depending on the rebate % offered. If 50% rebate is offered, the customer will end up paying USD 250,016 of outstanding profit along with outstanding costs of USD 2,000,032.



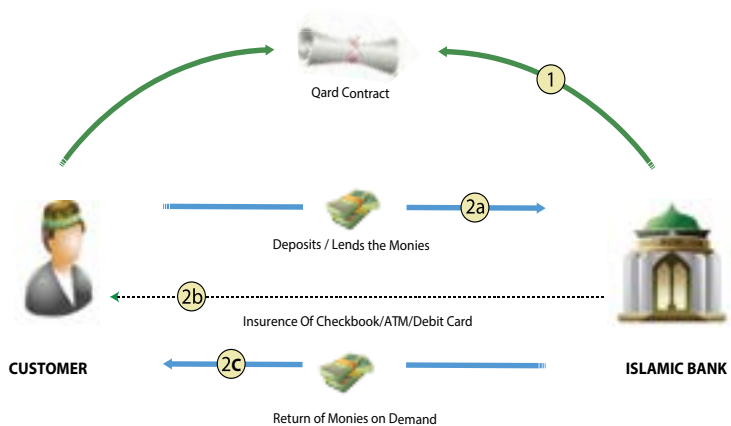
All the Finances extended through Murabaha generate the fixed income stream while under Ijarah finance there is a variable income as well.

CURRENT ACCOUNT

An Islamic current account provides the account holder with a guarantee on the principal amount deposited as it is based on Qard (interest free loan). The account holders are not entitled to receive any profits but do not bear any losses either. This type of account is designed specifically to meet the needs of customers who want to deposit or withdraw funds by cheques, through cash tellers at bank branches or through ATM machines.

The Islamic current account is structured using Qard contract. A Qard contract is an interest-free loan given by the depositor to the Bank. In this case also the bank can utilise the monies lent by the customer as creditor, but the bank is obliged to return the principal on demand or as per the contract.

STRUCTURE OF ISLAMIC CURRENT ACCOUNT:



ISLAMIC CURRENT ACCOUNT BASED ON QARD

Mechanism of Current Account based on Qard:

1. The Depositor and the Islamic bank enter into a Qard contract.
2. As per the Qard contract, the Customer is the creditor and the Islamic bank is the debtor.
3. The customer deposits the amount with the Islamic bank and the Islamic bank uses this money in any Shariah-compliant profitable project.
4. The Islamic bank is obliged to return the amount on demand of the depositor or on maturity of the contract.

CURRENT ACCOUNT BASED ON QARD			
Basic Assumptions	Alphabetical Equations and Formulas		
Particulars	Unit	Value	
Total Amount Deposited by Depositor	USD	1,000,000	D
Profit Rate allotted fixed % of)	%	Nil	
Amount available on demand or maturity	USD	1,000,000.0	D

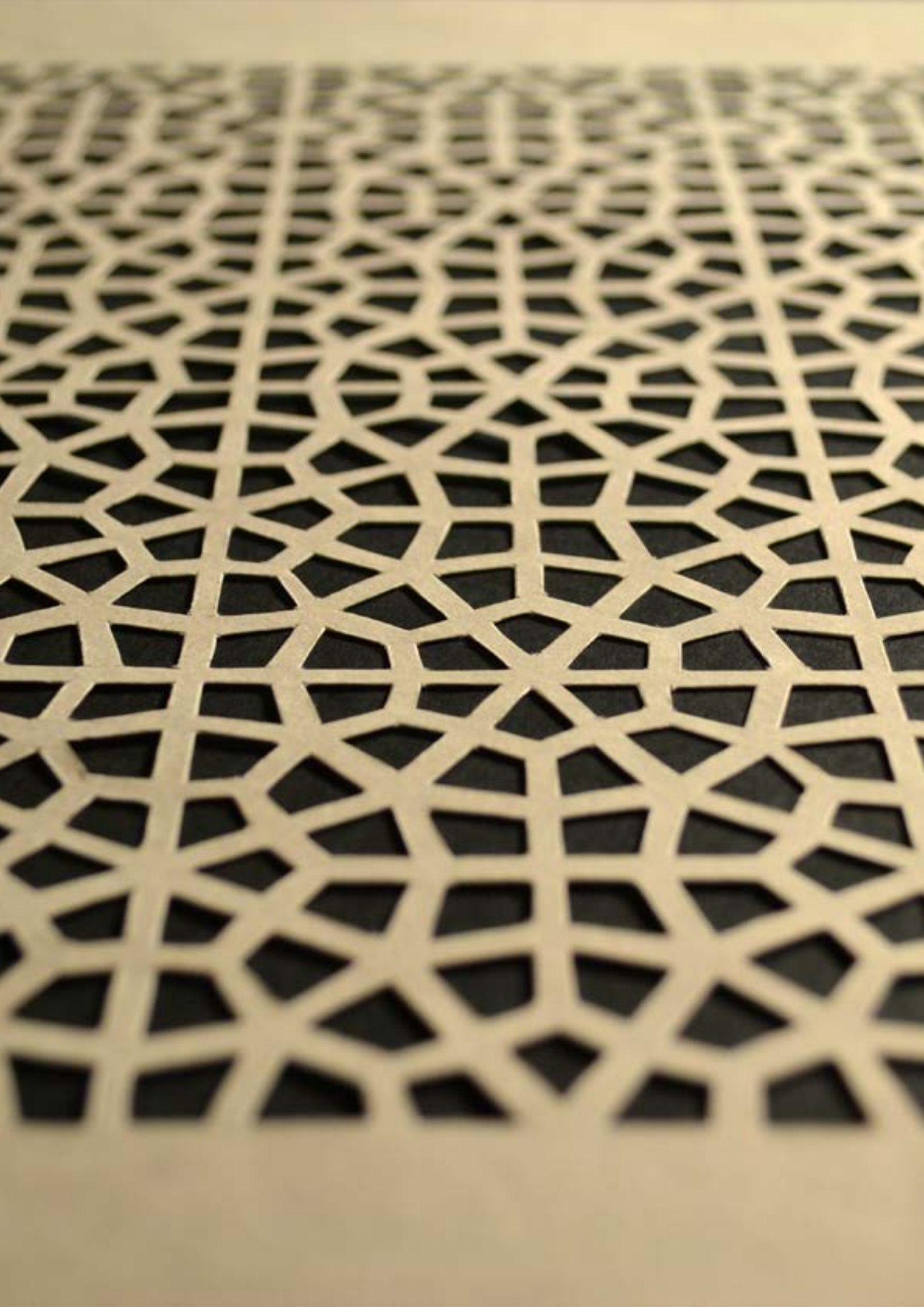
1. Let us take an example of Current Account where the Total deposits from the depositor is USD 1,000,000/-.
2. Customer deposits the amount with the Islamic bank on Qard basis. Therefore, there will be no profit or loss sharing between the depositor and Islamic Bank.
3. The amount available to the depositor on demand or on the maturity is USD 1,000,000.

SNAPSHOT OF WHAT WE HAVE LEARNED:

In this module we have learned about:

- **Bank Guarantee:** A bank guarantee is a written undertaking issued by the bank to pay the beneficiary or the creditor if the customer of the bank, who is the debtor or applicant, defaults in its debt or any obligation to the beneficiary or creditor.
- Application of Kafala and Wakala in an Islamic Bank Guarantee. We have seen that the structure of a guarantee is based on Kafala. If the customer, however, has paid the 100% margin against guarantee the guarantor bank (Islamic Bank) acts as a Wakil.
- **Letter of Credit:** An Islamic letter of credit (LC) can be defined as a written undertaking given by a financial institution (issuing bank which is representing the importer) to another financial institution (beneficiary bank which is representing the exporter) to the effect that the issuing bank will pay the beneficiary bank the stipulated amount in the LC provided all the terms and conditions of the LC are fully met.
- For extending any finance by the Islamic Bank through LC it can use Musharaka, Murabaha and Wakala structures.
- **Working Capital Finance:** The form of financing required to meet the short-term liabilities of the company or business is known as Working Capital Finance which can be extended to the corporate entity by an Islamic bank through Mudaraba, Murabaha and Wakala structures.
- **Syndicate Finance:** Syndication is a financing facility granted by a group of financiers. It is a lead arranged by one or more financiers.
- The Syndicate Finance is arranged, among other structures, commonly through Commodity Murabaha and Ijarah.
- All the Finances extended through Murabaha generate the fixed income streams while under Ijarah finance there is a variable income.
- Under the Mudaraba, Wakala and Musharaka based financing the income cannot be fixed. Rather, under Mudaraba and Musharaka the realized income is distributed on a pre agreed ratio while all the income generated under Wakala goes to the Muwakkil (Principal) while the Wakil (Agent) takes a fixed fee regardless if there is an income or not.







ISLAMIC

TREASURY PRODUCTS

Learning Objectives:

After completing this module the reader should be able to:

- Identify the Liquidity and Risk Management products offered by Islamic Financial Institutions.
- Recognise the various Islamic Finance and liquidity management structures used in designing the treasury products and understand the structures and mechanism of respective products.
- Practically calculate the financials such as Profit, Return and Shares of the parties, etc, for each of the treasury products.





INTRODUCTION

The rapid development in Islamic banking and finance industry has brought many new challenges before the industry. One of the major challenges facing the Islamic finance industry is that of Liquidity and Risk management. In terms of liquidity, the Islamic banks are also facing the problem of shortage and excess liquidity similar to its conventional counterpart. However, the treasury departments of Islamic financial institutions (IFIs) have been dealing with the issue of managing their liquidity through various newly invented products and money market instruments in the light of Shariah principles.

On the other hand, risk is inevitable in all financial transactions. It is an inherent part in most of the Islamic financial transactions to justify profit earning. The challenge of market risk, floating and fixed rate risk, currency exchange rate risk etc has made risk management an important aspect of the IFIs. A variety of instruments have been developed to meet the challenge of risk management under the umbrella of Islamic structured products or Islamic derivatives instruments. The main aim of these products is to hedge financial risk according to Shariah principles.

Keeping in view the importance of these two aspects i.e. liquidity management and risk management, this module is designed to introduce the basic and most important liquidity management and risk management instruments that are currently practiced in Islamic finance industry.

LIQUIDITY MANAGEMENT

The term liquidity is often used in multiple contexts. An asset's liquidity can be used to describe how quick, easy and costly it is to convert that asset into cash. In the banking context, the word liquidity can be used to describe the amount of cash or near cash assets, which a particular bank has; the more the liquid assets, the higher the bank's liquidity and vice versa.

The banks may face liquidity risk prevalently as it is easy for a bank to lose its liquidity because depositors can withdraw funds when they choose. In addition to this, banks face another risk, where their cash reserves can be strained by fulfilling obligations to companies. These companies have previously established loan commitments, called credit lines, which can be borrowed from the conventional bank when needed. Historically, bank runs have shown certain banks' predisposition to liquidity risk and its severity of impact on the whole economy. In fact, the liquidity risk is intricately tied to the nature of banking.

Similar to other banking businesses, Islamic banks also face liquidity risk, since they are also constrained by illiquid assets to meet their liquid liabilities and financial obligations. According to theory, Islamic banks are less exposed to liquidity risk and therefore to instability than their conventional counterparts. In the Islamic bank deposit arrangements, it is believed that the depositors who bear the risk on the liabilities side will naturally absorb any adverse outcomes on the assets side of the bank's balance sheet. In other words, any negative shock to an Islamic bank's asset returns is absorbed by both shareholders and saving/investments account depositors in proportion to their contribution to the financing of that asset. Liquidity management presents two components; the first component would be the actual management of liquidity, of placing funds in the money market to obtain profit from an Islamic perspective. The second component is to mitigate risk, so one can perform hedging in a Shariah compliant manner.

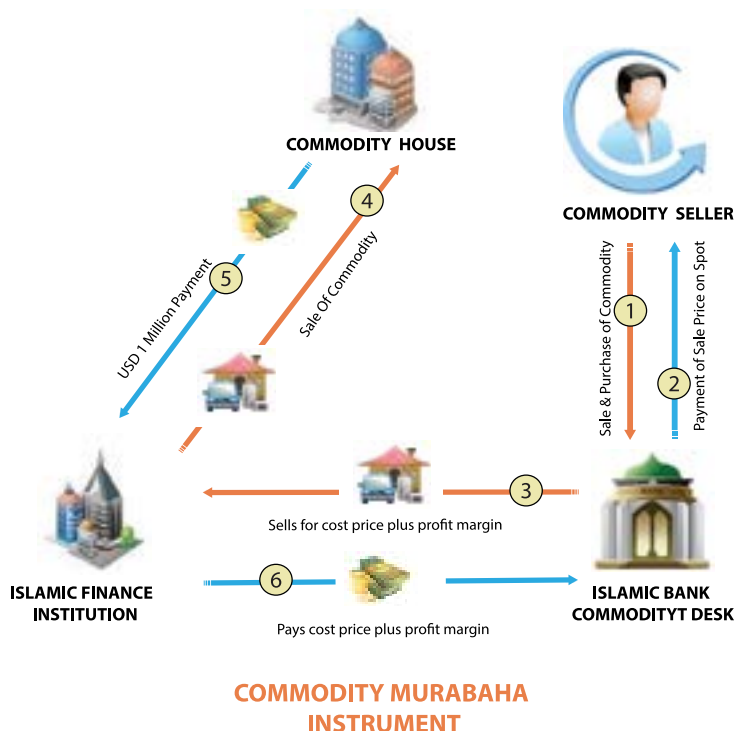
The liquidity management instruments play a key role in managing the liquidity risk. These instruments enable large sums of money to be transferred quickly at low cost with a high degree of safety and low price risk due to the short tenure, i.e., the maturity period which is 1 day to 1 year. They are also very much active in the secondary market and can be converted quickly into cash at a low cost.

There are various types of instruments that are developed in the Islamic finance industry globally. Though they are practiced with different names in different regions, the basic structure or contract on which the product is developed remains the same. Let us explore each of the important liquidity management instruments in detail.

COMMODITY MURABAHA INSTRUMENT

The earliest form of Islamic liquidity management instrument had been commodity-linked investments based on the Murabaha principle. Murabaha is a markup sale contract in which a commodity is purchased on the spot and sold on cost plus profit margin, generally on a deferred payment basis. Therefore, in Commodity-Murabaha instrument an Islamic financial institution (IFI) purchases a commodity and sells it to the commodity desks of the Islamic bank on deferred-payment terms, adding its profit margin. The commodity desk uses the commodity for its trading. Later, on the maturity date of Murabaha, the bank would pay the Murabaha selling price (i.e. cost plus profit margin) to IFI. This is applied in both the cases where the bank places the excessive liquidity or seeks liquidity in case of shortage.

STRUCTURE OF COMMODITY MURABAHA INSTRUMENT:



Mechanism of Commodity Murabaha Instrument:

1. The Islamic Bank Commodity Desk will buy certain commodities on the spot at market price from a Commodity Seller.
2. The Commodity Seller delivers the commodities to the Islamic Bank Commodity Desk and the Islamic Bank Commodity Desk pays the purchase price in cash to the Commodity Seller.
3. After getting the ownership and possession thereof the Islamic Bank

The liquidity management instruments play a key role in managing the liquidity risk. These instruments enable large sums of money to be transferred quickly at low cost with a high degree of safety and low price risk due to the short tenure, i.e., the maturity period which is 1 day to 1 year. They are also very much active in the secondary market and can be converted quickly into cash at a low cost.

In a Commodity Murabaha instrument an Islamic Bank Commodity Desk purchases a commodity and sells it to the IFI on deferred-payment terms, adding its profit margin. The IFI uses the commodity for its trading. Later, on the maturity date of Murabaha, the IFI would pay the Murabaha selling price (i.e. cost plus profit margin) to Islamic Bank Commodity Desk. This is applied in both the cases where the bank places the excess liquidity or seeks liquidity in case of shortage.



Commodity Desk sells the commodities to the Islamic Financial Institution (IFI) at a higher price adding its profit margin payable in 6 months (in this example). The pricing in such a sale is generally based on certain benchmarks. However, the Murabaha profit is fixed and known in figure at the time of signing the Murabaha Sale contract. The IFI will use the commodity acquired for its trading book.

4. On the maturity of 6 months (in this example), the IFI will pay the deferred price, i.e., cost plus profit to the Islamic Bank Commodity Desk.

Calculations:

LIQUIDITY MANAGEMENT BASED ON COMMODITY MURABAHA			
Basic Assumptions	Alphabetical Equations and Formulas		
Particulars	Unit	Value	
Liquidity Requirement of Islamic Bank	USD	1,000,000	C
Market Price of the Commodity paid by IFI	USD	1,000,000	F
IFI Profit Margin (Fixed Rate) % p.a.)	%	3%	R
Term of Financing	Months	6	T
Total Profit Amount	USD	15,000	$P = F * R * (T/12)$
Total Murabaha Sale Price	USD	1,015,000	$SP = F + P$
Monthly Installment	USD	169,166	$I = SP/T$
Cash in Bank's Treasury	USD	1,000,000	$C = F$

1. Let us look at an example of Commodity Murabaha Liquidity Management. The bank's treasury requirement is USD 1,000,000/- or 1 Million for six months.
2. The Islamic Bank Commodity Desk purchases a commodity on the spot paying market price which is USD 1,000,000.
3. The Islamic Bank Commodity Desk sells the commodity to the IFI on Murabaha (deferred sale) basis payable in 6 months.
4. The total Murabaha Sale Price will be USD 1,015,000; this is made up of cost price paid by the Islamic Bank Commodity Desk, which is USD 1,000,000 plus its total Profit Margin, which is USD 15,000.
5. The profit amount of USD 15,000 is arrived at as shown below:

$$\text{Profit} = [\text{Price paid by Islamic Bank Commodity Desk for Commodity (F)} * \text{Profit Rate (R)} * \text{Term of financing}]$$

$$\text{Profit} = [1,000,000 * 3\% * 6/12] = 15,000$$
6. The monthly Installment of USD 169,166 is arrived at as shown below:

$$\text{Monthly Installment} = [(\text{Price Paid by Islamic Bank Commodity Desk's for Commodity (F)} + \text{Profit Amount (P)}) / \text{Term of financing}]$$

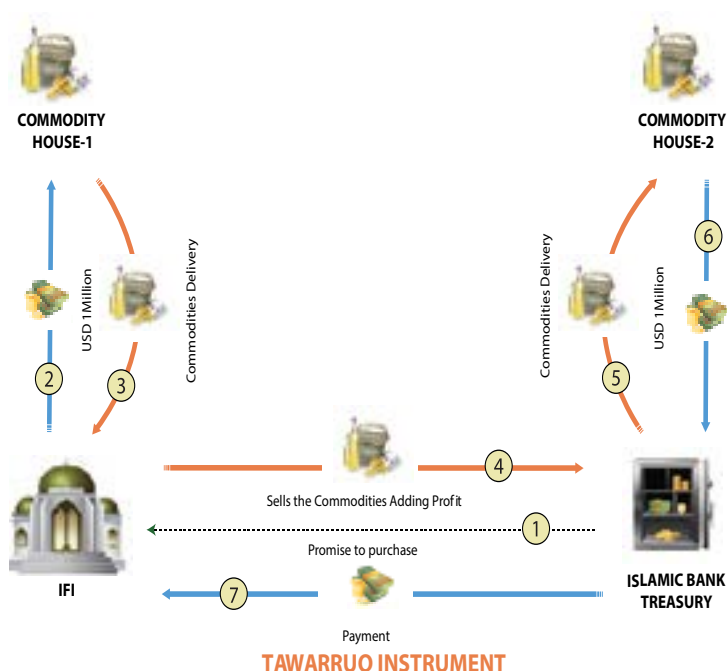
$$\text{Installment} = (1,000,000 + 15,000) / 6 = 166,166.$$
7. The IFI would pay the total amount of USD 1,015,000 (i.e. 169,166 * 6) in 6 installments.
8. The IFI further trades in Commodity with the Commodity House.

TAWARRUQ INSTRUMENT

Tawarruq is a transaction in which a commodity is purchased from a seller on mark-up price on deferred payment terms and sold to a third party on the spot at cost price. Tawarruq is similar to the commodity murabaha structure. In Tawarruq instrument, an IFI purchases a commodity and sells directly to the treasury department of the Islamic bank on deferred-payment terms, adding its profit margin. The treasury department immediately sells the commodity to a third party on the spot at cost price. Later, on the maturity date

of Murabaha, the bank would pay the selling price (i.e. cost plus profit margin) to IFI.

STRUCTURE OF TAWARRUQ INSTRUMENT:



Mechanism of Tawarruq Instrument:

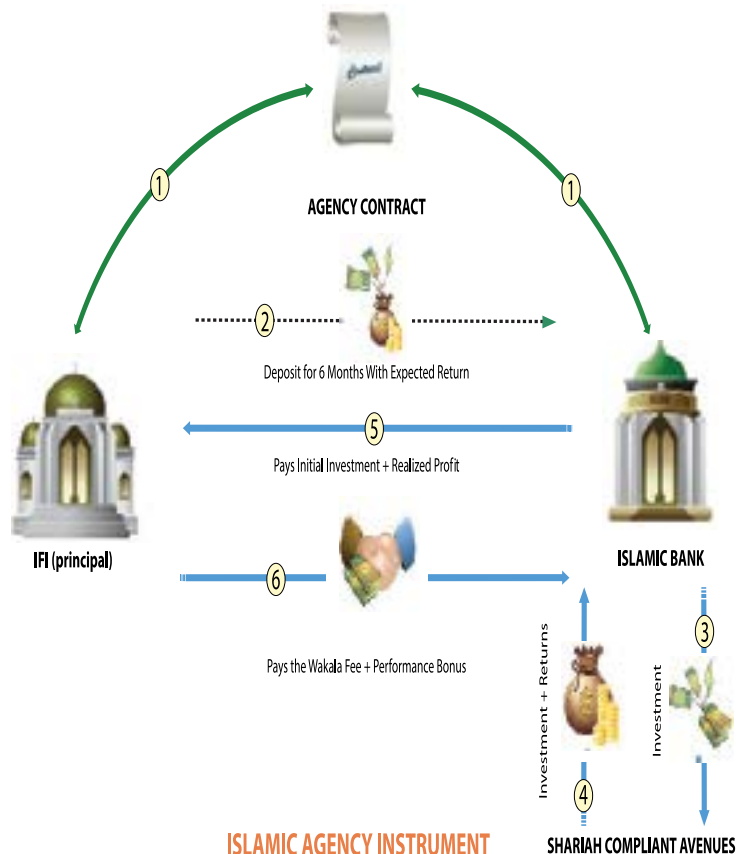
1. The Islamic Finance Institution (IFI) will buy certain commodities on a spot payment basis at cost price from the Commodity House-1.
2. The Commodity House delivers the commodities to the IFI and the IFI makes cash payment to the Commodity House-1.
3. After getting the ownership and the possession thereof, the IFI sells the commodities to the Islamic bank at a higher price adding its profit markup payable in 3 months (in this example).
4. The Islamic bank's treasury department will immediately sell the commodities to the Commodity House-2 on cost price.
5. The Commodity House-2 makes the cash payment to the Islamic bank and the Islamic bank delivers the commodities to the Commodity House-2.
6. On the maturity of 3 months (in this example), the Islamic bank will pay the deferred price, i.e. cost plus profit to IFI.

ISLAMIC AGENCY INSTRUMENT

Wakala is an agency contract under which the principal delegates the responsibility of managing the agency on his behalf to the agent (Wakil). In Agency instrument, an IFI appoints the Islamic bank as its agent and deposits its surplus funds for a certain period for the purpose of investment. The Islamic bank invests the surplus of IFI in profitable Shariah compliant avenues. On the maturity date, the Islamic bank would return the original investment plus the realised profit to IFI. The IFI advises the Islamic bank of its expected return (which is often linked to prevailing money-market rates) and accordingly the Islamic bank invests the money only in those avenues where it can get the return expected by IFI or higher. Under Agency arrangement the Agent (Islamic bank) gets the fixed Agency Fee. Most often, any return on investment higher than IFI's expectation is given to the Islamic bank as an incentive for its better performance.

Under Wakala arrangement IFI advises the Islamic bank of its expected return (which is often linked to prevailing money-market rates) and accordingly the Islamic bank invests the money only in those avenues where it can get the return expected by IFI or higher. Under Agency arrangement the Agent (Islamic bank) gets the fixed Agency Fee. Most often, any return on investment higher than IFI's expectation is given to the Islamic bank as an incentive for its better performance.

STRUCTURE OF ISLAMIC AGENCY INSTRUMENT



Using Sukuk instrument certificate holders jointly own the asset and share the profit and losses. It is permissible to set up a parallel Ijarah on tangible asset by employing the same description for the usufruct that was provided to the holders of the Sukuk. The two lease contracts must remain independent.



Mechanism of Islamic Agency Instrument:

1. The Islamic Finance Institution (IFI) appoints the Islamic bank as its investment agent (or Agent Bank). The Agent bank is entitled to a pre-defined Wakala Fee.
2. The IFI places or deposits its surplus funds with the Islamic bank say for a six month period against an Expected Return.
3. The Islamic bank will invest the funds according to Islamic principles, with a targeted return that is normally more than or equal to the 'Expected Return' of the IFI.
4. The Islamic bank will receive the initial investment plus total returns (may be more than the expected return of IFI from the investment).
5. On the maturity of 6 months, the Islamic bank will pay the initial investment plus realized profit to the IFI. It is important to note that the Investment Agent cannot guarantee the principal or profit amount and accordingly is not liable for any loss except in case of negligence or misconduct on its part.
6. On completion of the agency IFI would pay the Wakala fee fixed at the time of contract to the Islamic bank. In addition, if the total return realised from the investment is more than the Expected return of the IFI, then pursuant to the contract term IFI will grant any amount above the expected return to the Islamic bank as a performance bonus.

Sukuk Instrument

Investment of liquidity in purchasing Sukuk is another important method to manage liquidity by many financial institutions. The active secondary market provides an excellent tool for Islamic finance Institutions to help manage the liquidity. A financial institution with excess liquidity may choose to invest in Sukuk that will offer a return and can be traded if required.

RISK MANAGEMENT

If risk in an investment is the possibility of the occurrence of something unpleasant, then it is apparent to us that the reduction and prevention of risks by lawful mechanisms is not only permissible but also praiseworthy. That is because it serves to preserve wealth, which is one of the objectives of the Shariah. The outcome of all these risk management procedures is protection of one's wealth from loss. Careful investment and mitigation of different kinds of investment risks is the prime responsibility of any Islamic bank as it accepts the deposits, being a Mudarib or Wakil (who is considered to be Ameen) from its depositors. Apart from the general risks in the banking and finance industry, the Islamic bank is also exposed to certain inherent risks related to the ownership of the asset and product structure.

From an Islamic finance perspective, hedging is an attempt by a party to reduce the level of risk faced in a financial transaction. Islamic derivatives are meant to hedge the financial risk that is associated with an underlying asset.

Significant developments have occurred in the area of Islamic derivative products. Many forms of Islamic hedging instruments have been established and offered to sophisticated and institutional investors. Products such as capital protected funds, equity linked notes, Islamic forward FX, Islamic options, Islamic profit rate swap, and Islamic currency swaps are few among the many innovative products developed in recent years. In this module we are going to discuss a few commonly used derivative products that are listed below:

1. *Islamic Profit Rate Swap*
2. *Forward FX*
3. *Spot FX*
4. *Currency Exchange Swap*
5. *Islamic Options*

Islamic Profit Rate Swap

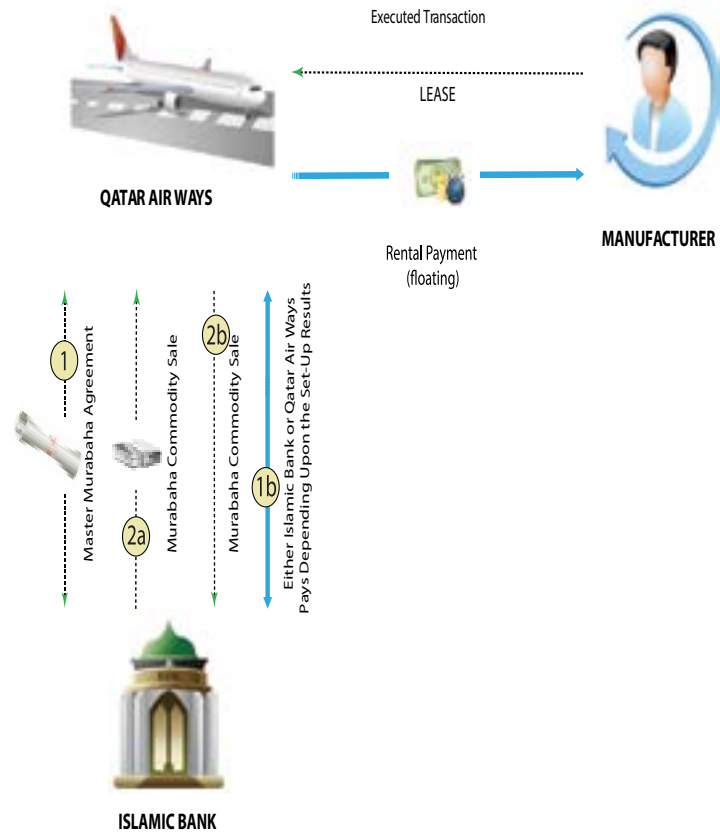
The assets and liabilities of an Islamic bank have both floating obligations and fixed obligations. Islamic profit rate swaps are used to hedge the floating obligations of the assets with the fixed obligations of the liability, and the floating obligations of the liabilities to the fixed obligations of the assets to avoid a potential mismatch of asset-liability.

An Islamic profit rate swap is an arrangement to exchange profit rates between a fixed-rate party and a floating rate party or vice versa. It is structured using Murabaha and Waad concepts. Under this structure each party issues an independent and unilateral undertaking (Waad) to enter into a Murabaha transaction on a specified date. The parties enter into Murabaha contracts to sell Shariah-compliant assets (often metals and commodities) to each other for immediate delivery and usually on immediate payment. A term Murabaha is used to generate fixed payments (comprising both a cost price and a fixed profit element) and a series of corresponding reverse Murabaha contracts are used to generate the floating leg payments (the cost price element under these reverse Murabaha contracts is fixed but the profit element is floating) in the Master Murabaha contract and fixed only on the day Murabaha transaction is executed. After executing the underlying transactions on the trade date the obligations of both the parties are set off and consequently the party in money gets paid for any difference.



The Ijarah Sukuk can be used to provide regular payments throughout the life of a financing arrangement to the investors. In addition, the use of a purchase undertaking is widely accepted in the context of Sukuk al-Ijarah through Ijarah-Muntahia-Bittamleek contract. These characteristics make Ijarah relatively straight forward to adapt for use in the underlying structure for a Sukuk issuance.

STRUCTURE OF ISLAMIC PROFIT RATE SWAP:



ISLAMIC PROFIT RATE SWAP

Mechanism of Islamic Profit Rate Swap:

1. A company has taken an asset on lease with Ijarah financing from the property owner for a lease period of five years. Its rental obligations must be paid every six months, based on the 6 months LIBOR, which is currently at 5%. If LIBOR increases to 6%, the company has to pay an additional 1% rent.
2. The company enters into an Islamic profit rate swap to move away from a floating rate obligation to one that is based on a fixed rate with the Islamic bank.
3. In every six-month period, the company purchases an asset or commodity from the Islamic bank on Murabaha at a fixed rate, for example 5%.
4. At the same time, the Islamic bank purchases an asset or a commodity from the company at floating rate certainly equal to the company's Ijarah financing obligation, i.e. Six Month LIBOR.
5. Now the only remaining obligation of the company is the payment of 5% fixed rate to the Islamic bank, which will be paid through a Murabaha transaction on the required date.
6. The company pays the floating rate to the Manufacturer from the cash flow it receives from the Islamic bank under Profit Rate Swap by entering into a Murabaha transaction based on the given Waad.

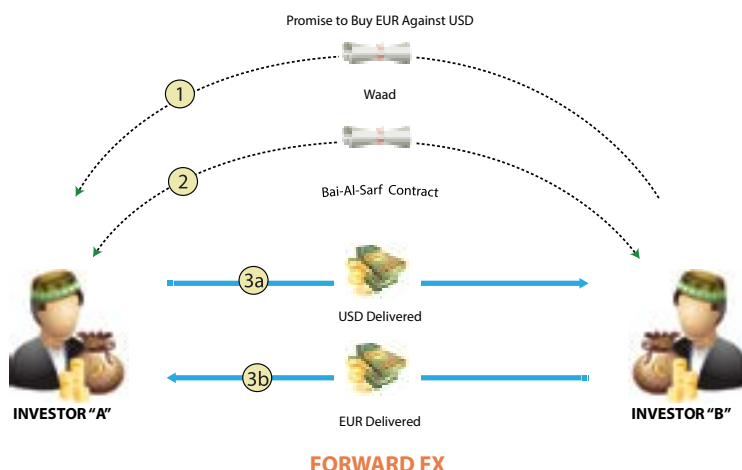
Forward FX

Forward Fx is structured using Waad or Promise. Forward Fx involves exchange of currencies (Bay al-Sarf) between two parties with a promise or undertaking (Waad) by one party to buy the required currency against another currency on a specified future date at a promised exchange rate. Generally, the Islamic bank enters into such transaction to hedge its foreign currency rate exposure or to meet the shortage of liquidity in any particular foreign currency.

From an Islamic finance perspective, hedging is an attempt by a party to reduce the level of risk faced in a financial transaction. Islamic derivatives are meant to hedge the financial risk that is associated with an underlying asset.



STRUCTURE OF WAAD BASED FX TRANSACTION:



Mechanism of Forward FX:

1. An Islamic bank wishes to hedge its EUR currency rate exposure against Dirham.
2. It seeks a unilateral undertaking from a bank (Promissor) to sell the required amount of EUR on a specified future date for Dirham at a promised exchange rate.
3. On the trade date, the Islamic Bank exercises its right under the given undertaking and obligates the (Promissor) to sell EUR for Dirham.
4. Both the parties enter into an Offer and Acceptance to exchange both Dirham and EUR currencies which are delivered to each other.

Calculations:

FORWARD FX BASED ON WAAD			
Basic Assumptions	Alphabetical Equations and Formulas		
Particulars	Unit	Value	
Islamic Bank	BD	100,000	BD
Promissor Bank	EUR	120,000	EUR
Exchange Rate	USD:BD	Rate 1:1.2	BD:EUR

1. An Islamic bank wishes to hedge its EUR currency rate exposure against Dirham.
2. It seeks a unilateral undertaking from a bank (Promissor) to sell the required amount of EUR on a specified future date for Dirham at a promised exchange rate, i.e. 1:1.20.
3. On the trade date the Islamic bank exercises its right under the given undertaking and obligates the (Promissor) to sell EUR 120,000 for Dirham 100,000.
4. Both the parties enter into an Offer and Acceptance to exchange both Dirham and EUR currencies which are delivered to each other.

Spot FX

In Spot FX, two different currencies are exchanged against each other. The basic rules for this type of structure are that the transaction should be executed on the spot and both currencies must be delivered to both parties simultaneously. Any deferment of one or both of the currencies will render the transaction deferred, thus not compliant to Shariah principles. However, as per the AAOIFI standard, a slight delay, no longer than three days, in the reconciliation of settlement is tolerated. But neither party can onward sell the purchased currency unless this purchased currency is credited in its account with clear fund.

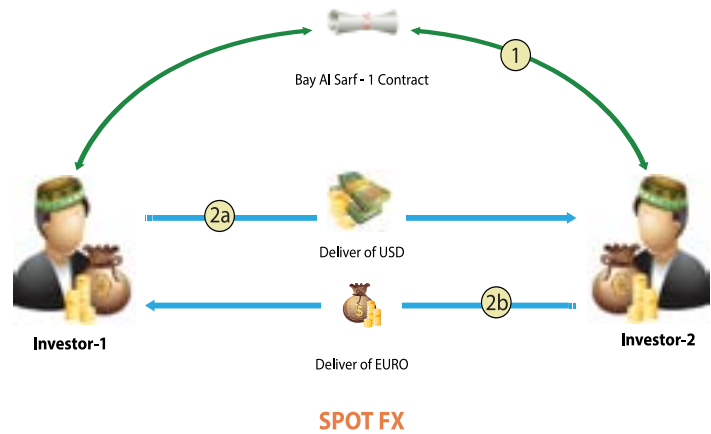


Forward FX is structured using Waad or Promise. Forward FX involves exchange of currencies (Bay al-Sarf) between two parties with a promise or undertaking (Waad) by one party to buy the required currency against another currency on a specified future date at a promised exchange rate. Generally, the Islamic bank enters into such transaction to hedge its foreign currency rate exposure or to meet the shortage of liquidity in any particular foreign currency.

In Spot FX, two different currencies are exchanged against each other. The basic rules for this type of structure are that the transaction should be executed on the spot and both currencies must be delivered to both parties simultaneously. Any deferment of one or both of the currencies will render the transaction deferred, thus not compliant to Shariah principles.



STRUCTURE OF SPOT FX:



Mechanism of Spot FX:

1. An Investor-1 exchanges USD against Euro with Investor-2 on the current exchange rate, which is 1:1.4.
2. The currencies are delivered by transferring Euro in Investor-1's account and USD in Investor-2's account.

Calculations:

SPOT FX			
Basic Assumptions		Alphabetical Equations and Formulas	
Particulars	Unit	Value	
Investor-1	USD	100,000	USD
Investor-2	EURO	140,000	EURO
Exchange Rate	USD:EURO	Rate 1:1.40	USD:EURO

1. Let us look at an example of Spot FX Transaction. There are two investors, Investor-1 and Investor-2.
2. The Investor-1 exchanges USD 100,000 against EUR 140,000 with Investor-2 on current exchange rate, which is 1:1.40.
3. Within a specified time period not more than 3 days USD 100,000 shall be transferred to the Investor-2 account. At the same time, EURO 140,000 shall be transferred to the Investor-1 account.

Currency Swap

Islamic currency swaps are one of the most popular applications of financial engineering. The concept behind a currency swap is to exploit one's comparative advantage in a particular market by raising capital at favourable rates and then agreeing with another party to exchange cash flows according to a pre-determined schedule for cash flows in another currency. A currency swap can help an institution reduce its exposure to a particular currency by allowing it to swap existing assets or liabilities for more desirable ones. Since a currency swap is an agreement to exchange cash flows according to a fixed schedule, a currency swap can also be viewed as a series of currency forward contracts for each period of the schedule.

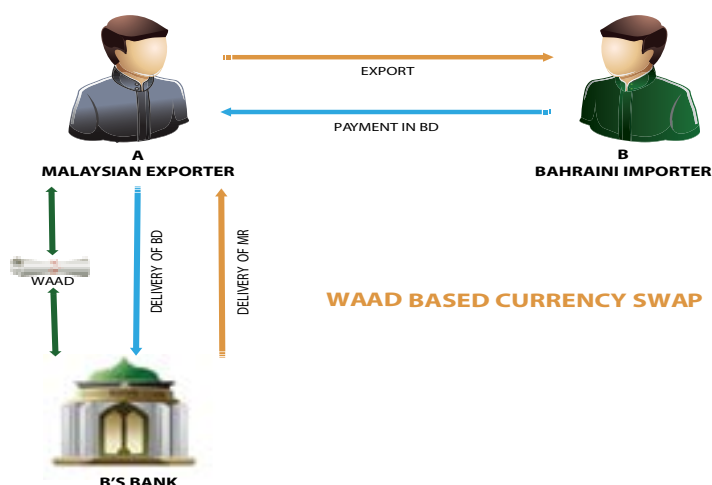
In Islamic finance industry the two Islamic contracts, namely, Waad and Murabaha-tawarruq are used to structure currency swap. These contracts have been used to assist Islamic finance customers in hedging their real exposure to currency risk. We will discuss here only the waad based currency swap.

Waad based Currency Swap:

This structure is based on unilateral promise between the parties involved in currency swap. To be compliant with Shariah principles, only one party can give the undertaking or promise to buy or sell the currency in future. Without this hedging technique, the parties may suffer a loss

that was due to the fluctuation of the exchange rate of Foreign currency involving Malaysian Ringgit and Bahrain Dinar, in the following example.

STRUCTURE OF WAAD BASED CURRENCY SWAP:



Mechanism of Waad based Currency Swap:

1. An Exporter from Malaysia exports the goods to the Importer in Bahrain for three months credit period.
2. To avoid the exchange rate risk, the Exporter undertakes a Waad to seek the Malaysian Ringgit (RM) for the Bahrain Dinar (BD) from an Islamic bank or the Importer's bank in three months time the current exchange rate which is 1.40:1.
3. After three months, when the Importer pays BD the Exporter exchanges the BD for RM with the Islamic bank under Currency Sale and Purchase contract as per the Waad on the due date at the promised exchange rate which is 1.40:1. Ultimately, the Exporter is free from the risk of exchange rate.

ISLAMIC OPTIONS

Islamic options are used to protect the downside of any investment in assets or commodities and provide an opportunity to benefit from the market upside. The option gives the holder the right to buy (a call option) or sell (a put option) certain assets in the future, but at a 'locked in' price fixed today.

This instrument is structured using the Islamic contract known as Bay al-Urboon. Urboon is referred as the earnest money that gives the right to buy or sell based on the partial payment (Urboon) on the price of goods. The seller retains the Urboon amount in case the buyer withdraws from purchase or sale contract. Hence, the downside risk in this instrument is limited to the amount paid for the option or Urboon. Profit is realised if the market price of the asset goes higher than the locked in price.

The following points shall be noted while exploring the Islamic Options:

- The Urboon amount will not be deemed as a price for the option rather it is partial payment of the total purchase or sale price of an underlying asset.
- Islamic option is not tradable in the secondary market.
- Urboon, which is a part payment of total price of an underlying asset, is not eligible for purchase or sale under Islamic commercial law as it only gives the right to the purchaser or seller to pay the total outstanding payment on the underlying asset. A partial payment is not in itself an asset that can be sold



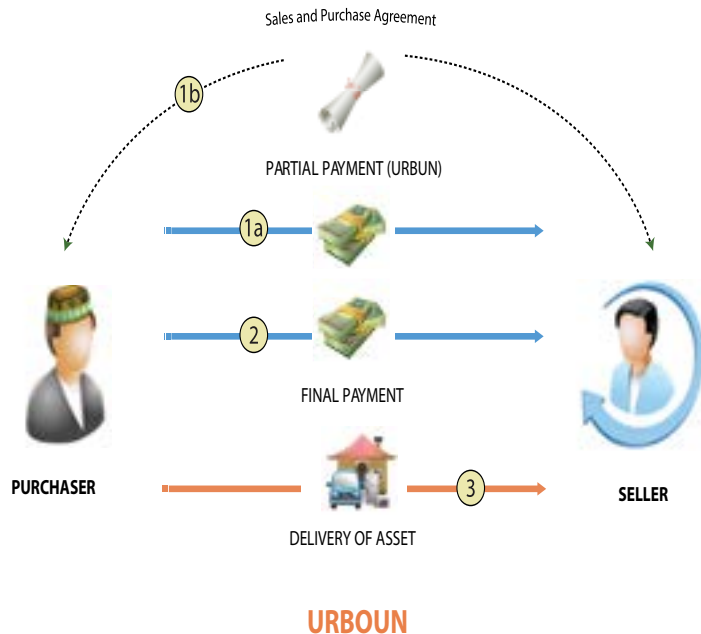
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or purchased.

- The Seller and the Purchase cannot enter into an Urboon contract unless the Seller has the ownership of the underlying goods and the possession thereof.

STRUCTURE OF ISLAMIC OPTION:



Mechanism of Islamic Option:

1. A customer wants to purchase an asset from the Supplier. Instead of buying on the same day, the customer seeks an Islamic Option buy the asset in the future (say within 3 days).
2. The customer pays a part of the purchase price as Urboon to the Supplier.
3. On the maturity date, the customer finds that the price of the asset has gone up. Therefore, the customer utilises the option and purchases the asset from the supplier paying the balance amount of the total purchase price of the asset.
4. In case the price goes down the customer loses its Urboun it made to the Supplier due to non-payment of the full purchase price of the purchased asset.

SNAPSHOT OF WHAT WE HAVE LEARNED:

In this module we have learned about:

- Liquidity Management is a method adopted by the Islamic Financial Institutions to manage the liquidity risk, i.e., the shortage and excess liquidity issues. The Islamic Bank uses Tawarruq, Wakala, Sukuk structures as Liquidity Management Instruments both for its shortage or excess liquidity management.
- Risk Management is the process of the reduction and prevention of risks by lawful mechanisms. Profit Rate Swap, Forward FX, Spot FX, Currency Swap, Islamic Options, etc., are some of the Risk Management Instruments.
- To cover its future currency exchange rate risk, fixed or variable return the Islamic Bank uses a waad based structure to execute the Forward FX and Profit Rate Swap.
- Islamic Option is based on the Urboun (Down Payment) where the sale and purchase of the asset is executed with an option with the purchaser to pay the full price and receive the asset.





ISLAMIC FUNDS

Learning Objectives:

After completing this module the reader should be able to:

- Understand the basic forms of an Islamic Investment Fund.
- Understand the various Islamic Finance structures applied in Islamic Fund.
- Understand the operations and mechanism of Islamic Fund.
- Know the different types of funds available in Islamic finance market.
- Understand the Shariah screening methodology and purification process.
- Practically calculate the financials such as Return, Profit, Shares of the parties, etc., with respect to each Islamic Finance structure applied in an Islamic Fund.







INTRODUCTION:

The term 'Islamic Investment Fund' generally refers to a joint pool wherein investors contribute their surplus money for the purpose of its investment to earn profits in strict conformity with Shariah principles. The distinguishing feature between an Islamic investment fund and a conventional one is that while the Islamic investment fund follows the Shariah principles, the conventional fund does not.

According to K. Geert Rouwenhorst in 'The Origins of Mutual Funds', during the late 1700s "a Dutch merchant and broker, Adriaan Van Ketwich, invited subscriptions from investors to form a trust to provide an opportunity for small investors with limited means to diversify their businesses". The concept of pooling investments that was developed in Europe in the late 1700s led to the development of present day unit trusts or mutual funds. It is believed that the concept of investment funds first took shape in Switzerland, and the Societe Civile Genevoise d'Emploi de Fonds was created in 1849.

The concept of pooling funds and appointing a manager to manage the funds also existed in the Arab world even in the pre-Islamic era. Prophet Mohammed (Peace be upon Him) was known as al-amin (the trustworthy) and the people of Mecca preferred to keep their money with Him as he also acted as Mudarib (manager) while he was doing business for Khadijah (May Allah be pleased with her). The issue of trust (amanah) plays a very important role in Islamic financial transactions. Therefore, we find the concept of trust (amanah) in every Islamic contract, be it a partnership (mushraka) or trust-financing (Mudaraba) or agency (Wakala). By virtue of this contract, the capital or property of the partnership is held in trust by one of the partners on behalf of the other partners.

Even in contemporary society, the concept of trust has as much importance as it had in the past. This form of business has been in practice as a result of the fact that in a society there are many who have money, but do not have the skill and ability to conduct business; and there are those who have the capability but do not have the financial means. Here, the concept of trust comes into picture and the one who has money will entrust their money to the person who has the ability to manage it. The same principle works behind the modern day fund management business.

However, the development of Islamic Investment funds gained momentum in the late 1980s. Since then, a number of Islamic equity funds have been launched successfully focusing on diverse sectors such as real estate and international equities. Target markets for Islamic funds vary from place to place and time to time. Some cater to their local markets; others target the international markets, whereas a few others tend to target retail investors and high-net-worth individuals and corporate institutions.

ISLAMIC INVESTMENT FUNDS

Let us now understand Islamic Investment funds with respect to their structures, functions, mechanism, important concepts and practices.

Fund management companies are specialised financial institutions that help investors in gaining a relatively high return on investment at a lower risk. Investors subscribe to the units issued by the fund managers and entrust with them their funds. These units represent the equity holding of the investors and can be bought and sold as

The basic objective of screening and purification is to protect the company and its shareholders from illegitimate wealth or income. The Shariah boards of various organisations have put forth various criteria to define the maximum degree of compromise which could be considered acceptable under Shariah, given the current business environment.



per their Net Asset Value on every trading day. The fund manager pools together the funds of investors to form a large pool. This large pool is then invested as per the guidelines provided by the Shariah board, by specially trained personnel or a fund manager. Profits and income shall be shared among the investors and the fund manager as per the agreement. The manager distributes the profit share of the investors. The investor can redeem the units by selling it to the fund manager on Net Asset Value (NAV).

FUNCTIONING OF AN ISLAMIC INVESTMENT FUND

An Islamic investment fund functions in a manner similar to a mutual fund. It executes its functions in the form of a legal entity. The legal form of the fund depends on many factors and can vary as per the requirement. However, an Islamic investment fund can generally be in any of the legal forms discussed below:

- i. *Company*
- ii. *Trust*
- iii. *Partnership*

ISLAMIC FUND AS A COMPANY:

In a company form, the fund manager takes on the role of a board of directors and investors act in the capacity of shareholders. Shareholders would give the mandate of managing the invested fund to the board of directors. In such a scenario, the provision of the company law in the jurisdiction where the fund has been incorporated also governs the fund. This form is particularly preferred in the Middle East region.

ISLAMIC FUND AS A TRUST:

In a trust form, the investors appoint a fund manager as a trustee to manage and invest the funds of the trust. The trust law takes effect and the trustee has a fiduciary responsibility to manage the funds.

ISLAMIC FUND AS A PARTNERSHIP:

In a partnership form, the fund manager plays the role of a general partner and investors play the role of an ordinary partner. The general partner is responsible for handling the funds.

No matter what form is adopted, the roles and responsibilities of the parties remain more or less the same. The fund manager is responsible for managing the funds and providing returns to the investors.

STRUCTURE OF AN ISLAMIC FUND

There are various parties like investors, the fund manager, Shariah board and others who come together, as a result of a contractual relationship, to structure an Islamic Fund.

Parties involved in Islamic Fund:

- a. **Investors:** Investors are the individuals or institutions who own the shares or units of the fund and entrust their surplus for investment to the fund manager.
- b. **Fund Manager:** Fund Manager (individual or company) is the trustee/custodian of the investor's surplus and acts on their behalf or in their interest.
- c. **Shariah board:** Shariah board consists of the Shariah scholars who provide Shariah guidelines to the fund to ensure that the investment is compliant with the principles of Shariah.
- d. **Others:** The term 'Others' include third parties or other mutual

funds with whom the fund manager enters into different contracts for the purpose of investment or the distributors who bring investors into the fund scheme against the commission, etc.

STRUCTURES OF ISLAMIC FUND:

The contractual relationship between investors and the fund manager is the most important as it originates the structure of the fund. An Islamic fund can be incorporated using any of the structures discussed below:

i. Mudaraba

ii. Wakala (investment agent)

iii. Musharaka

Mudaraba structure:

Mudaraba is a partnership in profit whereby one party provides capital (rab-al-maal) and the other party provides management skills (mudarib).

Under this structure, the investors provide capital and the fund manager manages the investment. Profit is shared between the investors and the fund manager as per the ratio agreed upon at the time of contract. Losses are solely borne by the investors. Profit can be a fixed percentage or can be linked to the performance of the fund. For example, if the fund achieves the prescribed profit level then the complete profit above the ceiling shall either be given to the Mudarib or shared among the parties in a new sharing ratio as mutually agreed. However, it cannot be a fixed amount or a lump sum. Profits can be shared periodically as per the agreement.

Wakala structure

Wakala can be defined as the delegation of one person (the principal) for another (the agent) to take his place in a known and permissible dealing. In this regard, the agent (wakil) represents and deals for and on behalf of the principal.

Under this structure, the investors appoint a fund manager as their agent in managing the investment for agreed fees as per the terms and conditions of the investment. The agency fee can be pre-agreed as a flat fee or variable (linked to performance of the fund). However, it has to be specific. The agent who is given the power of attorney is considered a trustee and is not liable for anything unless there is any negligence on the agent's part.

Musharaka structure:

Musharaka (sharikatul al-inan) is a partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on condition that profit is distributed according to the partnership agreement and losses are borne in accordance with the contribution of each partner to the capital.

Under this structure, investors and the fund manager agree to join in a temporary partnership for effecting a certain investment within an agreed period. Both parties contribute to the capital of the investment and agree to share the net profit in proportions agreed in advance. The profit ratio can be a fixed percentage or it can be linked to the performance of the fund. For example, if the fund achieves the prescribed profit level the complete profit above the ceiling shall either be given to one partner or it can be shared



It is established in the Shariah that a debt cannot be sold to a third party; but is allowed if sold on par. Likewise, selling cash for cash is an example of a transaction that must comply with the conditions of currency of exchange as sanctioned by the Shariah.

A share of a company represents undivided portion of the assets of the company. If these assets are primarily cash and receivables, then the share must not be sold at a price different from the face value of these assets, because if they are sold at a different value for this, it would be considered as ‘interest’ from the Shariah point of view.



between the two parties in a new sharing ratio as mutually agreed between the parties. The loss shall be borne only in proportion to their capital contribution.

After this brief introduction to the different forms and structures of an Islamic fund, let us now move on to the most important aspect of this topic, the Shariah screening process, one of the unique features of an Islamic fund.

SHARIAH SCREENING METHODOLOGY

An Islamic Investment fund consults Shariah advisors to ensure that investment operations and portfolios are managed in compliance with Shariah principles. The Shariah board acts as an independent or external consultant to the fund. The major regulation of Islamic fund from the Shariah perspective is done with respect to screening and purification.

Islamic finance scholars have devised a mechanism of screening and purification. The basic objective of screening and purification is to protect the company and its shareholders from illegitimate wealth or income. The Shariah boards of various organisations have put forth various criteria to define the maximum degree of compromise which could be considered acceptable under Shariah, given the current business environment.

Main Components of Shariah Screening:

The screening of companies for investments is generally of two types:

- a) Industry Screening*
- b) Financial Screening*

a) Industry Screening

In the Quran Allah says:

“And Allah will never lead a people astray after He has guided them until He makes clear to them as to what they should avoid. Verily, Allah is the All-Knower of everything” (Al Quran 09:115).

The types of businesses in which Shariah does not allow investments are discussed at length in the literature of Islamic law. Investment in the shares of any company engaged in such haram activities is clearly impermissible. The core business activity of the company is considered before taking a decision on its permissibility and impermissibility. A brief list of prohibited business activities includes income derived from any of the following:

- Interest-based products, services and instruments.
- The manufacture or distribution of alcohol products
- The manufacture or distribution of arms and weapons
- Gaming or gambling
- Any type of conventional assurance-related activity
- The production, packaging, processing or any other activity relating to pork or pork products and other non-Halal meat
- The production or distribution of pornographic material
- Any other activities not permissible under Shariah as determined by the respective Shariah boards

However, the above list may not be exhaustive and it is submitted that any activity which is derivative of these or may open the way

for the spreading of these activities may also come within this prohibition.

b) Financial Screening

The second component of Shariah screening is financial screening, which has basically the following four components:

- i. Impure Income earned through 'interest' and other suspect earnings*
- ii. Cash and Debt Vs Total Assets or Average Market Cap*
- iii. Debt Vs Equity or Average Market Cap*
- iv. Account Receivables*

i) Impure Income earned through 'interest' and other suspect earnings: The most common requirement for companies is the working capital. Generally organised companies resort to financial institutions to address this concern. In an environment where Islamic finance is available this will not be an issue; but the practice of Islamic finance is not wide spread and many Islamic financial institutions may not have products to cater to working capital needs leading them to borrow.

Banks play a crucial role in facilitating transactions in modern times. All cash flows of an enterprise are routed through banks. As a result, all businesses have to maintain accounts with banks. These accounts attract some nominal interest. Companies also deploy excess short-term liquidity in bank deposits and securities as a measure of treasury management. This also accrues some interest income for them.

In such cases scholars have provided a ceiling and stipulated that the ratio between interest and unlawful unearned income (or both combined), to the company's total income should be negligible and as low as possible. Most of scholars agree that it should not exceed 5 % of the total income.

ii) Cash and Debt Vs Total Assets or Average Market Cap: Trading of debt has been an issue of debate amongst various schools of Islamic law. It is established in the Shariah that a debt cannot be sold to a third party; but is allowed if sold on par. Likewise, selling cash for cash is an example of a transaction that must comply with the conditions of currency of exchange as sanctioned by the Shariah. Hence, scholars conclude that the total cash and debts in the balance sheet of a company should not exceed the total value of assets or average market cap, i.e., cash and debt should be less than 30-50% of the existing Assets or Average Market Cap.

iii) Debt Vs Equity or Average Market Cap: It is noticed that many joint stock companies sometimes resort to leverage at a certain interest for expanding their business activities or meet their emergency cash requirements. This involves the payment of interest to the lending parties. From an extended survey of many joint stock companies, it has been found that the ratio between debts and shareholders' equity is sometimes as much as sixteen times as high. For this reason, the Shariah supervisory boards argue that a percentage of not more than 30-33% is considered to comply with this requirement.

iv) Account Receivables: Account Receivables is the money owed by customers (individuals or corporations) to a company in exchange for goods or services that have been delivered or used, but not yet paid for. Shariah considers account receivables as debt due to the company. The general Shariah principle for purchase/sale of debt is that it is only allowed at par.



Purification, in relation to Islamic funds, simply means deducting from one's investment those earnings the source of which is not acceptable from a Shariah point of view.



A share of a company represents undivided portion of the assets of the company. If these assets are primarily cash and receivables, then the share must not be sold at a price different from the face value of these assets, because if they are sold at a different value for this, it would be considered as 'interest' from the Shariah point of view. Generally, Shariah scholars have set the acceptable limit for the ratio of receivables to Total assets or Market Cap at 33%.

Global Shariah Indices at a glance:

Every Shariah index has its own methodology and parameters based on the circumstances, environment and the financial set-up they operate in. The tables (1&2) below reflect the different methodologies and parameters of Shariah screening adopted by the major Shariah indices at a global level.

Table-1: Comparison of Screening According to Nature of Business

Index	Alcohol	Conventional Financial Services	Pork Related Products	Tobacco	Weapons	Entertainment
DJIMI	✓	✓	✓	✓	✓	✓
S & P	✓	✓	✓	✓	X	✓
FTSE	✓	✓	✓	✓	✓	✓
MSCI	✓	✓	✓	✓	✓	✓
SC- Malaysia	✓	✓	✓	✓	X	✓
AAOIFI	✓	✓	✓	✓	X	✓

In Table-1 above, the major Shariah indices are represented vertically on the left side corner, whereas the nature of business is mentioned horizontally on the top. It is clearly visible that all Shariah indices are in agreement on the nature of most businesses that are non-Shariah compliant, except in the case of businesses involved in weapon manufacturing. In this case, the S&P, SC-Malaysia and AAOIFI are not in agreement with other Shariah indices. These three indices consider weapon manufacturing to be Shariah compliant, hence investment in such business is permitted.

Table-2: Comparison of Companies in relation to Finance Screens

Index	Average Market Cap	Total Assets	Debt	Cash + IBS	Account Receivables	Interest Income	Revenue from NSCA
DJIMI	✓	X	33%	33%	33%	X	X
S & P	✓	X	33%	33%	49%	X	5%
FTSE	X	✓	33%	33%	50%	5%	X
MSCI	X	✓	33%	33%	33%	X	5%
SC - Malaysia	X	✓	33%	33%	X	X	X
AAOIFI	✓	X	30%	30%	X	5%	X

In Table-2 above, the major Shariah indices are represented vertically on the left side corner whereas the different financial parameters are mentioned horizontally on top. It appears from the table that three indices DJMI, S&P and AAOIFI use the Average Market Capitalization and the other three FTSE, MSCI and SC-Malaysia use the Total Assets as the base for calculating different ratios. The debt to Equity or Total Assets or Average market cap ratio is limited to 33% in all indices with the exception of the AAOIFI which has kept a limit of 30%. For the cash plus interest bearing securities to total Assets or Average Market Cap, all the indices have kept a ratio of 33%, whereas the AAOIFI kept a limit of 30%. As far as the Account Receivables are

concerned, Dow Jones stipulated 33%, S&P 49%, FTSE 50% and MSCI 33% of total Assets or Average Market Cap, as the maximum level, whereas SC-Malaysia and AAOIFI have no ceiling. Only FTSE and AAOIFI have limited the interest income up to 5%. S&P and MSCI have limited the Revenue from Non-Shariah Compliant Activities (NSCA) up to 5% of the Total Income.

The One-Third Rationale:

The one-third rule has been deduced from some of the Shariah rulings on the determination of minimum and maximum limits. The scholars generally have considered anything which is less than one-third, as the minimum or small percentage of the whole. Following is the Hadith that is generally referred to in relation to this ruling: Narrated Sad bin Abi Waqqas (May Allah be pleased with Him): The Prophet came visiting me while I was (sick) in Mecca, ('Amir the sub-narrator said, and he disliked dying in the land, whence he had already migrated). He (i.e. the Prophet) said, "May Allah bestow His Mercy on Ibn Afra (Sad bin Khaula)." I said, "O Allah's Apostle! May I will all my property (in charity)?" He said, "No." I said, "Then may I will half of it?" He said, "No". I said, "One third?" He said: "Yes, one third, yet even one third is too much. It is better for you to leave your inheritors wealthy than to leave them poor begging others, and whatever you spend for Allah's sake will be considered as a charitable deed even the handful of food you put in your wife's mouth. Allah may lengthen your age so that some people may benefit by you, and some others be harmed by you." At that time Sad had only one daughter. (Al-Bukhari, Book 51, Number 5, Volume 4, Bukhari vol 3, Hadith number 196, and Muslim Vol 3, Hadith 1250 and in all the four Sunan as well).

Some of the critics of the one-third rule assert that it involves an out-of-context use of the above Hadith. Though there may be no direct relation between the Hadith and the way the one-third rule is being derived from it, one concurs that this has been the Ijtihad of some of the prominent Shariah scholars to facilitate the growth of Islamic finance. It can be inferred that if the one-third rule can be applied to other issues, it can also be applied to financial transactions. The application or extension of this ruling to the financial sector has greatly benefitted Islamic investors and has opened up newer investment opportunities for them.

The interpretation of this Hadith can be understood from two perspectives - one is how important it is to leave savings for one's family so that they do not have to suffer after the caretaker of the family expires; and the other is that the benchmark of defining anything in excess is 'one third'. In reference to financial matters, the one-third rationale became common practice.

PURIFICATION PROCESS

After understanding the process of Shariah screening, let us now discuss the process of purification.

Purification:

Purification, in relation to Islamic funds, simply means deducting from one's investment those earnings the source of which is not acceptable from a Shariah point of view.

In the current interest-based economy, it is difficult for businesses to operate without incurring any interest-based payments or impure income. Therefore, Shariah scholars have provided guidance on



Riba has two forms in contemporary business:

- a. Interest earned by a company by extending loans or credit.
- b. Interest paid by a company to the lender of a Riba-based loan.

SPV is an entity whose operations are limited to the acquisition and financing of specific assets. It is usually a subsidiary company with an asset/liability structure and legal status that makes its obligations secure even if the parent company goes bankrupt. A company uses such a vehicle to finance a large project without putting the entire firm at risk.



purifying the impure income from the earned income of the Islamic funds. It is submitted that this is a temporary stopgap measure which may change once the Islamic economy has attained maturity.

The amount of impure income will be calculated by the investment manager of the fund in accordance with the Shariah guidelines and will be donated periodically in charity. It is to be noted that utilisation of the prohibited component of income is not permitted in any way.

Purification Method:

Elimination or deduction from the intermediary, agent or manager's commission or wages is not obligatory as this is their right in lieu of the work they have undertaken. In case of intermediation, however, it is bound to inform the person dealing in it, of the mechanism for the elimination of the prohibited component. The institution may offer these services, with or without a charge, for those dealers who desire them.

The investment manager will derive the percentage used for the purification of impure income as per the following criteria:

- i. For impure income derived from prohibited activities*
- ii. For impure income derived from non-operating interest income*
- iii. For total impure income*

Calculation Timing:

Upon receiving the financial report, within an agreed number of business days the investment manager will calculate and provide the impure income percentage to the administrator and provide a breakdown of the calculation to the sponsor. Upon receipt of the impure income percentage from the investment manager, the administrator will calculate the amount attributable to impure income and deduct that amount from the assets of the fund on the next valuation day.

The administrator will first calculate the impure income amount for a company within the universe by multiplying its respective impure income percentage to its dividends per share, and then by the number of shares owned by the Fund.

Profit Returns on Borrowed Money:

Riba has two forms in contemporary business:

- a. Interest earned by a company by extending loans or credit.*
- b. Interest paid by a company to the lender of a Riba-based loan.*

There is no dispute on removing the first type whether the company has made a profit or loss. However, the question here is what we do with the profit element earned by a company by virtue of investing the money borrowed on interest. Dr. Anas refers to this amount of profit as "doubtful amount" and is of the view that it is obligatory to calculate that amount of the company's profit and purify it.

Method of Calculation:

There are two methods to calculate the impure income advanced by different Shariah screening institutions. They are as follows:

Method adopted by AAOIFI:

- Step 1: The income from interest and other non-permissible sources earned by the company during the year, say USD 200.
- Step 2: Total number of shares outstanding of company A is 1,000.

- Step3: The impure income per share is ascertained by dividing the total impure income by the total number of shares outstanding. So, $200 / 1,000 = 0.2$ or 20%.
- Step 3: If an individual holds 100 shares of the company, then it is multiplied by the impure ratio and the resulting amount shall be purged off.
- So, $20\% \times 100$ is equal to USD 20. It means that USD 20 needs to be disposed of to charity as impure income.

BASIC TERMINOLOGIES OF AN ISLAMIC FUND

To understand any business model or structure, it is necessary that one should understand the basic terminologies used in it. So in this section the basic terminologies of an Islamic fund have been introduced along with their formulas (wherever necessary).

Units / Shares:

Units or shares represent an equitable right of investors in the assets or pool of the fund.

Special Purpose Vehicle (SPV):

SPV is an entity whose operations are limited to the acquisition and financing of specific assets. It is usually a subsidiary company with an asset/liability structure and legal status that makes its obligations secure even if the parent company goes bankrupt. A company uses such a vehicle to finance a large project without putting the entire firm at risk.

Net Asset Value (NAV):

Net Asset Value indicates the intrinsic worth of a fund. NAV per unit represents the worth of each unit that investors hold. The NAV of a fund can be calculated using either of the two formulas given below:

- $NAV = (\text{Value of all assets} - \text{value of liabilities other than to unit holders})$
- $NAV = (\text{Capital} + \text{Reserves})$

If NAV of a fund is further divided by the number of outstanding shares in the fund, then we get NAV per share which is the price at which shares in the fund are bought and sold (plus or minus any sales fees). Generally funds calculate their NAVs once per trading day at the close of the trading session.

Trading day:

It is usually a business day on which the units of the fund are bought and sold.

Public Offering Price (POP):

The public offering price (POP) is the price at which units / shares are sold to the public.

- For funds that do not charge a sales commission (or "load"), the $POP = \text{Net Asset Value (NAV)}$.
- For a load fund, the $POP = (NAV + \text{Sales charge})$

Load / Fee:

This is a fee that is charged by the fund when investors buy or sell the units of a fund. The load is a percentage of the NAV.

- When you buy the units of a fund, you pay a percentage of it as a fee. This is known as the entry load. From the manager's point of view, $\text{Sale Price} = (NAV + \text{Entry load})$
- When you sell the units of a fund, you pay a percentage of it as a fee. This is known as the Exit load. From the manager's point of view, $\text{Re-purchase Price} = (NAV - \text{Exit load})$



In a Mudarabah based Fund Net Profit or Income derived from the investment would be shared between the investors and the Fund Manager as per the agreement. Further, it is the responsibility of the Fund Manager to distribute the share of the profit to the investors as per their contribution to the portfolio.



Redemption:

The funds are generally bound by law to purchase the units held by investors when they want to redeem. This option makes the investment liquid i.e., the investors can liquidate their shares/units in the mutual fund at their will.

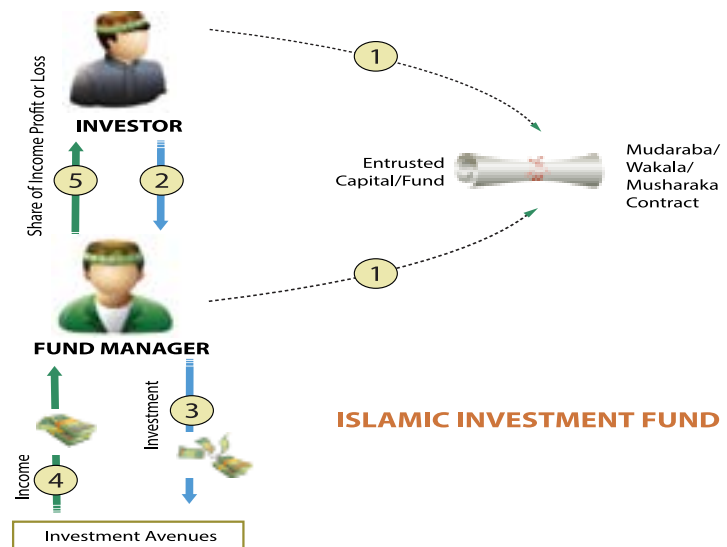
Dividend / Income:

Dividend is the proportion of the profit earned and distributed by the fund through its operations. It is distributed to the investors periodically. In real estate funds, the lease rentals are distributed to investors as the regular income.

Capital gains:

It is also one of the sources of income to investors. The NAV of units held by investors increases if the fund realises the profit and retains it. If the NAV at the time of redemption is higher than the NAV at time of subscription, then the investor realises the capital gains.

BASIC MODEL OF AN ISLAMIC FUND



As discussed earlier, the Islamic fund can be structured in any of three contracts, i.e. Mudaraba, Wakala or Musharaka. Now let us understand the mechanism of the fund with respect to these three structures.

Mechanism of Mudaraba based Fund:

1. The Investors have surplus money and want to invest in any Shariah-compliant profitable business. They enter into a Mudaraba contract with the Fund Manager (or Company) that pools the funds of the investors with an objective of investing in profitable shariah compliant avenues on their behalf. As per the contract, the investors are the Rab-al-Maal and the Fund Manager is the Mudarib.
2. The Fund Manager creates an SPV as an Islamic investment fund and issues the shares or units that represent the equity holding of the investors in proportion to one's capital contribution.
3. Both the Investors and the Fund Manager agree to share the Net Profit in a certain ratio. The profit share can be a fixed percentage or can also be linked to the performance of the portfolio. For instance, if the fund achieves the prescribed profit level, the complete profit above the ceiling shall either be given to the Mudarib or shared between the parties on a sharing ratio as mutually agreed between them. In case of loss, only the investor has to bear the 100% loss.
4. The Fund Manager consults the Shariah advisors for guidelines to

operate and invest the fund. And based on their guidelines, the Fund Manager invests the fund through any of the Islamic contracts (such as Mudaraba, Murabaha, Ijarah, etc) with a third party.

5. The Net Profit or Income derived from the investment would be shared between the investors and the Fund Manager as per the agreement. Further, it is the responsibility of the Fund Manager to distribute the share of the profit to the investors as per their contribution to the portfolio.

MECHANISM OF WAKALA BASED FUND:

1. The investor(s) who has surplus money and wants to invest in any Shariah-compliant profitable business enters into a Wakala contract with the Fund manager (or Company) that pools the funds of the investor(s) with an objective of investing in profitable avenues. As per the contract, the investors are the Principal and the Fund manager is the agent who agrees to manage the investment on their behalf.
2. The Fund Manager creates an SPV as an Islamic investment fund and issues the shares or units that represent the equity holding of the investors in proportion to their capital contribution. As per the agreement, the Fund Manager is entitled to a Wakala fee for its management services. The Wakala fee commonly is a fixed percentage of NAV of the portfolio.
3. All the realised profit or loss belongs solely to the investors.
4. The Fund Manager consults the Shariah advisors for guidelines to operate and invest the fund. And as per the guidelines, the Fund Manager invests the fund through any of the Islamic contracts (such as Mudaraba, Murabaha, Ijarah, etc) with a third party.
5. The Fund Manager deducts its Wakala fee and then transfers the Net Profit or Income to the investors. Further, it is the responsibility of the Fund Manager to distribute the share of profit or income to the investors as per their contribution portfolio.
6. In most of the wakala funds, apart from the wakala fee some incentive for the good performance of the wakil is also agreed between the parties which is generally an amount over and above the expected or targeted return.

MECHANISM OF MUSHARAKA BASED FUND:

1. The investor(s) who has surplus money and wants to invest in any profitable business enters into a Musharaka Contract with the Fund Manager (or Company) who pools the funds of the investor(s) with an objective of investing in profitable avenues. As per the contract, both the investors and the Fund Manager contribute the capital to the portfolio or fund.
2. The Fund Manager creates an SPV as an Islamic investment fund and issues the shares or units that represent the equity holding of the investors in proportion to their capital contribution.
3. The investors and the Fund Manager agree to share the Net Profit in a certain ratio. The profit share can be a fixed percentage or can also be linked to the performance of the portfolio, for example, if the fund achieves the prescribed level of profit, then the complete profit above the ceiling shall either be given to the Fund Manager or be shared between the investors and the Fund Manager on a new sharing ratio as mutually agreed between the parties. In case of loss, both the Investors and the Fund Manager share the loss in proportion to their capital contributions.
4. The Fund Manager consults the Shariah advisors for guidelines to operate and invest the fund. As per their guidelines, the Fund Manager invests the fund through any of the Islamic contracts (such as Mudaraba, Murabaha, Ijarah, etc) with a third party.
5. The Net Profit or Income derived from the investment would be



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shared between the parties as per the agreement. Further, it is the responsibility of the Fund Manager to distribute the share of profit to the investors as per their contribution in the portfolio.

TYPES OF ISLAMIC FUNDS

After having understood Islamic fund, its Shariah screening process, structure and mechanism, let us now move on towards the different types of funds available in the market. Funds can be structured in a variety of ways and some may have Shariah implications. The following section briefly discusses the various forms that a fund structure can take, and when and how some of these structures may affect Shariah compliance issues either at the issuance/ origination or at the trading stage.

Open-ended fund:

This is a fund that allows the fund manager to issue new shares on demand and also allows investor(s) to redeem the existing shares on the basis of prevailing NAV. The NAV acts as a benchmark for both the fund manager and the investors in pricing new shares or units to be issued or redeemed for existing shares or units. The features of 'open-ended fund' do not pose any Shariah issues, therefore acceptable in Shariah.

Close-ended fund:

In a close-ended fund the number of shares or units must be limited to the volume of the issue at the inception of the fund. It means no more shares or units will be issued to the market. The shares or units of a close-ended fund can be listed and traded on an exchange and may be traded on a secondary market subject to market forces. The investor may trade the shares or units of close-ended fund at a premium or at a discount to NAV.

Exchange traded fund (ETF):

An exchange traded fund (ETF) can be traded on a daily basis. It can also be described as an index tracking fund or a listed index-tracked fund as it is listed on an exchange. It tracks a particular index that is used as a benchmark for the fund's performance. It is similar to traditional mutual fund and index fund, except that shares or units in an ETF can be listed and traded.

On the basis of the investment criterion and the contract between the fund manager and the third party, the Islamic fund is divided into a few more types as discussed below:

Equity fund:

Equity fund is the joint pool of money from investors to invest in the equity business. In this fund, the surplus of different investors is pooled together and invested in purchasing the equities and shares of Shariah-compliant joint stock companies by the fund manager. Profits are achieved through the capital gains, i.e., by purchasing the shares when their prices are low and selling them when they are high. The difference between the sale price and purchase price is the gross profit. The net profit (i.e. profit -fund management fee) is shared between the fund manager and the investors. The profit share of investors is distributed as per their shareholding in the pool.

Ijarah Fund:

An Ijarah fund is a type of fund wherein the surplus of investors is pooled together into a single pool for the purpose of investing in assets that will generate leasing returns. The fund is invested in assets such as real estate projects, equipment, machinery, aircrafts, vessels, etc. The income generated from such funds will be in the form of rent paid by the lessees on a medium to long term basis. Basically, there are two contracts signed in this type of fund. First is the contract of mudaraba



or wakala signed between investors and the fund manager, and second is the contract of lease signed between the lessee and the fund manager (as a lessor on behalf of the owners of the asset or investors). The lessee pays the rentals against the usufruct of the asset to the lessor or fund manager (an agent of the owners of the asset). The fund manager is entitled to a share in income (in case of Mudaraba) or fee for the services rendered (in case of Wakala).

Specific Shariah guidelines for Ijarah fund:

- The asset must be owned by the lessor or the fund management.
- The leased assets must have some usufruct.
- The rental must be charged only from that point of time when the usufruct is handed over to the lessee.
- The leased assets must be of a nature that their Halal (permissible) use is possible.
- The lessor must undertake all the responsibilities consequent to the ownership of the assets.
- The rental must be fixed and known to the parties, right at the beginning of the contract.

Commodity Fund:

A commodity fund is the joint pool of money from investors to invest in the commodity business. In this fund, the surplus of different investors is pooled together and invested in purchasing different commodities with an objective of resale. Profits are achieved through the capital gains, i.e., by purchasing the commodities when their prices are low and selling them when their prices are high. The difference between the sale price and purchase price is the gross profit. The net profit (i.e. profit-fund management fee) is shared between the fund manager and the investor (in case of mudaraba). The profit share of investor(s) is distributed as per their share holding in the pool.

Specific Shariah guidelines for Commodity fund:

- The commodity must be owned by the seller at the time of sale.
- Forward sales and short sales are not allowed except in the case of Salam and Istisna.
- Commodities must be Halal, therefore, prohibited commodities like wines, pork, etc., are not allowed.
- The price of the commodity must be fixed and known to the parties.

Murabaha Fund:

A Murabaha fund is the joint pool of money from investors to invest in purchasing assets or goods or commodities with the purpose of resale on markup. In this fund, the surplus of different investors is pooled together and invested in purchasing the different commodities or assets or goods with an objective of resale on markup with deferred payment. Profits are achieved through the markup, i.e., purchase price plus profit margin. The difference between the sale price with markup and the purchase price is the gross profit. The net profit (i.e. profit-fund management fee) is shared between the fund manager and the investor(s) (in case of mudaraba). The profit share of investor(s) is distributed as per their shareholding in the pool.

Though the Murabaha fund seems to be similar to the commodity fund, there is a difference between them. In commodity fund, the goods are sold on the spot and the payment is received at the same time. There is no deferred payment in commodity fund. Whereas in Murabaha fund, the goods are sold on the spot and the payment is deferred and received in the future, in installments. Another difference is that, in commodity fund, the fund manager need not disclose the profit margin and actual



It can be concluded that investment funds are exposed to the risk of capital loss. Despite this risk, they offer investors several benefits. Investors can diversify their portfolios and spread risk by buying units in a fund because each unit represents a small amount of each financial asset the fund owns. The fund also helps many investors by offering access to various investment avenues that are not within the reach of individual investors. And last but not least, funds can purchase investments in large amounts incurring relatively low transaction costs.

cost of the commodities to the customer, whereas in Murabaha fund it is a must that the fund manager discloses the actual cost of the goods and the profit margin to the customer or end user.

Specific Shariah guidelines for Murabaha fund:

- Goods must be owned by the seller at the time of sale.
- Goods must be Halal, therefore, prohibited commodities like wines, pork, etc., are not allowed.
- The price of goods must be fixed and known to the parties.
- The seller must disclose the profit margin to the purchaser.
- Delivery of goods should be on spot.
- Payment must be deferred or in installments.
- Certificates of this fund are not negotiable.

MIXED FUND:

A Mixed fund is the joint pool of money from the investor(s) to employ it in different types of investments like equities, leasing, commodities and murabaha business. The net profit or net income in case of lease (i.e. profit-fund management fee) is distributed to investors as per their share holding in the pool. In this type of fund, if the tangible assets are more than 51% and the liquidity and debt are less than 50%, then the certificates of this fund may be negotiable. However, if the proportion of liquidity and debt exceeds more than 50%, then the certificates of ownership cannot be traded.

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SNAPSHOT OF WHAT WE HAVE LEARNED:

In this module we have learned:

The term 'Islamic Investment Fund' generally refers to a joint pool wherein investors contribute their surplus money for the purpose of its investment to earn profits in strict conformity with Shariah principles.

Islamic Investment Fund functions with a legal entity of a Company, Trust or a Partnership.

The Mudaraba, Wakala and Musharaka contracts are used in Islamic Funds to structure the respective funds.

Shariah Screening which includes the Industrial Screening and Financial Screening is inevitable for any Islamic Fund.

Shariah Indices provide with the list of Shariah compliant companies though there are certain differences among them in relation to the screening parameters.

Purification in relation to Islamic funds simply means deducting from one's investment those earnings the source of which is not acceptable from a Shariah point of view.

Different types of Funds such as Open-ended Funds, Close-ended Funds, Exchange Traded Funds (ETFs), Equity Funds, Mixed Funds etc can be established as an Islamic Fund by using the relevant contracts.





Sukuk-Islamic Bonds

Learning Objectives:

After completing this module the reader should be able to:

- Understand the definition and meaning of Sukuk (Islamic Bonds).
- Know the origin and history of Sukuk.
- Understand the basic structures, Shariah conditions of the Sukuk.
- Know the different categories and various types of Sukuk available in Islamic Finance Market.
- Understand the mechanism, operations, key features, required documentation of Sukuk.
- Understand the basic concepts such as Sukuk Issuance, Sukuk Trading, Sukuk Redemption, NAV, etc.
- Practically calculate the financials such as Return, Profit and Shares of the parties with respect to each of the Islamic Finance structure applied in Sukuk.





INTRODUCTION

Sukuk, a Shariah-compliant alternative to a conventional bond, has shown phenomenal growth in the past decade and is showing promising signs of going further ahead. The striking difference between a Sukuk and a conventional bond is that a Sukuk is an asset linked certificate where the income to the certificate holder is derived from the underlying asset of the Sukuk. But in case of a conventional bond there is no asset which is linked to the bond, which can justify the income of the bond holder.

The investors, rating agencies and lead arrangers perceive Sukuk as a Shariah-compliant bond, but most of the Shariah scholars and academicians perceive it as asset-based or asset-backed securities. However, Sukuk are the most important products of Islamic capital market and constitute a large proportion in Islamic finance industry. Sukuk provide liquidity to the financial market as well as allow corporations to have direct access to funds.

After this brief introduction to Sukuk, let us now move towards its legitimacy and history.

RECOGNITION OF SUKUK BY PROMINENT INSTITUTIONS

Islamic Fiqh Academy:

With regard to the recognition of Sukuk as a Shariah compliant instrument in Islamic finance by any institution, the Islamic Fiqh Academy comes right on top. The first formal resolution issued on Sukuk by Islamic Fiqh Academy was Resolution No. 30(3/4) concerning Muqaradah Bonds and Investment Certificate which was adopted in February 1988. This resolution was then followed by a series of equally important resolutions from the Islamic Fiqh Academy. It should be noted that resolutions issued by the Academy have addressed the general theoretical aspects of Sukuk, particularly the Muqaradah Sukuk and Ijarah Sukuk.

Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI):

The organization has declared the permissibility of Sukuk on the basis of the following points:

- The basis for permissibility of issuing investment certificates is that such certificates are usually issued on the basis of Shariah nominated contracts.
- The basis for considering the issue prospectus as an offer and the fact of subscription as an acceptance as that valid contracts take place on the basis of anything that indicates consent without specifying a particular form of expression.
- The basis for the right of certificate holders to management is that they own the property that their certificates represent, and management is a part of the ownership.

SUKUK - ISLAMIC BONDS

Sukuk- A brief History:

According to prominent research scholars, documentary evidence for the term Sakk appears to have begun in the early Islamic caliphates. The earliest evidence of the term Sakk found by western researches comes during the first century Hijri, within one hundred years of the Prophet's (Peace be upon Him) migration to Medina from Mecca. Although Hadith and references to Sukuk are limited, there are clear references in the literature that help to establish the basis for modern Sukuk investments and their transfer.

Historical documents show that Imam Malik had recorded the first account of Sukuk in his famous treatise al Muwatta. It is stated that in the 7th century CE, the Umayyad government would pay soldiers and public servants both in cash and in kind. The payment in kind was in the form of Sukuk al Badai, which has been translated as 'commodity coupons'. These Sukuk were either redeemed on the maturity date against a fixed amount of food commodity, or sold to others for cash before maturity date.

The first effort to issue Islamic bonds was made in the year 1978 when the Jordan government allowed the Jordan Islamic Bank to issue Muqaradah bonds. A similar effort was made in 1980 in Pakistan where a special law called the Mudarabah Companies and Mudarabah Flotation and Control Ordinance were introduced. Due to the lack of proper infrastructure and transparency in the market, neither of these two efforts resulted in any noteworthy activity in this spectrum. Later, in 1983 in Malaysia, the Islamic bonds were successfully introduced for the first time with the issuance of the Government Investment Issues (GII) - formerly known as the Government Investment Certificate (GIC).

Having provided a historical overview of Sukuk, let us now proceed to understand the definition of Sukuk.

Sukuk - Definition and Derivation

AAOIFI defines Sukuk as the "certificates of equal value representing undivided share in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity. However, this is true after receipt of the value of the Sukuk, the closing of subscription and the employment of funds received for the purpose for which the Sukuk were issued."

The Arabic word Sukuk is the plural of the word Sakk, meaning certificate which reflects participation rights in an underlying asset. The term Sukuk has been recognised in the traditional Islamic jurisprudence for a long time. The Shariah recognises and validates a financial asset that derives its return from the performance of an underlying real asset.

Formally, Sukuk represents proportionate beneficial/legal ownership of an asset for a defined period when the risk and the return associated with underlying assets in a pool are passed to the Sukuk holders or investors. Sukuk plays an important role for the investors by their ability to transfer assets into liquidity without long legal complications. The process of designing the Sukuk is similar to that of securitisation of assets in conventional markets. Just as in conventional securitisation, where a pool of assets is built and securities are issued against this pool, the Sukuk are issued as participation certificates against a single asset or a pool of assets.

The basic idea of securitisation in Islamic finance is to transform something, be it tangible assets, usufruct or receivables (subject to the conditions going to be discussed in following paragraphs), into papers that are later tradable in the secondary market. The transformation of something that is illiquid into liquid is the very essence of securitisation, not only in Islamic finance but also in conventional finance.

Before moving further to explore in detail the Sukuk, it is worth knowing about the Special Purpose Vehicle, generally known as SPV,

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Before moving further to explore in detail the Sukuk, it is worth knowing about the Special Purpose Vehicle, generally known as SPV,



which plays a vital role in the process of securitisation and issuing Sukuk.

Special Purpose Vehicle (SPV)

Special Purpose Vehicle (SPV) is a separate legal entity formed for the purpose of managing the securities issues. As such, an SPV is capital and tax efficient. All the operations of an SPV are limited to the acquisition and financing of specific assets. The major characteristic feature of an SPV includes bankruptcy remote. It plays a role in collecting the investment amounts, in purchasing the assets, to issuing the Sukuk and to making initiation of bankruptcy or insolvency proceedings.

SUKUK CATEGORIES

The Sukuk have been categorized into two broad categories as follows:

- i. *Asset based Sukuk*
- ii. *Debt-based Sukuk*

Asset-based Sukuk:

Asset-based Sukuk are Sukuk in which the asset remains with the issuer or the investor or the owner throughout the maturity period (of the Sukuk). In this type of Sukuk, the pay-off to the investors is linked to the performance of the assets.

Example: Sukuk al-Musharaka, Sukuk al-Mudaraba, Sukuk al-Ijarah, Sukuk al-Wakala are some of the Asset-based Sukuk.

Debt-based Sukuk:

Debt-based Sukuk are Sukuk in which the asset does not remain with the issuer or the investor or the owner throughout the maturity period (of the Sukuk). In this type of Sukuk, the pay-off to the investors is linked to the credit risk of the originator.

Example: Sukuk al Murabaha, Sukuk al-Istisna and Sukuk-al-Salam are some of the Debt-based Sukuk.

Chart showing categories of Sukuk		
Type	Sukuk Name	Basic Feature
Asset-based Sukuk	Sukuk al-Musharaka, Sukuk al-Mudaraba, Sukuk al-Ijarah, Sukuk al-Wakala	The pay-off to the investors is linked to the performance of the assets.
Debt-based Sukuk	Sukuk al Murabaha, Sukuk al-Istisna, Sukuk-al-Salam	The pay-off to the investors is linked to the credit risk of the originator.

DIFFERENT TYPES OF SUKUK

Sukuk are generally differentiated on the basis of the Islamic Finance structure on which they are designed or structured. There are various types of Sukuk that have been structured and issued using different Islamic Finance structures so far. Let us explore each of the types of Sukuk in detail.

Sukuk al-Musharaka:

According to AAOIFI, these are certificates of equal value issued with



Formally, Sukuk represents proportionate beneficial/legal ownership of an asset for a defined period when the risk and the return associated with underlying assets in a pool are passed to the Sukuk holders or investors. Sukuk plays an important role for the investors by their ability to transfer assets into liquidity without long legal complications.

the aim of using the mobilised funds for establishing a new project, developing an existing project or financing a business activity on the basis of any of partnership contracts so that the certificate holders become the owners of the project or the assets of the activity as per their respective shares. The issuer of these certificates is the inviter to a partnership and the subscribers are the partners in the contract. The realised funds are the share contribution of the subscribers to Musharaka capital. The certificate holders own the assets of partnership and are entitled to their share both in the profits and inviter losses.

Musharaka is a partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on condition that the profit is distributed according to the partnership agreement and losses are borne in accordance with the contribution of each partner to the capital.

Musharaka arrangements can be structured in a number of ways; however, in practice, the following two structures are utilised for the purposes of issuing Sukuk:

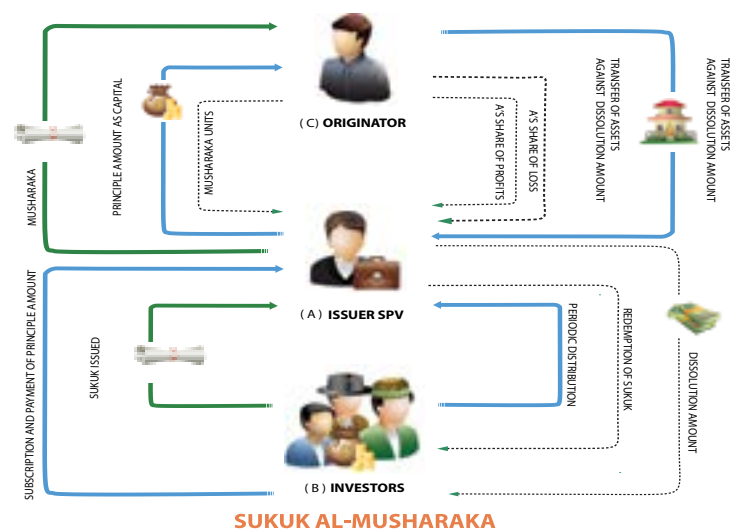
The transformation of something that is illiquid into liquid is the very essence of securitisation, not only in Islamic finance but also in conventional finance.



a. Contractual Partnership (Shirkat al-'Aqd): Contract partnership is an agreement between two or more parties to combine their assets or to merge their services or obligations and liabilities with the aim of making profit.

b. Partnership of Ownership (Shirkat al-Melk): Partnership of ownership is a combination of the assets of two or more persons in a manner that creates a state of sharing the realised profit or income or benefitting from an increase in the value of the partnership assets. This combination of assets for making profit necessitates bearing losses, if any. The ownership partnership is created by events beyond the partners' control such as the inheritance rights of heirs in the legacy of deceased person. This partnership is also created by the wish of partners such as when two or more parties acquire common shares in a particular asset.

STRUCTURE OF SUKUK-AL MUSHARAKA:



Mechanism of Sukuk al-Musharaka (shirkat-al Aqd):

1. Issuer SPV issues prospectus and the Investors subscribe and pay the proceeds as the Principal Amount.
2. After receiving the Principal Amount, Issuer SPV issues the Sukuk to the Investors. The Sukuk represent an undivided ownership in

an underlying asset going to be purchased. They also represent a right of the Investors to the Periodic Distribution Amount and the Dissolution Amount.

3. Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors.
4. Issuer SPV enters into a Musharaka arrangement with the Originator and both agree on their contribution to the capital of Musharaka and allocate a number of units in the Musharaka in proportion to their capital contribution.
5. Issuer SPV pays the Principal Amount to the Originator as its contribution to the Musharaka capital.
6. The Originator transfers the Musharaka units to the Issuer SPV in accordance with its capital contribution.
7. In addition to the capital contribution, the Originator also manages the Musharaka Enterprise or Assets.
8. On each Periodic Distribution Date, the Originator pays the actual profits generated by the Musharaka Assets to Issuer SPV in proportion to its capital contribution or in a pre-agreed ratio.
9. If the actual share of Issuer SPV's profit exceeds its pre-defined expectation, then the excess amount is given to the Originator as an incentive for its good performance.
10. Issuer SPV pays each Periodic Distribution Amount to the Investors using the profit it has received from the Musharaka Assets.
11. In case of loss, both Issuer SPV and the Originator shall share that loss in proportion to their capital contribution only.
12. In case of maturity or default or pre-payment, the Investors would redeem the Sukuk to Issuer SPV against the Dissolution Amount.
13. At the maturity, default or pre-payment of Sukuk, Originator pays the Dissolution Amount to Issuer SPV.
14. Issuer SPV pays the Dissolution Amounts to the Investors using the amount it has received from Originator.
15. In the event of maturity or default the Issuer SPV, by exercising its rights under the Purchase Undertaking, obligates the Originator to purchase the Assets from Issuer SPV
16. In case of pre-payment, tax payment or any other event as agreed between the parties, the Originator, by exercising its rights under the Sale Undertaking, obligates the Issuer SPV to sell the Assets to the originator.

Key Features of the Underlying Structure

- The Musharaka Enterprise or Assets must be Shariah-compliant.
- The ratio of profit sharing must be mutually agreed at the outset in terms of percentage of the realized profit and not a lump sum amount or a percentage of the Musharaka capital contribution.
- Before the maturity or termination of Musharaka, the profit shall be distributed among the parties by constructive liquidation of Musharaka Assets.
- The Musharaka assets must comprise of at least 33% or, as per few Shariah scholars' opinion upto 50% of tangible asset for the purpose of tradability.
- The losses must be borne by the parties in proportion to their capital contribution.
- Both Originator and Trustee can, from a Shariah perspective, terminate the Musharaka at any time after giving notice.
-

Required Documentation

- Prospectus between the Issuer SPV as Issuer and the Investor as Subscriber.



In case of loss, both the Investors and the Fund Manager share the loss in proportion to their capital contributions.

- Trusteeship agreement between SPV as Trustee and Investor as Principal.
- Musharaka Agreement between the Originator and the Issuer SPV as partners.
- Master Purchase Agreement between the Originator as purchaser and the Supplier as Seller.
- Management Agreement between the Issuer SPV as partner and the Originator as Managing Partner or Agent.
- In the event of maturity and default, a unilateral Purchase Undertaking by the Originator as purchaser and a unilateral Sale Undertaking by the Issuer SPV as Seller.
- Sale and Purchase Agreement between the Issuer as Seller or Purchaser and the Originator as Purchaser or Seller.

The issuer of these certificates is the inviter to a partnership and the subscribers are the partners in the contract. The realised funds are the share contribution of the subscribers to Musharaka capital. The certificate holders own the assets of partnership and are entitled to their share both in the profits and inviter losses.

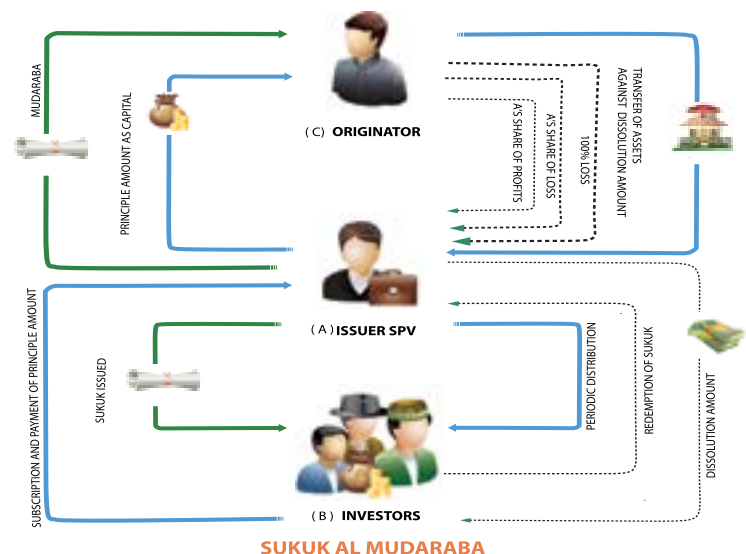


Sukuk al-Mudaraba:

According to AAOIFI, these are certificates that represent projects or activities managed on the basis of Mudaraba by appointing one of the partners or another person as the Mudarib for the management of the operation. The issuer of these certificates is the Mudarib, the subscribers are the owners of the capital (Arbabul Maal), and the realised funds are the Mudaraba Capital. The certificates holders own the assets of Mudaraba and the realised profits are distributed among the Mudarib and the owners of the capital, while the loss is borne only by the capital owners (Arbabul Maal).

Mudaraba is a partnership in profit whereby one party provides capital (Rab-al-Maal) and the other party provides labour (Mudarib). The same characteristics of the Mudaraba structure can also be adopted for use as the underlying structure in a Sukuk issuance as each Investor's purchase of Sukuk would represent units of equal value in the Mudaraba capital, and are registered in the names of the Sukuk certificate holders on the basis of undivided ownership of shares in the Mudaraba Capital. The returns to the investors from the Mudaraba Capital would be distributed at a pre-agreed ratio between the Rab-al-Maal and the Mudarib, which would then pass to the Investors according to each investor's percentage of investments in Sukuk Mudaraba.

STRUCTURE OF SUKUK AL-MUDARABA:



Mechanism of Sukuk al-Mudaraba:

1. Issuer SPV issues the prospectus and the Investors subscribe and pay the proceeds as the Principal Amount.

2. Issuer SPV, after receiving the Principal Amount, issues the Sukuk to the Investors. The Sukuk represent an undivided ownership in the Mudaraba asset. They also represent a right of the Investors to the Periodic Distribution Amount and the Dissolution Amount.
3. Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors.
4. Issuer SPV and the Originator enter into a Mudaraba Agreement. As per the agreement the Originator acts as Mudarib and the Issuer SPV as Rab al- Maal.
5. Issuer SPV pays the Principal Amount to the Originator as capital to the Mudaraba Enterprise.
6. The Originator, as a Mudarib, contributes its expertise and management skills to the Mudaraba Enterprise.
7. Profits generated by the Mudaraba Enterprise are divided between the Issuer SPV and the Originator in accordance with the profit sharing ratios set out in the Mudaraba Agreement. The time period agreed to carry out Mudaraba Enterprises is equal to the maturity period of the Mudaraba Sukuk.
8. The Originator pays the share of Mudaraba profits to Issuer SPV.
9. Issuer SPV as Trustee pays each Periodic Distribution Amount to the Investors using the share of Mudaraba profits it has received from the Originator.
10. In addition to its profit share, the Originator as Mudarib may be granted some incentive for providing its expertise and management skills if the profit generated by the Mudaraba Enterprise exceeds a benchmarked return. This incentive (if any) would either be calculated at the end of the Mudaraba term and upon liquidation of the Mudaraba or on each Periodic Distribution Date.
11. Losses in Mudaraba Enterprises shall be borne only by the Issuer SPV.
12. In case of maturity or default or pre-payment, the Investors would redeem the Sukuk to Issuer SPV against the Dissolution Amount.
13. At the maturity, default or pre-payment of Sukuk, the Originator pays the Dissolution Amount to Issuer SPV against the purchase of the Mudaraba assets belonging to the investors
14. Issuer SPV pays the Dissolution Amounts to the Investors using the amount it has received from the Originator.
15. In the event of maturity or default the Issuer SPV, by exercising its rights under the Purchase Undertaking, would obligate the Originator (Mudarib) to purchase the Assets from Issuer SPV at the applicable Exercise Price.
16. In case of pre-payment, tax payment or any other event, the Originator (Mudarib), by exercising its rights under the Sale Undertaking, would obligate the Issuer SPV to sell the Assets to the Originator at the applicable Exercise Price.

Key Features of the Underlying Structure

- The Mudaraba Enterprise must be Shariah-compliant.
- The Originator (as Mudarib) should perform its obligations with the degree of skill and care that it would exercise in respect of its own assets;
- The Mudaraba would be entered into on a restricted basis (al-Mudaraba al- Muqayyadah) in which the Originator (as Mudarib) must invest the Sukuk proceeds in accordance with the specified investment plan. For Shariah purposes, at least 33% of the capital of the Mudaraba enterprise should be invested in tangible assets at all times.



Any profit distributed prior to maturity or termination of the Musharaka is deemed to be in advance and is treated as an “on account” payment which shall be adjusted to the actual profit the Originator and Trustee are entitled to at that time.

The issuer of these certificates is the Mudarib, the subscribers are the owners of the capital (Arbabul Maal), and the realised funds are the Mudaraba Capital. The certificates holders own the assets of Mudaraba and the realised profits are distributed among the Mudarib and the owners of the capital, while the loss is borne only by the capital owners (Arbabul Maal).



- The profit sharing ratio between the Issuer SPV (as Rab-al-Maal) and the Originator (as Mudarib) must be agreed upon at the time of conclusion of the Mudaraba Agreement.
- Any losses of the Mudaraba Enterprise would be borne only by Issuer SPV (as Rab-al- Maal) except in case of fraud, willful misconduct and negligence on the party of Mudarib.
- No guarantee of return shall be given by the Originator (Mudarib) either for the Principal amount or any return thereupon to the issuer SPV (Rab-al-Maal) or Investors.

Required Documentation

- Prospectus between Issuer SPV as issuer and the Investors (B) as subscriber.
- Trusteeship agreement between Issuer SPV as Trustee and Investors as Principal.
- Mudaraba Agreement between the Originator as Mudarib and Issuer SPV as Rab-al-Maal.
- Master Purchase Agreement between the Originator as Purchaser and the Supplier as the Seller.
- In the event of maturity and default, a unilateral Purchase Undertaking by the Originator as Purchaser and a unilateral Sale Undertaking by Issuer SPV as Seller.
- Sale and Purchase Agreement between Issuer SPV as Seller or Purchaser and the Originator as Purchaser or Seller.

SUKUK AL-IJARAH:

According to AAOIFI, these are certificates of equal value issued either by the owner of a leased asset or a tangible asset to be leased by promise, or they are issued by a financial intermediary acting on behalf of the owner with the aim of selling the asset and recovering the value through subscription so that the holder of the certificates becomes owner of the assets.

The issuer of these certificates is the seller and the subscribers are the buyers. The funds mobilised through the subscription are the purchase price of the asset. The certificates holders jointly own the asset and share the profit and losses. It is permissible to set up a parallel Ijarah on tangible asset by employing the same description for the usufruct that was provided to the holders of the Sukuk. The two lease contracts must remain independent.

The term Ijarah means leasing of property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration. One of the forms of Ijarah is Ijarah Muntahia-Bittamleek. This is a form of leasing contract which includes a promise by the lessor to transfer the ownership in the leased property to the lessee, either at the end of the term of the Ijarah period or through stages during the term of the contract.

The Ijarah Sukuk can be used to provide regular payments throughout the life of a financing arrangement to the investors. In addition, the use of a purchase undertaking is widely accepted in the context of Sukuk al-Ijarah through Ijarah-Muntahia-Bittamleek contract. These characteristics make Ijarah relatively straightforward to adapt for use in the underlying structure for a Sukuk issuance.

Shariah scholars have permitted to structure an Ijarah Sukuk in any of the following three lease forms:

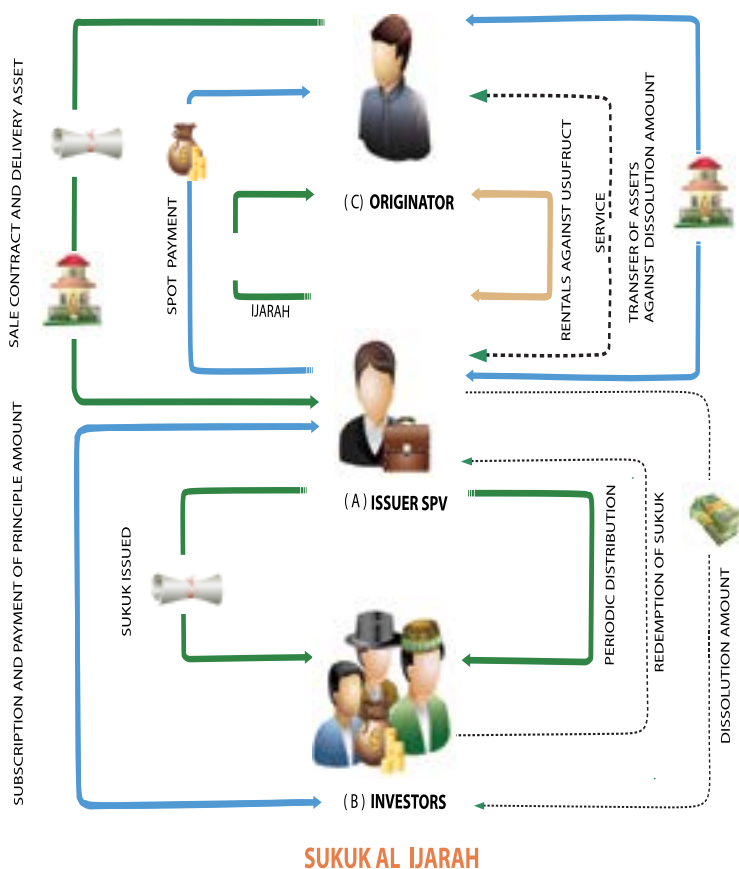
- i. Purchase-lease-back: Under this structure, the leased asset is

purchased and leased back to the same person from whom the asset was purchased. In this case, however, if the property is already leased, the ongoing lease contract must be terminated before the sale of the asset.

ii. Purchase-lease: Under this structure, the asset is purchased from a third party and leased by the lessee to another party.

iii. Head lease-sublease: Under this structure, there are two lease contracts. The first is the head-lease through which the leased asset is taken on lease for a long-term, say for 50 years. And the second is the sub-lease, under which the lease asset is leased back to the same person who is lessor in first lease contract, for a short period, say for 5 years.

STRUCTURE OF SUKUK AL-IJARAH (PURCHASE AND LEASE BACK):



Mechanism of Sukuk al-Ijarah (Purchase and leaseback):

1. Issuer SPV issues prospectus and the Investors subscribe and pay the proceeds as the Principal Amount.
2. Issuer SPV after receiving the Principal Amount issues the Sukuk to the Investors. The Sukuk represent an undivided ownership in an underlying asset going to be purchased. They also represent a right of the Investors to the Periodic Distribution Amount and the Dissolution Amount.
3. Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors.
4. The Originator enters into a sale and purchase arrangement with Issuer SPV. As per the agreement, the Originator sells and delivers the tangible assets to the Issuer SPV.
5. Issuer SPV pays the Principal Amount as the purchase price for the tangible asset to the Originator.
6. Issuer SPV and the Originator enter into an Ijarah contract.



Under this structure, the leased asset is purchased and leased back to the same person from whom the asset was purchased. In this case, however, if the property is already leased, the ongoing lease contract must be terminated before the sale of the asset.

Issuer SPV and the Originator will enter into a service agency agreement whereby Issuer SPV will appoint the Originator as its Servicing Agent to carry out certain of its obligations under the lease arrangement, namely the obligation to undertake any major maintenance, insurance (or takaful) and payment of taxes in connection with the assets on behalf of Issuer SPV.



- As per the contract Issuer SPV leases the agreed assets to the Originator for a term that reflects the maturity of the Sukuk against specific and periodic rentals.
7. The Originator as a lessee utilises the usufruct of the asset delivered by Issuer SPV as lessor and makes rental payments at regular intervals. The amount of each rental is periodically distributed among the Investors.
 8. This amount may be calculated by reference to a fixed rate or variable rate (to a benchmark) depending on the denomination of Sukuk issued and subject to mutual agreement of the parties in advance.
 9. Issuer SPV and the Originator will enter into a service agency agreement whereby Issuer SPV will appoint the Originator as its Servicing Agent to carry out certain of its obligations under the lease arrangement, namely the obligation to undertake any major maintenance, insurance (or takaful) and payment of taxes in connection with the assets on behalf of Issuer SPV.
 10. Issuer SPV pays each Periodic Distribution Amount to the Investors using the rental it has received from the Originator.
 11. In case of the maturity or default or pre-payment, the Investors would redeem the Sukuk to Issuer SPV against the Dissolution Amount.
 12. At the maturity, default or pre-payment of Sukuk, the Originator pays the Dissolution Amount to Issuer SPV against the purchase of the lease assets.
 13. Issuer SPV pays the Dissolution Amounts to the Investors using the amount it has received from the Originator.
 14. In the event of default, the Issuer SPV, by exercising its rights under the Purchase Undertaking, obligates the Originator to purchase the Assets from Issuer SPV at the applicable Exercise Price, which will be equal to the outstanding fixed rental (outstanding Principal Amount) plus any accrued but unpaid variable rental owing to the Investors.
 15. In case of pre-payment, tax payment or any other event the Originator, by exercising its rights under the Sale Undertaking, obligates the Issuer SPV to sell the Assets to the Originator at the applicable Exercise Price, which will be equal to the outstanding fixed rental (outstanding Principal Amount) plus any accrued but unpaid variable rental owing to the Investors.

Key Features of the Underlying Structure

- The Ijarah asset and its use must be Shariah-compliant.
- The ownership of the asset(s) must remain with the Issuer SPV or lessor and only the usufruct right may be transferred to the originator or Lessee.
- The lease rentals must be specific at an agreed rate and for an agreed period.
- The liabilities or the risk arising from the ownership must also rest with the Trustee (as Owner).
- Any liabilities relating to the use of the asset(s), however, rest with the Originator (as Lessee).
- In the event of the total loss to the asset, the lease contract may be terminated.
- If the total loss is caused by the misuse or negligence of the lessee, then the lessee will be liable to compensate the lessor (Issuer SPV) for depreciation in the value of the affected asset.
- In the event that an asset has only suffered partial loss or damage, Ijarah will continue to survive with respect to the remaining asset and the rental shall be recalculated or adjusted accordingly.

- ### Sukuk al-Wakala:

Wakala can be defined as the delegation of one person (the Principal) for another (the Agent) to take their place in a known and permissible dealing. In this regard, the agent (Wakil) represents and deals for and on behalf of the principal. A principal (the investor) appoints an agent (Wakil) to invest funds provided by the principal into a pool of investments or assets, and the Wakil lends its expertise and manages those investments on behalf of the principal for a particular duration, in order to generate an agreed upon profit return.

If the total loss is caused by the misuse or negligence of the lessee, then the lessee will be liable to compensate the Trustee for depreciation in the value of the affected asset.

The diagram illustrates the Sukuk Issuance Process involving three main parties: **INVESTOR**, **SPV (ISSUER)**, and **ORIGINATOR**.

- INVESTOR** provides the **Payment of Investment Amount** to the **SPV (ISSUER)**.
- The **SPV (ISSUER)** issues the **Prospectus** to the **INVESTOR**.
- The **SPV (ISSUER)** provides the **Periodic Distribution of Profit** to the **INVESTOR**.
- The **SPV (ISSUER)** provides the **Sukuk Redemption** to the **INVESTOR**.
- The **ORIGINATOR** provides the **Investment Wakala Agreement** to the **SPV (ISSUER)**.
- The **ORIGINATOR** provides the **Incentive** to the **SPV (ISSUER)**.
- The **ORIGINATOR** provides the **Profit** to the **SPV (ISSUER)**.
- The **ORIGINATOR** provides the **Investment in Wakala Assets** to the **SPV (ISSUER)**.
- The **SPV (ISSUER)** provides the **Principal Amount** to the **ORIGINATOR**.
- The **SPV (ISSUER)** provides the **Profit Payment** to the **ORIGINATOR**.
- The **ORIGINATOR** **Establishes SPV**.

The **INVESTMENT AVENUES** are highlighted in a box at the bottom.

In the event that an asset has only suffered partial loss or damage, Ijarah will continue to survive with respect to the remaining asset and the rental shall be recalculated or adjusted accordingly.

Islamic Banking: Principles and Practices



Mechanism of Sukuk al-Wakala:

1. Issuer SPV issues the prospectus and the Investors subscribe and pay the proceeds as the Principal Amount.
2. Issuer SPV after receiving Principal Amount issues the Sukuk to the Investors. The Sukuk represent an undivided ownership in an underlying asset going to be purchased. They also represent a right of the Investors to the Periodic Distribution Amount and the Dissolution Amount.
3. Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors.
4. Issuer SPV enters into a Wakala agreement with the Originator. As per the agreement Issuer SPV acts as the Principal and the Originator as Wakil. The Originator agrees to manage the wakala assets .
5. Issuer SPV purchases the assets from the Originator using the Sukuk proceeds it has received from the investors.
6. Wakala assets will be held and managed by the Originator, on behalf of the Issuer SPV, for the duration of the Sukuk in order to generate an expected profit to be agreed upon.
7. The Originator transfers the profit or income generated by Wakala asset to Issuer SPV. Normally, the ratio of the profit or the amount of the income would be the amount equal to each Periodic Distribution Amount. In case of the a shortfall in the periodic distribution amount due to less income generated from the wakala assets, the agent arranges the finance on behalf of the Issuer SPV to cover the shortfall.
8. Issuer SPV pays the Periodic Distribution Amounts to the Investors on the relevant Periodic Distribution Dates.
9. Any profit in excess of the Periodic Distribution Amounts will be paid to the Originator as an incentive fee by Issuer SPV at the end.
10. In case of the maturity or default or pre-payment, the Investors would redeem the Sukuk to Issuer SPV against the Dissolution Amount.
11. Issuer SPV pays the Dissolution Amounts to the Investors using the amount it has received from Originator.
12. In the event of default, maturity or early payment the Originator purchases the wakala assets from the Issuer SPV on an exercise price which is equal to the principal and the unpaid periodic distribution amounts.

Key Features of the Underlying Structure:

- The Wakala arrangement and the Wakala asset must be within the boundaries of Shariah principles.
- The subject matter of the Wakala agreement that includes the duration of the Wakala, the type or criteria of assets that the Wakil can select, the fees payable to the Wakil for the services, etc., must be specific and clear.
- The Wakil must be paid a fee, even if nominal, in order for the Wakala to be valid.
- Wakala assets must comply with eligibility criteria. First, at least 30% of the portfolio of assets should comprise of tangible assets (such as Ijarah or equities or other asset-based Sukuk).
- In order to ensure the continuing acceptance and tradability of the Sukuk (in case where two or more types of contracts are combined to form a portfolio), it will be necessary to introduce safeguards into the documentation to ensure that the net asset value of Ijarah contracts (together with underlying assets), shares and asset- based Sukuk certificates (i.e. non-Sukuk al-Murabaha) comprised of the Sukuk assets as at any given date is not less than 30% of the net asset value of the Sukuk assets (taken as a whole) as at the closing date.

- Principal Amounts from the underlying financial assets should never be used for service coupon payments under the Sukuk.
- Wakala fee can be combined with incentive fees payable at maturity based on the overall performance of the Sukuk assets.

Required Documentation

- Prospectus between the Issuer SPV as Issuer and the Investors as Subscriber.
- Trusteeship agreement between the Issuer SPV as Trustee and the Investors as Principal.
- Wakala Agreement between the Issuer SPV as Principal and the Originator as Wakil.
- Master Purchase agreement between the Originator as Purchaser and the Supplier as Seller.
- In the event of maturity and default, a unilateral Purchase Undertaking by the Originator as Purchaser and a unilateral Sale Undertaking by the Issuer SPV as Seller.
- Sale and Purchase Agreement between the Issuer SPV as Seller or Purchaser and the Originator as Purchaser or Seller.

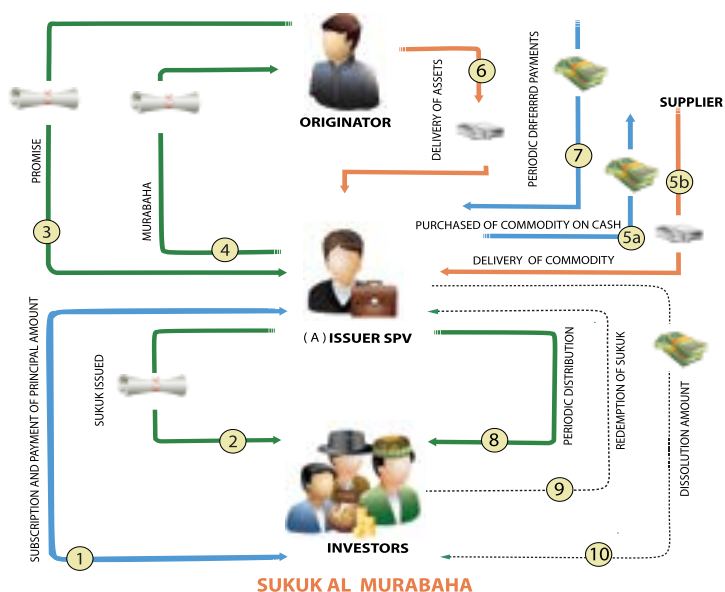
Sukuk al-Murabaha:

According to AAOIFI, these are certificates of equal value issued for the purpose of financing the purchase of goods through Murabaha so that the certificate holders become the owners of the Murabaha commodity.

The issuer of these certificates is the seller of the Murabaha commodity, the subscribers are the buyers and the realised funds are the purchasing cost of the commodity. The certificate holders own the commodity and are entitled to its sale price. It is not permissible to trade in Murabaha certificates after delivery of the Murabaha commodity to the buyer.

The same characteristics of the Murabaha structure can also be adapted for use as the underlying structure in a Sukuk issuance. Sukuk proceeds from Investors may be applied by Issuer SPV to acquire commodities and sell such commodities to the Originator to generate revenue from the Murabaha deferred price which would be distributed to the Investors throughout the term of the Sukuk al-Murabaha.

STRUCTURE OF SUKUK AL-MURABAHA:



Wakala assets must comply with eligibility criteria. First, at least 30% of the portfolio of assets should comprise of tangible assets (such as Ijarah or equities or other asset-based Sukuk).

Mechanism of Sukuk al-Murabaha:

1. Issuer SPV issues the prospectus and the Investors subscribe and pay the proceeds as the Principal Amount.
2. The Issuer SPV after receiving the Principal Amount issues the Sukuk to the Investors. The Sukuk represent an undivided ownership in murabaha assets. They also represent a right of the Investors to the Periodic Distribution Amount and the Dissolution Amount.
3. The Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors.
4. The Originator issues a unilateral Promise in favour of the Issuer SPV to purchase the commodities or asset on Murabaha basis if Issuer SPV purchases the assets from a third party.
5. Issuer SPV purchases the Commodities from the Supplier and pays the Cost Price on spot.
6. Supplier makes the delivery of the Commodities to Issuer SPV in consideration for the Cost Price paid on the spot.
7. Originator enters into a Murabaha Agreement with the Issuer SPV, where the Originator is the purchaser and the Issuer SPV is the Seller.
8. Issuer SPV sells and delivers the Murabaha Commodities to the Originator under Murabaha Sale.
9. Originator makes the (deferred) payments of Murabaha Sale Price at regular intervals to the Issuer SPV. The amount of each deferred payment or installment is distributed among the investors on Distribution Date. The period for the payment of the deferred price will reflect the maturity of the Sukuk.
10. In case of the maturity or default or pre-payment, Investors would redeem the Sukuk to Issuer SPV against the Dissolution Amount.
11. At the redemption Issuer SPV pays the remaining deferred sale price (equal to the Principal amount) to Investors as Dissolution Amount.

Key Features:

- The Murabaha commodities or assets must be Shariah-compliant.
- The Issuer SPV can appoint the Originator as its buying agent under a buying agency agreement to buy the commodities from the Supplier in its capacity as agent.
- The Issuer SPV must disclose the cost price and the profit margin in the Murabaha Sale Contract.
- The deferred price must be known as lump-sum amount and payment terms must be agreed between the parties.

Required Documentation

- Prospectus between the Issuer SPV as Issuer and the Investors as Subscriber.
- Trusteeship Agreement between the Issuer SPV as Trustee and the Investors as Principal.
- Sale and Purchase Agreement between the Issuer SPV as Purchaser and the Supplier as the Seller.
- Murabaha Sale Agreement between the Originator as Purchaser and the Issuer SPV as Seller.

Sukuk al-Istisna:

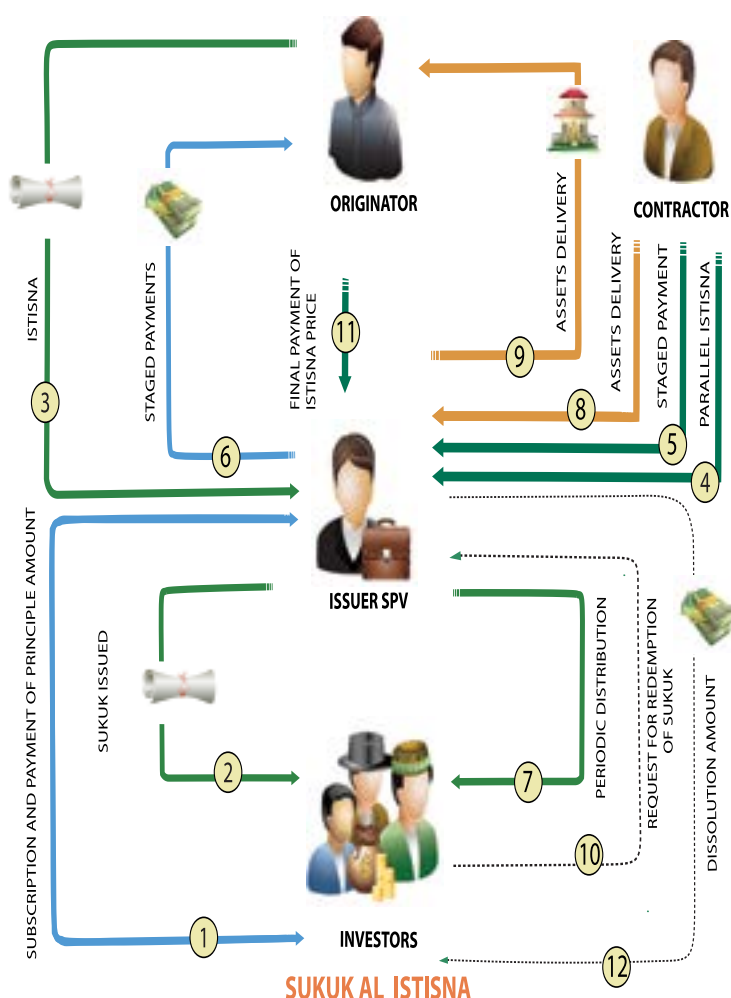
According to AAOIFI, these are the certificates of equal value issued with the aim of mobilising funds to be employed for the production of goods so that the goods produced come to be owned by the certificate holders.



The issuer of these certificates is a manufacturer (supplier/seller), the subscribers are the buyers and the funds realised from subscription are the cost of the product. The certificates holders are the owners, and are entitled to the sale price of the certificates or the sale price of product sold on the basis of a parallel Istisna. It is permissible to trade in or redeem Istisna certificates if the funds have been converted into assets owned by certificates holders.

Istisna is a contract of sale of specified items to be manufactured or constructed with an obligation on the part of the manufacturer or builder (contractor) to deliver them to the customer upon completion. The same characteristics are used to designing the Istisna Sukuk. Istisna arrangement is often combined with a lease arrangement (Ijarah Mowsufa-Fi-al-Dhimmah), through which the investors can advance funds to an originator and also seek periodical payment on the Ijarah contract.

STRUCTURE OF SUKUK-AL-ISTISNA:



Mechanism of Sukuk-al-Istisna:

1. Issuer SPV issues the prospectus and the Investors subscribe and pay the proceeds as the Principal Amount.
2. The Issuer SPV, after receiving Principal Amount, issues the Sukuk to the Investors. The Sukuk represents an undivided ownership in an underlying asset going to be built or manufactured. They also represent a right of the Investors to the Periodic Distribution Amount and the Dissolution Amount.
3. Issuer SPV declares a trust over the proceeds and thereby acts as



The same characteristics of the Murabaha structure can also be adopted for use as the underlying structure in a Sukuk issuance. Sukuk proceeds from Investors may be applied by Issuer SPV to acquire commodities and sell such commodities to the Originator to generate revenue from the Murabaha deferred price which would be distributed to the Investors throughout the term of the Sukuk al-Murabaha.

Trustee on behalf of the Investors.

4. The Originator (as Mustasne) enters into an Istisna agreement with Issuer SPV (as San'e). As per the contract, the Issuer SPV agrees to manufacture or construct the Istisna Assets and undertakes to deliver those assets at a specified future date.
5. The Issuer SPV (as Mustasne) enters into a parallel Istisna contract with the ultimate contractor (as San'e).
6. Issuer SPV (as Mustasne) pays the Istisna Asset purchase price in staged payments to the ultimate contractor (San'e).
7. Generally, during the construction period, the Originator (as Mustasne) pays to the Issuer SPV (San'e) only that part of Istisna Price which is equal to the profit portion. In some cases, depending upon the Sukuk maturity, such payment continues even after the construction is completed.
8. Issuer SPV pays each Periodic Distribution Amount to the Investors using the money it has received from the Originator (Mustasne).
9. The ultimate contractor (San'e) delivers the Istisna Assets at regular intervals in different stages or at the time of final completion to the Issuer SPV (Mustasne).
10. Similarly, the Issuer SPV (as Sane) delivers the Istisna Asset to the Originator (Mustasne) in the same way it receives from the ultimate contractor (San'e).
11. In case of the maturity or default or pre-payment, the Investors would request the Issuer SPV to redeem the Sukuk against the Dissolution Amount.
12. At the maturity, default or pre-payment of Sukuk, the Originator pays the remaining amount of the Istisna sale price (Dissolution Amount) to Issuer SPV which is ultimately paid to the investors. Against such payment by the Originator (Mustasne) the mortgage, if there is any, over the Istisna Asset, is released by the Issuer SPV.



Key Features of the Underlying Structure

- The Istisna Asset must be Shariah-compliant.
- The price and specifications for the goods or asset to be manufactured or constructed need to be specified at the outset.
- The payment for Istisna asset have the flexibility and can either be made in different stages corresponding to certain stages of manufacturing or upfront or at the time of delivery.
- The purchaser may fix a maximum time for delivery. And if delivery is made after the scheduled completion date, then the purchaser has the right to reject the goods.

Required Documentation

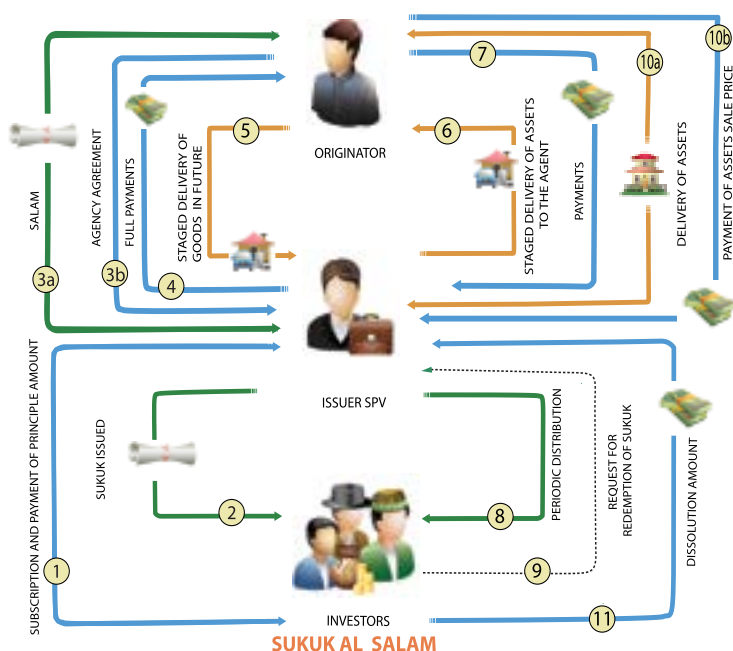
- Prospectus between the Issuer SPV as Issuer and the Investors as Subscriber.
- Trusteeship agreement between the Issuer SPV as Trustee and the Investors as Principal.
- Istisna Agreement between the Issuer SPV as Purchaser and the Originator as the Contractor.
- Lease (Ijarah Mowsufa-Fi-al-Dhimmah) Agreement between the Issuer SPV as Lessor and the Originator as Lessee.
- Service Agency Agreement between the Issuer SPV as Principal and the Originator as Servicing Agent.
- In the event of default or maturity a unilateral Purchase undertaking by the Originator as Purchaser and a unilateral Sale undertaking by the Issuer SPV as Seller.
- Sale and Purchase Agreement between the Issuer SPV as Seller or Purchaser and the Originator as Purchaser or Seller.

Sukuk al-Salam:

According to AAOIFI, these are the certificates of equal value issued for the purpose of mobilising Salam capital so that the goods to be delivered on the basis of Salam come to be owned by the certificate holders. The issuer of these certificates is the seller of goods of Salam and the subscribers are the buyers. The funds realised from subscription are the purchased price of the goods. The holders of Salam certificates are the owners, and are entitled to the sale price of the certificates or the sale price of Salam goods sold through a parallel Salam. It is not permissible to trade in Salam certificates.

A Salam transaction is the purchase of the commodity for deferred delivery in exchange for immediate payment. It is a type of sale in which the price, known as the Salam Capital, is paid at the time of contracting, while the delivery of the item to be sold, known as Al-Musalam Fihi (the subject matter of a Salam Contract), is deferred. The seller and the buyer are known as Al-Musalam Ilaihi and Al-Musalam or Rab al-Salam, respectively. Sukuk al-Salam can be used to provide regular payments throughout the life of a financing arrangement to the Investor.

STRUCTURE OF SUKUK AL-SALAM:



Mechanism of Sukuk al-Salam:

1. Issuer SPV issues the prospectus and the Investors subscribe and pay the proceeds as the Principal Amount.
2. The Issuer SPV after receiving Principal Amount issues the Sukuk to the Investors. The Sukuk represent an undivided ownership in an underlying asset going to be purchased. They also represent a right of the Investors to the Periodic Distribution Amount and the Dissolution Amount.
3. The Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors.
4. The Originator enters into Salam contract with the Issuer SPV. As per the contract, the Originator agrees to sell, and the Issuer SPV agrees to purchase, the Salam Assets on immediate payment and deferred delivery terms.
5. The Issuer SPV appoints the Originator as its agent to sell the salam assets on SPV's behalf.
6. The Issuer SPV pays the sale price in advance to the Originator as consideration for its purchase of the Salam Assets in an amount equal



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to the Principal Amount.

7. The quantity of the Salam Assets sold will typically be engineered at the outset to be an amount that is sufficient to make periodic deliveries of a proportion of the Salam Assets during the life of the Sukuk (in order to allow for payments of Periodic Distribution Amounts) and to make a single delivery of the remaining proportion of Salam Assets on maturity or an early redemption of the Sukuk in order to allow for payments of the Principal and any remaining due amount.
8. Prior to each date on which the Periodic Distribution Amounts are due to the Investors, the Originator delivers a proportion of the Salam Assets to the Issuer SPV.
9. Then the SPV delivers back the salam assets to the Originator (agent) to sell the same on behalf of the Issuer SPV and pay the relevant sale price to the Issuer SPV.
10. The Issuer SPV pays each Periodic Distribution Amount to the Investors using the Sale Price it has received from the Originator (Agent).
11. In case of the maturity or default or pre-payment, the Investors would redeem the Sukuk to Issuer SPV against the Dissolution Amount.
12. At the maturity, default or pre-payment of Sukuk, the Originator delivers the remaining quantity of salam assets to the Issuer SPV.
13. The Issuer SPV pays the Dissolution Amounts to the Investors using the amount it has received from the Originator.
14. It is to be noted in the event of maturity or default, the Originator will be obliged to deliver all the Salam Assets (which have not yet been delivered) to the Issuer SPV. The Issuer SPV will sell the Salam assets through its agent (Originator) at the applicable Exercise Price which will be equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors.

Key Features of the Underlying Structure

- Salam goods must be Shariah-compliant.
- The currency, amount and manner of payment of the Salam capital must be certain and specifically known to both the Trustee and the Originator.
- The Payment of the Salam capital must be made immediately or on the spot at the time of contract.
- The Salam Assets can only be fungible goods or individual articles which do not differ significantly, or the assets manufactured by companies that can be identified by standardised specifications.
- The assets cannot be gold, silver or any currency or any asset or item for which the Originator may not be held responsible (e.g. land or trees) or any asset or item whose value can change according to subjective assessment (e.g., precious stones).
- The quality, quantity and time of delivery of the Salam Assets must be clearly known to the Originator and the Trustee in a manner that removes any uncertainty or ambiguity which may lead to a dispute.
- The delivery of the Salam Assets can occur periodically by way of installments.
- The Trustee cannot sell the Salam Assets before it has taken delivery of the Salam Assets.
- The delivery of the Salam Assets prior to the agreed delivery date is permissible.
- The Sukuk certificates held by the Investors are generally non-tradable as they represent a debt (the debt being the future delivery of the Salam Assets). This is, however, the general position. In principle, once the Salam Assets (or a proportion thereof) have been delivered and provided that as a result of such delivery the tangibility of the pool of Sukuk assets at that time (i.e. the Salam Assets delivered) is

sufficient to satisfy Shariah requirements (which can vary between 33% and 50%), the Sukuk can be traded at that time.

- The liabilities associated with the Salam Assets remain with the Originator and only once the Salam Assets have been delivered to the Trustee do the liabilities pass to the Trustee.

Required Documentation

- Prospectus between the Issuer SPV as Issuer and the Investors as Subscriber.
- Trusteeship agreement between the Issuer SPV as Trustee and the Investors as Principal.
- Salam Agreement between the Originator as Seller and the Issuer SPV as Purchaser.
- In the event of maturity and default, a unilateral Purchase Undertaking by the Originator as Purchaser and a unilateral Sale Undertaking by the Issuer SPV as Seller.
- Sale and Purchase Agreement between the Issuer SPV as Seller or Purchaser and the Originator as Purchaser or Seller.

SUKUK AL-MUZARAA (SHARECROPPING):

These Sukuk are issued to use the fund raised through subscription in a cultivation project. It is structured on the basis of Muzara contract. The certificate holders become entitled to a share in the crop according to the terms of the agreement. In some cases, the issuer of these certificates is the owner of the land, the subscribers are the cultivators and the realised funds are the cultivation cost. In other cases, the issuer of these certificates may be the cultivator, the subscribers are the owners of the land and the certificates holders are entitled to a share of the produce of the land.

SUKUK AL-MUSAQA (IRRIGATION):

These Sukuk are issued to use the funds raised through subscription in an irrigation project such as providing irrigation to fruit bearing trees, spending on them and caring for them. It is structured on the basis of Musaqah contract. The certificate holders become entitled to a share in the crop as per the agreement. In some cases, the issuer of these certificates is the owner of the land that consists of trees; the subscribers are those who assume the obligation of irrigation through a Musaqah contract, while the realised funds are the maintaining cost of the trees. And in other cases, the issuer of these certificates may be the irrigator and the subscribers are the owners of the land, and the certificates holders are entitled to a share of the produce of the trees.

SUKUK AL-MUGHARASA (AGRICULTURAL):

These Sukuk are issued to use the funds raised through subscription in an agricultural project such as planting trees and undertaking the work and expenses required by such plantation. It is structured on the basis of Mugharasa contract. The certificate holders become entitled to a share in the land and the plantation. In some cases, the issuer of these certificates is the owner of the land suitable for planting, the subscribers are those who assume the obligation of planting on the basis of Mugharasa contract, while the realised funds are the cost of maintaining the plantation. In other cases, the issuer may be the planter, the subscribers the owners of the land and the certificates holders are entitled to share both the trees and the land as per agreement.

SUKUK AL-MANFAAH:

These Sukuk are issued by the owner of an existing asset with the aim of subleasing the usufruct and receiving rentals. Sukuk holders become owners of the usufruct. These are also part of asset based securitisation



It is to be noted in the event of maturity or default, the Originator will be obliged to deliver all the Salam Assets (which have not yet been delivered) to the Issuer SPV. The Issuer SPV will sell the Salam assets at the applicable Exercise Price which will be equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors.

though the asset is in the form of usufruct and services.

Sukuk al-Intifa:

These Sukuk are issued for the purpose of leasing out tangible future assets and for collecting rentals so that the usufruct of the described future asset passes into the ownership of the holders of the Sukuk. These are deemed to be part of asset-based securitisation though the underlying asset is the future services to be performed in the future.

Sukuk Milkiyyat al-Khadamat:

These Sukuk are issued for the sake of providing or selling services through a specified supplier (such as educational programmes in a nominated university) and obtaining the value in the form of subscription income, in which case the holders of the Sukuk become owners of the services. Similar to the other Ijarah based securities, these securities come under the purview of asset based securitisation.

Sukuk al-Khadamat al-Mawsufah-fi-al-Zimmah:

These Sukuk are issued for the purpose of providing future services through described providers (such as certain prescribed educational benefits from a university without naming the educational institution) and obtaining fee in the form of subscription income so that holders of the Sukuk become owners of the services. Services, though to be provided in the future are deemed as an asset, thus making this security a type of asset based securitisation.

KEY ISSUES RELATED TO SUKUK PRACTICES

Sukuk is one of the important features of the Global Islamic Finance industry. The growth and expansion of the Sukuk market in recent years is not hidden. Many nations, states and institutions have raised the required capital or funds through different types of Sukuk. On the other hand, the Sukuk instruments such as Sukuk-al-Mudaraba and Sukuk-al-Murabaha, etc, are subjected to strong criticism from the Shariah scholars on their operational or technical aspects. Let us explore a few of the issues related to global Sukuk practices.

Ownership:

As per the Shariah rule the ownership of the Sukuk assets must remain with the Investors. If there is any purchase or sale of the assets, then it must be real. There must be actual transfer of both physical and beneficial ownership of asset from one party to another.

Guarantee:

The Shariah scholars are very particular about guarantee in case of Sukuk-al-Mudaraba. They opine that as per Shariah the SPV or the fund manager is not allowed to provide a guarantee to the investors irrespective of the business realisation.

However, in case of providing guarantee in Sukuk, the option which can be thought of is the undertaking given by a third party. The third party can be an insurance company or a sovereign. The other option is to build a guarantee in the structure and let the directors of the client's company provide the guarantee in their individual capacity for the defaulted amount in the Sukuk.

Tradability:

Sukuk represents tangible assets or usufruct of such assets that can be traded in secondary market. The tradability of a particular Sukuk is decided on the factor whether that Sukuk creates debt or not. If any of the Sukuk create debt, they cannot be traded in secondary market. As per AAOIFI, Sukuk-al-Murabaha, Sukuk al-Istisna and Sukuk al-Salam cannot be

KEY DOCUMENTS RELATED TO SUKUK

Document	Parties	Details
Prospectus	Issuer and Subscribers	It is a document that includes the details of contract, the participants, the obligations, the investment, etc.
Trusteeship contract	Principal and Trustee	It is a contract between the SPV and the investor through which the investors entrust their monies to SPV for the purpose of investment.
Sale and Purchase Undertakings	Seller and Purchaser	The sale and purchase undertakings are the independent and unilateral promises based on which the sale and purchases contract are signed in order to transfer the ownership of asset from one party to another against the payment of purchase price.
Service Agency contract	Principal and agent	It is a contract under which the agent is entitled to act on behalf or in the interest of the Principal.
Relationship agreement	As per the contract	Musharaka, Mudaraba, Wakala, Salam, Istisna, Ijarah, etc. As per the contract the identity of two parties is defined.



traded either on premium or on discount except at par. However, Sukuk al Murabaha is tradable only if the receivables are less than 50% and Sukuk al-Istisna is tradable only if the funds are converted into assets before sale.

Redemption:

Generally Sukuk are redeemed on maturity at an Exercise Price already decided. But the redemption may also occur in the event of default or in pre-payment due to a tax event.

SNAPSHOT OF WHAT WE HAVE LEARNED

In this module we have learned about:

- Sukuk: The word Sukuk is the plural of the Arabic word Sakk, meaning certificate, which reflects participation rights in an underlying asset. Sukuk appears to have begun in the early Islamic caliphates.
- Sukuk has been recognized by prominent institutions such as International Islamic Fiqh Academy and Accounting & Auditing Organization for Islamic Finance Institutions (AAOIFI).
- Asset-based Sukuk are those in which the asset remains with the the investors as the owner throughout the maturity period (of the Sukuk). In this type of Sukuk, the pay-off to the investors is linked to the performance of the assets. Example: Sukuk al-Musharaka, Sukuk al-Mudaraba, Sukuk al-Ijarah, Sukuk al-Wakala.
- Debt-based Sukuk are Sukuk in which the assets do not remain with the investors throughout the maturity period (of the Sukuk). Rather the Sukuk assets in this case are sold to the Originator through any appropriate sale and purchase agreement. In this type of Sukuk, the pay-off to the investors is linked to the credit risk of the originator. Example: Sukuk al Murabaha, Sukuk al-Istisna, Sukuk-al-Salam.
- Those Sukuk which create debt (Debt based Sukuk) like Murabaha, Istisna and Salam Sukuk are not tradable because they cannot be sold on premium or discount.





TAKAFUL

Learning Objectives:

After completing this module the reader should be able to:

- Know the origin, legitimacy and a brief history of Takaful (Islamic Insurance).
- Identify the basic features and understand the basic concepts such as Participants Account (PA), Participants Special Account (PSA), etc.
- Understand the different models with respect to the Islamic Finance Structures applied in Takaful business.
- Know the different types of Takaful products available in the Islamic Finance market.
- Understand the structure and the mechanism of a Takaful fund.
- Understand the concept, structure and the mechanism of Re-Takaful.
- Understand the difference between the Takaful and conventional insurance.
- Practically calculate the financial such as Return, Profit, Surplus, Share of the parties, etc, in Takaful business.





INTRODUCTION

All human beings naturally love their lives and possessions. This love motivates them to protect themselves against any loss and to avoid anticipated risks by all possible means and measures. A risk is the possibility of loss in an event. It is an inevitable part of life because almost every human endeavour carries risk. It relates to uncertain events in the future such as accidents, thefts, disasters or death that may result in loss, damage and financial difficulties. Insurance is one of the important tools available to manage such risks.

Islam does not prohibit the concept of risk management, but promotes risk management with a few conditions. It states, for example, that there should not be speculation on risk for profit making and there should not be profit at the expense of others.

The efforts to tackle the problem of risk in Shariah-compliant principles have resulted in the emergence of Takaful. Takaful, with its basic principle of mutual contribution and mutual indemnity, has been practiced for centuries. Takaful is playing a vital role in mitigation and management of risk in light of Shariah principles. The idea of Takaful is basically to distribute the loss among the participants or policyholders rather than transferring it to an insurance company or insurer, as practiced in conventional insurance.

Takaful, as defined by the AAOIFI, is a process of agreement among a group of persons to handle the injuries resulting from specific risks to which all of them are vulnerable. A process is thus initiated, involving payment of contributions as donations, and leading to the establishment of an insurance fund that enjoys the status of a legal entity and has independent financial liability. The resources of this fund are used to indemnify any participant who encounters injury, subject to a specific set of rules and a given process of documentation. The fund is managed by either a selected group of policyholders, or a joint stock company that manages the insurance operations and invests the assets of the fund, against a specific fee.

CONVENTIONAL INSURANCE

Before proceeding to the introduction of Takaful, it is worth taking a brief look at the business and mechanism of conventional insurance. At the outset, it is to be noted that conventional insurance mechanism is based on the elements of uncertainty, gambling, contract of indemnity and the involvement of interest based investments. Let us take a brief look at these elements:

UNCERTAINTY (GHARAR):

Gharar or uncertainty can be defined as “that whose consequences are hidden” or “that whose nature and consequences are hidden”, or “that whose consequences are unknown”. Gharar, for instance, means that it is not acceptable in contract arrangements to make payments conditional upon the outcome of an uncertain event. Gharar is forbidden in order to ensure the full consent and satisfaction of the parties to a contractual agreement. This can only be achieved through certainty, full knowledge, disclosure and transparency. It is understood that uncertainty cannot be totally avoided in any business; it is excessive uncertainty that is prohibited. The uncertainty in insurance is that both the timing and the amount of an insured event are unknown at the time of the policy.

GAMBLING (MAYSIR):

Maysir or gambling is a form of Gharar and a zero sum game where

no additional value is created. Conventional insurance is regarded as a form of gambling as the insured makes a bet on loss occurrence and the same applies in reverse to the insurer. It is also regarded as acquiring wealth through luck or by chance and at the cost of others.

INTEREST OR RIBA:

Riba literally means increase, addition, expansion or growth. It is understood here as an increase upon usurious items and upon debt, due to the deferred payment term. This type of Riba is of two sub-categories:

- Riba al-Fadl: It is referred to the exchange of ribawi items (i.e., the six items of gold, silver, wheat, barley, dates and salt), on spot basis but with a difference in value. For example, selling 10 grams of gold for 15 grams of gold on spot.
- Riba al-Nasi'ah: It is referred to any increase on the principal due to deferments, e.g. exchanging 100 kg of salt now against 120 kg of salt in one year.
- With regard to insurance, there are two obvious areas of Riba transactions:
- Paying and/or receiving interest is not permissible; in insurance companies this relates to the investment side (e.g. investments in fixed interest rate assets like deposits or bonds) as well as to the liability side (e.g. interest on policy loans).
- There is a mismatch between premiums paid and claims benefit received. The discrepancy is both between the amount paid and the difference in timing (Riba al-Fadl and Riba al-Nasi'ah).

CONTRACT OF INDEMNITY:

The underlying contract between the insurance company and the client, under conventional insurance, is a contract of indemnity. The insurance company, under this contract, promises to pay losses in the event of an insured peril in consideration of a premium. This contract is a bilateral contract and similar to sale. The premium in this business is considered as the income, whereas the claims are considered as the expenditure to the insurance company. The difference between the total premium received and the total claims paid is considered to be the surplus, which is retained by the insurance company as its profit.

HISTORY OF CONVENTIONAL INSURANCE:

According to the studies related to insurance, the oldest form of insurance appeared in the tenth century B.C. when the first regulation related to public loss was issued in Rhodes in 916 B.C. As per that regulation, the losses incurred as a result of jettisoning part of the cargo into the sea is required to be distributed among the owners of the goods transported on that ship.

Similar forms of Cooperative Insurance also appeared in China about 5,000 years ago when some of the families who lived on floating houses agreed to tie their houses and adjacent stores together so that if one house was exposed to the risk of drowning, they would all share the losses.

In ancient Rome, some societies helped the families of their military members when one of them died. The society provided the necessary amounts of money and salaries to those who were alive in return for a subscription fee that every member paid.

The concept of insurance passed on to the Phoenicians, then to the Lombardians in north Italy. Pools were established and funded by merchants who owned goods in order to reduce the losses which any merchant might be exposed to while transporting their goods by sea. After this brief introduction about the history of conventional insurance,

A process is thus initiated, involving payment of contributions as donations, and leading to the establishment of an insurance fund that enjoys the status of a legal entity and has independent financial liability. The resources of this fund are used to indemnify any participant who encounters injury, subject to a specific set of rules and a given process of documentation.

let us now move on to understanding the concept of Takaful.

TAKAFUL - THEORY AND LAW

Takaful is an Arabic term derived from the root word kafala or takafala, to guarantee or to mutually guarantee. Literally, it means mutual help and assistance. It is based on the system of ta'awun (mutual assistance) and tabarru' (gift, donate) whereby the associated is shared among a group of people voluntarily. The legitimacy of Takaful is derived from the primary sources, i.e., the Quran and the Sunnah.

In the Quran Allah says:

“And of them there are some who say: ‘Our Lord! Give us in this world that which is good and in the Hereafter that which is good, and save us from the torment of the Fire!’ (Al Quran 2:201). ‘This is the Book (the Qur’an), whereof there is no doubt, a guidance to those who are Al-Muttaqun [the pious believers of Islamic Monotheism who fear Allah much (abstain from all kinds of sins and evil deeds which He has forbidden) and love Allah much (perform all kinds of good deeds which He has ordained)]’ (Al Quran 5:2).

Here are a few Hadiths for reference: “Anas bin Malik r.a. narrated that the Holy Prophet (S.A.W.S) told a Bedouin Arab who left his camel untied trusting to the will of ALLAH (s.w.t) to tie the camel first then leave it to ALLAH (s.w.t).”

Narrated by Amer ibn Sa'd saying that his father Abi Waqqas said: “In the year of the Holy Prophet's final pilgrimage I was taken seriously ill and the Holy Prophet (S.A.W.S) used to visit me to enquire after my health. I told Him: ‘I am best with illness and I am wealthy but have no inheritors except one daughter. Should I give two-thirds of my property to charity?’ He replied ‘No’. I asked: ‘Half then?’ He said, ‘No’. Then he added: ‘one-third, and one-third is a great deal. It is better to leave your inheritors wealthy rather than to leave them in poverty and obliged to beg from others.’”

Narrated by Abu Huraira (r.a) “the Holy Prophet (S.A.W.S) said: whosoever removes a worldly hardship from a believer, ALLAH (s.w.t) will remove from him/her one of the hardships of the Day of Judgment. Whosoever alleviates form one, ALLAH (s.w.t) will alleviate his/her lot in this world and the next.”

The concept of Takaful originates from the ancient Arab practice of Al-Aqilah, which was approved by the Prophet (Peace be upon Him) during his time. Here is a Hadith for reference: Narrated by Abu Huraira (r.a) “two women of Hudail fought each other and one hit the other with a stone. The stone hit her in the belly and she had been pregnant and the unborn child was killed. They both took the matter before the Holy Prophet (S.A.W.S), and he ruled that the blood money was due to her relatives for what she had in her womb as a male of female slave of the highest quality. Hamal ibn Nagigha said: ‘O messenger of God! Will I be penalized for a being that has not drunk or eaten or made a sound nor even come into existence?’ At that the Messenger of God (Peace be upon him) said: ‘He is a brother of those who tell fortunes’.

The practice of Aqilah (as practiced by the ancient Arabs) requires the tribe to be able to make a form of monetary contribution on behalf of the killer to compensate the heir of the victim or blood money

Takaful is based on the system of ta'awun (mutual assistance) and tabarru' (gift, donate) whereby the associated is shared among a group of people voluntarily. The legitimacy of Takaful is derived from the primary sources, i.e., the Quran and the Sunnah.



compensation. The concept of takaful also has a relation to the customary practice of Asabiyya, which is a form of tribal solidarity. Ibn Khaldoon, in his Prolegomena, mentioned some of the oldest forms of Cooperative Insurance practiced by Arabs before Islam. He stated that Arabs practiced insurance of properties in many different forms. During winter and summer trips, members of caravans agreed among themselves to compensate, from the profits of the trips, anyone of them who might lose a camel during the trip. All members paid a share in proportion to their profits or capital in the trip according to the condition. They also agreed to compensate those whose goods remained unsold or were destroyed due to the death of their camels.

In addition, in the area of trade and business the practice of takaful can be traced to the second century of the Islamic era when Muslim Arabs, while expanding their trade into Asia, mutually agreed to contribute to a fund to protect themselves in the event of mishaps or robberies along their numerous sea voyages (marine insurance).

The development of takaful in modern times was theoretically initiated by Ibn Abidin, a lawyer and Islamic jurist who looked into the concept of insurance. He looked at marine insurance as it was the first form of insurance that came into being in Islamic countries. Similarly, Muhammad Abduh, another Islamic jurist, issued two fatwas permitting insurance practice. The first of two fatwas, looked at insurance transaction as that of Mudaraba financing. While the second stated that the transaction which is similar to endowment or life insurance is legal.

Practical efforts towards institutionalising takaful were made by Sudan in 1979 and Malaysia in 1984. But the major role in the development of takaful was played by the declaration of Grand Counsel of Islamic Scholars in Makkah, Saudi Arabia and Majma Al-Fiqh in 1985 when the conventional commercial insurance was declared Haram (forbidden) and only insurance based on the application of Shariah-compliant cooperative principles and charitable donations, was declared Halal (permissible).

TAAWUN AND TABARRU:

Conventional insurance has been viewed as non-compliant because it contains the elements of uncertainty (i.e. Gharar), gambling (i.e. Maysir) and insurance policy monies are normally invested in interest based instruments. Takaful removes these issues by adopting the principles of mutual assistance (Taawun) and donation (Tabarru). The policy holder will donate a sum of money in the favour of other members of the Takaful pool as a contribution, to a Takaful fund on the basis of taawun and tabarru principles.

Taawun is an Arabic word denoting mutual assistance and mutual cooperation. It is a basic principle of economic enterprise in Islam. This concept unites the individuals and a group of individuals for mutual cooperation and helps to deal with arising problems and issues. Islam has always encouraged the concept of taawun in society.

A tabarru contract is a unilateral contract, wherein the consent and consideration from an offeree or recipient are not required to make the contract valid, and which is normally meant for gratuitous purposes. Under Islamic commercial law an element of uncertainty can be tolerated in all unilateral or gratuitous contracts, such as wills, rebate, donations, waivers and gifts. In the context of Takaful, a donation contract or tabarru has been viewed and accepted as the best possible contract to replace conventional insurance which utilises the contract of sale and purchase.



Conventional insurance has been viewed as non-compliant because it contains the elements of uncertainty (i.e. Gharar), gambling (i.e. Maysir) and insurance policy monies are normally invested in interest based instruments. Takaful removes these issues by adopting the principles of mutual assistance (Taawun) and donation (Tabarru). The policy holder will donate a sum of money in the favour of other members of the Takaful pool as a contribution, to a Takaful fund on the basis of taawun and tabarru principles.

SHARIAH GUIDELINES FOR TAKAFUL

Takaful Models:

If a Takaful business is based on the Mudaraba contract between participants and the fund manager, it is known as Mudaraba model. If a Takaful business is based on the Wakala contract between the participants and the fund manager, then it is known as Wakala model. If a Takaful business is treated as Waqf fund then it is known as Waqf model. If a Takaful business involves two different contracts (i.e. Wakala and Mudaraba) in one model, it is known as Hybrid model.

Contractual Relationship:

There are two types of contractual relationships in the Takaful arrangement. The first one is between the Takaful Fund Manager and the Participants for managing the Takaful Pool, which includes devising the Takaful policies, contribution (Tabarru) collection from the Takaful Pool Members; and maintaining the record and settlement of claims. The other relationship relates to the investment of the donation surplus which is established between the Tabarru Fund or Takaful Fund and the Investment Manager. The first relation is established either through Wakala where the Takaful Fund Manager is regarded as the Wakil (Agent) of the Takaful Pool Members or such a Takaful Fund Manager is appointed just as a trustee or Qayyem under the Waqf arrangement. The second relationship in regard to the investment is either based on Mudaraba or Wakala.

- Mudaraba (partnership in profit): The contractual relationship between the participants and the investment manager of Takaful Fund is partners in profit.
- Wakala (agency): The contractual relationship between the participants and the manager of Takaful Fund is principal and agent.
- Waqf (Endowment): The contractual relationship between the participants and the manager of Takaful Fund is of donors and trustee (Mudarib or Wakil).
- Hybrid: The contractual relationship between the participants and manager of Takaful Fund is principal and agent as per Wakala contract and Rab-al-Maal and Mudarib as per Mudaraba contract.

Takaful Accounts:

Donation commitment should be clearly stipulated in the contract. The company should maintain two separate accounts; 1) for its own right and liabilities, 2) for the rights and liabilities of the policy holders. The company should assume the role of a Mudarib or an agent or trustee as per the model adopted. The insurance account is entitled to the insurance assets and their returns, and should also bear the liabilities relating to these assets. The company may adopt any principle for disposal of surplus. However, it should be in the common interest of participants. The managing company is not entitled to any share of the surplus. When the company is liquidated, all provisions and accumulated reserves pertaining to insurance should be spent on charitable purposes or if stipulated in Tabarru contract, distributed among Takaful members. The policyholders may participate in the management of the insurance operations through appropriate legal arrangements. All the activities and investments should be Shariah-compliant. A Shariah supervisory board should be formulated for issuance of Fatwas.

Takaful Participants:

A non-Muslim can also participate with Muslims in various types of Takaful products. The contribution may be determined according to actuarial principles based on statistical techniques. In this regard, due

The first relation is established either through Wakala where the Takaful Fund Manager is regarded as the Wakil (Agent) of the Takaful Pool Members or such a Takaful Fund Manager is appointed just as a trustee or Qayyem under the Waqf arrangement. The second relationship in regard to the investment is either based on Mudaraba or Wakala.



consideration should be given to whether the risk involved is fixed or variable. The risk that constitutes the subject matter of insurance should be one that could probably occur.

Commitments of the participant:

The participant must submit the required information about the risks to be insured against. The participant must make the payment of contribution on time as per agreement. The participant must inform about the occurrence of the risk insured.

Conditions in Takaful Policies:

A condition stipulated in the Takaful policy remains binding as long as it does not contradict the rules and principles of Shariah. It is permissible to stipulate conditions in the Takaful policy with reference to special cases that lead to deprivation from indemnity provided that justice, preservation of rights, and avoidance of abusive conditions are well observed.

Commitments of the Takaful Company:

The Company should assume the various tasks of managing the Takaful operations including: preparation of Takaful policies, collection of contributions, payment of indemnities, and all other technical tasks. The company is entrusted with the duty of achieving common interest while undertaking the management of the Takaful operations. The company shall bear its pre-operating expenses as well as all other expenses that relate to conducting its own business or the investment of its own funds. The statutory reserve of the joint stock company is deducted from its share capital and becomes part of its shareholders equity. No deduction shall be made from the policyholders fund or profits for the benefit of the shareholders of the joint stock company. For the sake of serving the policyholders' interest, it is permissible to deduct part of their funds or profits to be used as reserves or allocations pertaining to the insurance fund. Such deductions, however, should by no means belong to the shareholders of the joint stock company. The company claims indemnity from the party who causes the injury, whether through breach of contractual commitment or any similar misbehaviour. When the company invests the policyholders' funds through Mudaraba, it should bear the expenses that are supposed to be borne by the Mudarib. When the Takaful assets along with indemnities received from re-Takaful companies fall short of covering indemnity commitments, the company may cover the deficit from project financing or Qard Hasan (interest-free or benevolent loan). The Takaful account shall bear all the expenses and fees that relate to Takaful activities. Reconciliation between the parties should be in the interest of the participant and in line with Shariah rules.

Takaful Indemnity:

The participant shall receive either the loss incurred because of the injury, or the Takaful amount; whichever is less, and as per regulations. The participant should not receive both the indemnity and the compensation from other parties for the injury caused to the individual. . In property insurance, indemnity should be confined to what has been provided for in the regulations, and may comprise subsidiary losses that can be appropriately estimated according to the actual injury.

Takaful Surplus:

The Takaful surplus is part of the assets of the Takaful account and should be disposed of in a way that serves the common interest of



The company may adopt any principle for disposal of surplus. However, it should be in the common interest of participants. The managing company is not entitled to any share of the surplus. When the company is liquidated, all provisions and accumulated reserves pertaining to insurance should be spent on charitable purposes or if stipulated in Tabarru contract, distributed among Takaful members.

The statutory reserve of the joint stock company is deducted from its share capital and becomes part of its shareholders equity. No deduction shall be made from the policyholders fund or profits for the benefit of the shareholders of the joint stock company. For the sake of serving the policyholders' interest, it is permissible to deduct part of their funds or profits to be used as reserves or allocations pertaining to the insurance fund. Such deductions, however, should by no means belong to the shareholders of the joint stock company.



the participants. For example, it can be in any of the forms discussed below:

- a) Distribution of the surplus among the policyholders in proportion to their respective contributions regardless of whether the policyholder has received indemnity during the financial period or not.
- b) Distribution of the surplus among the policyholders who have not received indemnity during the financial period.
- c) Distribution of the surplus among policyholders after deducting the amounts of indemnity they receive during the same financial period.
- d) Distribution through any other method approved by the Shariah supervisory board.

Expiry of the Takaful Policy:

The Takaful Policy expires in any of the cases mentioned below:

- a) At the end of the period agreed upon in the Takaful policy.
- b) Termination of the policy by the company or the participant, if the policy provides for the right of termination to each of the parties to contract.
- c) Complete damage of the insured property (in case of property Takaful), without nullifying the entitlement of the participant to the indemnity, subject to the contract's conditions.
- d) Death of the insured person in case of person's (life) Takaful, without nullifying the entitlement of the beneficiary to the Takaful benefits, subject to the contract's conditions.

BASIC CONCEPTS OF TAKAFUL

Takaful Contribution:

It is the amount, which the participant donates, along with its related profits, for the benefit of the Takaful scheme.

Takaful Amount:

It is the amount paid by the company out of the Takaful account at the occurrence of the risk insured.

Risk Insured Against:

It is the probable, legally acceptable, accident.

Takaful Participant:

Participant is a person who accepts the Takaful scheme, signs the related Takaful policy and undertakes to observe its consequent commitments. It may be referred to as the insured, the insured for and the policyholder.

Takaful Account:

It is the account established by the company by virtue of its articles of association, to accommodate the contribution of the participants and the returns thereon as well as the reserves. Such account has an independent financial liability towards its own claims and commitments, though it is represented by the company for all its affairs. This account is also known as the Takaful fund, the policyholders account or the portfolio of the participants group.

Takaful Surplus:

The surplus comprises residual contribution of the participants (the insured) in addition to the reserves and profits, after deducting all expenses and indemnity amounts (paid or payable during the same year). The residual amount, thus computed, is considered as surplus, rather than profit.

TAKAFUL BUSINESS MODELS

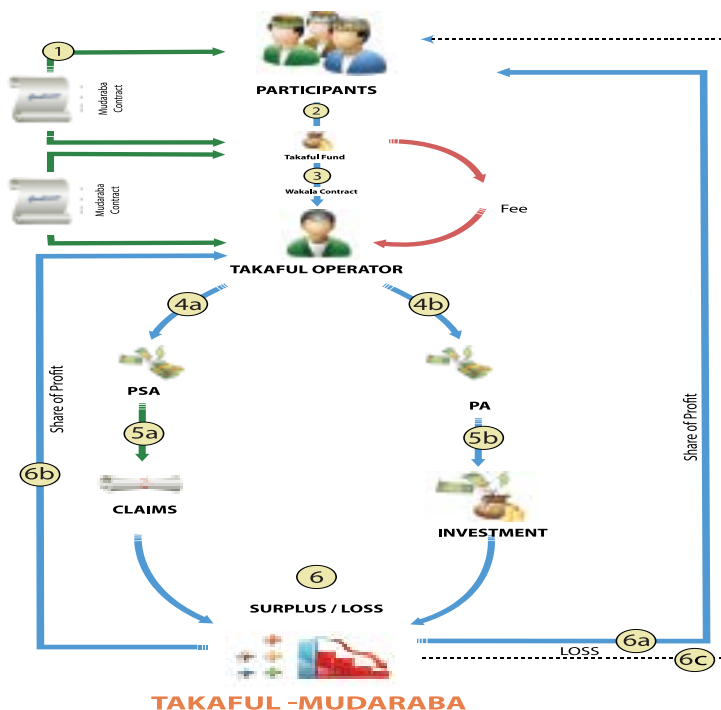
There are four Takaful models that are designed on the basis of different Islamic finance contracts which are signed between the participants and the Takaful operator. Let us see how the different Takaful models operate.

Mudharaba Model:

The mudharaba model is designed on the basis of Mudharaba contract. Mudharaba is a partnership in profit whereby one party provides capital (rab-al-maal) and the other party provides management skill or labour (mudharib).

In a Mudharaba model, the Takaful operator acts as a mudharib (fund manager) and the Tabarru Fund / Takaful Fund as Rab al Mal (capital provider). The surplus or profit derived from the operations of the Takaful fund investments are shared between the operator and the Tabarru Fund / Takaful Fund in the pre-agreed ratio. Any losses or deficits if incurred are borne solely by the Tabarru Fund / Takaful Fund (as rab-al-maal). The operator (as mudharib) is not entitled to receive any salary for its efforts except the profit share. The Takaful operator as Wakil (Agent) has responsibility to allocate or distribute the profits to the participants of the fund on the basis of their contributions and in accordance with the terms of the Takaful contract.

STRUCTURE OF MUDARABA TAKAFUL MODEL:



Mechanism of Mudharaba Takaful Model:

1. The Participants enter into a Mudharaba contract with the Takaful Operator. As per the contract, the participants are the Rab-al-Maal and the Takaful Operator the Mudharib.
2. The Participants entrust their monies to the Takaful Operator as contribution to the Takaful Fund under the contract of tabarru.
3. The Takaful Operator manages the money contributed by the Participants in Takaful Fund and maintains two separate accounts, namely Participant's Account (PA) and Participant's Special Account (PSA). The amount from the PA is invested in a Shariah-compliant business, whereas the losses, if any, can be claimed by the Participants from the amount maintained in PSA.
4. The Net Reserves from PSA (i.e. Total Donation - Claims - Operation Expenses) and the Net Realisation from PA (i.e. Total Investment + Profit - Operation Expenses) are transferred to the Surplus.
5. The surplus is shared between the Participants and the Takaful Operator as per mutually-agreed ratio, whereas the loss if any, shall be borne only by the Participants. Further, it is the



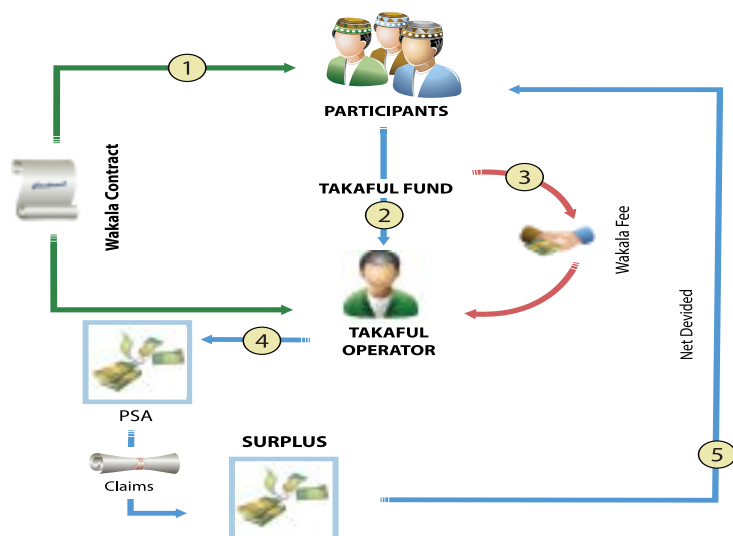
The surplus comprises residual contribution of the participants (the insured) in addition to the reserves and profits, after deducting all expenses and indemnity amounts (paid or payable during the same year). The residual amount, thus computed, is considered as surplus, rather than profit.

responsibility of the Takaful Operator to distribute the share of Surplus to the Participants as per their contributions.

Wakala Model:

This model is designed on the basis of wakala contract. Wakala can be defined as the delegation of one person (the principal) for another (the agent) to take the person's place in a known and permissible dealing. In this type of model, the Takaful operator acts as the agent on behalf of the participants to establish the Takaful / Tabarru Fund which is also the case in the Mudarba model. However, for the investment of the fund, the operator acts as an Agent (Wakil) of Tabarru / Takaful Fund. The operator is paid a pre-agreed management fee for the services rendered. The profit and the losses derived from the operations of Takaful fund and the investments belong to Tabarru / Takaful Fund only. The Takaful operator being the agent (Wakil) of the Participants has the responsibility to allocate or distribute the profits to the participants of the fund on the basis of their contributions.

STRUCTURE OF WAKALA TAKAFUL MODEL:



SIMPLE TAKAFUL STRUCTURE

Mechanism of Wakala Takaful model:

1. The Participants enter into a Wakala contract with the Takaful Operator. As per the contract, the Participants are the Principal and the Takaful Operator is the Agent.
2. The Participants entrusts their monies to the Takaful Operator as contribution into the Takaful fund under the contract of Tabarru.
3. The Takaful Operator is entitled to a predetermined Wakala fee, which is deducted from the contributions paid by the Participants.
4. The Takaful Operator manages the money contributed by the Participants in Takaful Fund and maintains two separate accounts, namely Participant's Account (PA) and Participant's Special Account (PSA). The amount from the PA is invested in a Shariah-compliant business, whereas the insured losses, if any, can be claimed by the Participants from the amount in PSA.
5. The Net Reserves (i.e. Total Donation - Claims - Operation Expenses), and the Net Realisation (i.e. Total Investment + Profit - Operation Expenses) from PSA from PA are transferred to Surplus.
6. The surplus or loss is completely transferred only to the Participants. Further, it is the responsibility of the Takaful Operator to distribute the Surplus to the Participants as per their contributions in Takaful Fund.

Waqf Model:

This model is designed on the basis of waqaf. Waqaf means 'as if

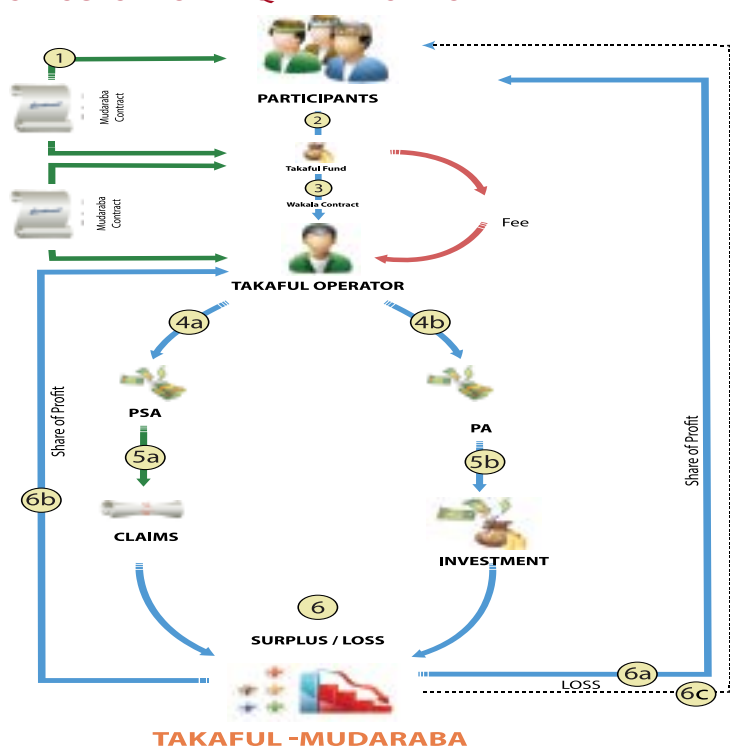
The Takaful Operator manages the money contributed by the Participants in Takaful Fund and maintains two separate accounts, namely Participant's Account (PA) and Participant's Special Account (PSA). The amount from the PA is invested in a Shariah-compliant business. Whereas the losses, if any, can be claimed by the Participants from the amount maintained in PSA.



it were owned by God'. In its application, the Takaful waqaf fund is owned by God and the participants have no ownership on the amount contributed to the waqaf fund.

The beneficiaries or participants become members of the Takaful Waqaf fund by subscribing and paying the donations as Tabarru. An operator is appointed as a Wakil or mudarib to manage the fund and paid a Wakala fee or profit share as per predetermined ratio. The participants can only claim the damages of loss from the fund and are not entitled to any surplus. The surplus or profits arising from the operations of the fund or from the investment would remain in the fund itself.

STRUCTURE OF WAQF TAKAFUL MODEL:



Mechanism of Waqf Takaful model:

1. The Participants enter into a Wakala contract with the Takaful Operator. As per the contract, the Participants are the Principal and the Takaful Operator is the Agent.
2. The Participants entrust their monies to the Takaful Operator as the contribution into Takaful fund under the contract of Tabarru.
3. The Takaful Operator is entitled to a predetermined Wakala fee which is deducted from the contributions paid by the Participants.
4. The Takaful Operator manages the money contributed by the Participants in Takaful Fund and maintains two separate accounts, namely Participant's Account (PA) and Participant's Special Account (PSA). The amount from the PA is invested in a Shariah-compliant business. Whereas the insured losses, if any, can be claimed by the Participants from the amount in PSA.
5. The Net Reserves (i.e. Total Donation - Claims - Operational Expenses), and the Net Realisation (i.e. Total Investment + Profit- Operational Expenses) from PSA from PA are transferred to Surplus.
6. It is to be noted that the surplus is not transferred to the Participants but retained in the Takaful fund by the Takaful Operator.

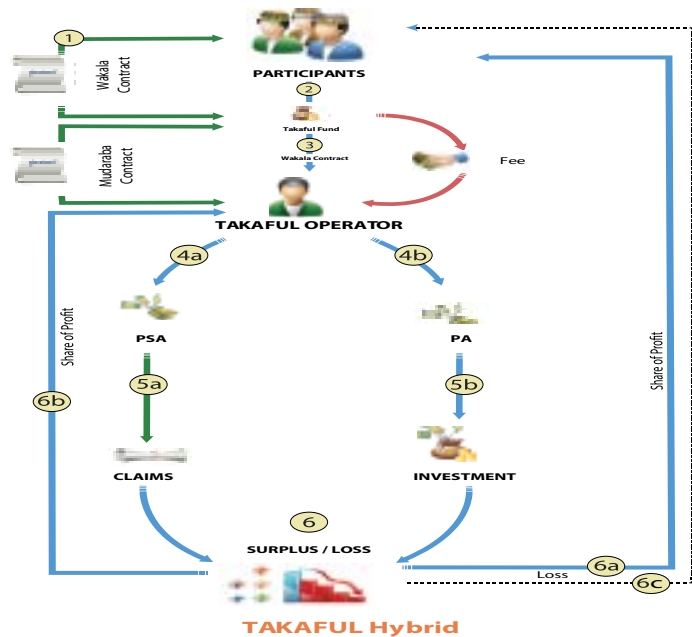
Hybrid Model:

Hybrid model is the combination of both Wakala and Mudaraba



models. In this model, the participants and the fund operator sign two contracts, i.e. wakala and mudaraba. The fund operator as per the Wakala contract is entitled to a wakala fee from the contribution paid by the participants and is also entitled to the predetermined percentage share of profit realised from the part of contribution amounts that is invested in any Shariah-compliant business. It is to be noted that the fund operator does not share the reserve amounts of the part of the contributions that remain after paying the claims.

STRUCTURE OF HYBRID MODEL:



Mechanism of Hybrid Takaful model:

1. The Participants enter into Wakala and Muadaraba contracts with the Takaful Operator. As per the first contract, the Participants are the Principal and the Takaful Operator is the Agent. And as per the second contract, the Participants are the Rab-al-Maal and the Takaful Operator is the Mudarib.
2. The Participants entrust their monies to the Takaful Operator as contribution into Takaful fund under the contract of tabarru.
3. Under Wakala contract, the Takaful Operator is entitled to a predetermined Wakala fee which is deducted from the contribution paid by the Participants. Whereas, under the Mudaraba contract, the Takaful Operator is entitled to a share of profit realised from the PA, normally a mutually agreed ratio.
4. The Takaful Operator manages the money contributed by the Participants in Takaful Fund and maintains two separate accounts, namely Participant's Account (PA) and Participant's Special Account (PSA). The amount from the PA is invested in a Shariah-compliant business. The insured losses, if any, can be claimed by the Participants from the amount in PSA.
5. The profit or loss realised from the amount invested in Shariah-compliant business is transferred to P&L account. And the amount remaining in PSA after paying the claims made by the participants is transferred to Reserves account.
6. The Net Profit from PA (i.e. Profit- Operational Expenses) is shared between the Participants and the Takaful Operator in agreed ratio.
7. The Net Reserves from PSA (i.e. Reserves- Operational Expenses) are completely transferred to the Participants.
8. It is to be noted that loss, if any, is completely borne by the Participants. Further, it is the responsibility of the Takaful Operator to distribute the Net Reserves to the Participants as per their contributions.



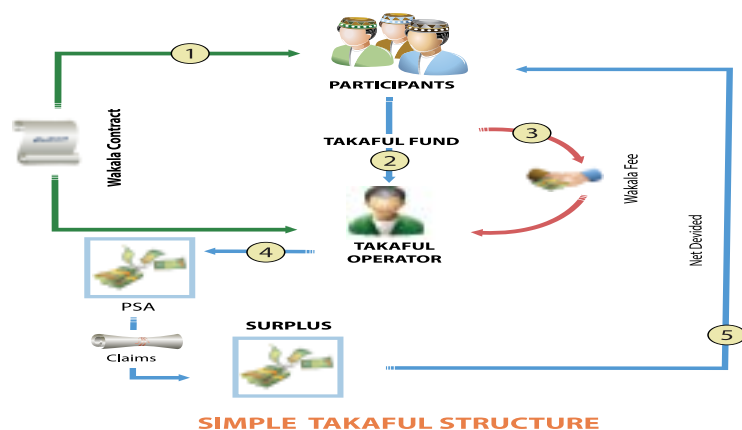
TAKAFUL PRODUCTS

Takaful products have evolved over time largely through product development, product adaptation and product innovation processes. The product of Takaful business can be divided into two key areas: General takaful and Family takaful.

General Takaful:

General Takaful entails indemnification for actual injury, and comprises insurance against fire, car accidents, airplane accidents, liability, and breach of trust. It provides protection on a short term basis, normally covering a period of one year. It commonly provides protection for property loss or damage, liability arising from damage caused by the insured to a third party and accidental death or injury to a third party. The Takaful Operator acts as a manager of the Takaful business and also as Mudarib or Wakil (Agent) in looking after the investment of their donated funds. General Takaful contracts are almost exclusively one-year contracts. At the end of each year, both renewability and contribution rates are subject to negotiation.

STRUCTURE OF GENERAL TAKAFUL (WAKALA MODEL):



Mechanism of General Takaful (Wakala model):

1. The Participants enter into a Wakala contract with the Takaful Operator. As per the contract, the Participants are the Principal and the Takaful Operator is the Agent.
2. The Participants entrust their monies to the Takaful Operator as contribution into Takaful fund under the contract of tabarru.
3. The Takaful Operator is entitled to a predetermined Wakala fee deducted from the contributions paid by the Participants.
4. The Takaful Operator manages the monies contributed by the Participants in Takaful Fund and maintains it in Participant's Special Account (PSA). The insured losses, if any, can be claimed by the Participants from the amount in PSA.
5. The Net Reserves (i.e. Total Donation - Claims - Operational Expenses from PSA) are transferred as Surplus. And the surplus or loss is completely transferred only to the Participants. Further, it is the responsibility of the Takaful Operator to distribute the surplus or loss to the Participants as per their contributions.

General Takaful Products:

There are various types of general Takaful products. A few among them are mentioned here for reference.

- **Motor/Vehicle Takaful:** In this type of product, the Takaful Company undertakes to indemnify the insured for loss of or damage to the insured vehicle, its accessories and spare parts. It also compensates the insured in the event of an accident caused by or arising out of the use of the motor vehicle, subject to the limits specified in the policy, against all sums which the insured shall become legally liable to pay as compensation for.



The participants can only claim the damages of loss from the fund and are not entitled to any surplus. The surplus or profits arising from the operations of the fund or from the investment would remain in the fund itself.

The fund operator as per the Wakala contract is entitled to a wakala fee from the contribution paid by the participants and is also entitled to the predetermined percentage share of profit realised from the part of contribution amounts that is invested in any Shariah-compliant business. It is to be noted that the fund operator does not share the reserve amounts of the part of the contributions that remain after paying the claims.



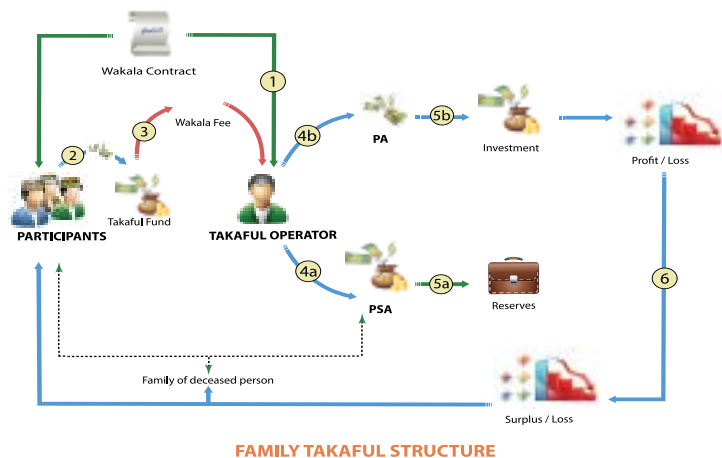
- Fire Takaful: This Takaful policy covers loss or damage by fire to immovable and movable property; buildings, plant and machinery, furniture, fixtures, fittings, contents, stocks, etc.
- Engineering Takaful: In this product the Takaful company protects the interests of contractors against the exposure to loss, damage or liability by a variety of external and internal causes, in civil, mechanical or electrical engineering like the construction of buildings, bridges, dams, towers, etc.
- Marine Takaful: Marine Takaful protects all goods whilst in transit. Coverage may be provided for individual shipments or under an ongoing contract; may be provided to only sea transport, or to only road transport or to only aviation transport or may be a combination of all.

Family Takaful:

The family Takaful includes insurance against the risk of disability and death. It is a scheme that provides cover to any individual participant who wishes to save a sum of money for dependants, in case the participants die prematurely. It acts as a contingency saving, if the participant survives, or to be set aside for peril from ill luck, tragedy or becoming permanently disabled.

Family Takaful offers a combination of protection and long term savings, usually covering a period of more than one year. It provides financial benefits if the insured is inflicted by a tragedy as well as potential investment profits. Risks covered include premature death, illness and permanent disability, and regular income during retirement.

STRUCTURE OF FAMILY TAKAFUL (WAKALA MODEL):



Mechanism of Family Takaful Model:

1. The Participants enter into a Wakala contract with the Takaful Operator. As per the contract, the Participants are the Principal and the Takaful Operator is the Agent.
2. The Participants entrusts their monies to the Takaful Operator as contribution into Takaful fund under the contract of tabarru.
3. The Takaful Operator is entitled to a predetermined Wakala fee deducted from the contributions paid by the Participants.
4. The Takaful Operator manages the money contributed by the Participants in Takaful Fund and maintains two separate accounts, namely Participant's Account (PA) and Participant's Special Account (PSA). The amount from PA is invested in a Shariah-compliant business. Whereas the insured losses, if any, can be claimed by the Participants or their family (in case of the death) from the amount in PSA.
5. The amount remaining in the PSA, after meeting all claims and

the operational expenses, is transferred to Net Reserves (i.e. Total Donation - Claims - Operational Expenses). Similarly, the realisation from the investment after deducting the operational expenses is transferred to Net Realisation (i.e. Total Investment + Profit- Operational Expenses).

6. The Net Reserves and the Net Realisation are transferred to Surplus. And the surplus or loss belongs to the Participants or their family (in case of death). Further, it is the responsibility of the Takaful Operator to distribute the surplus or loss to the Participants as per their contributions.

Family Takaful Products:

Similar to general Takaful products, there are various types of family Takaful products based on the nature and type of coverage. However, all products may be classified into individual takaful products and group takaful products as discussed below.

- Individual Takaful products: In individual takaful, the participants have a policy to protect themselves for security against defined risk. These plans include education, mortgage, health, etc. The beneficiary receives the financial benefits arising from illness, death and permanent disability.
- Group Takaful products: In group Takaful, participants will have the policy for a group, i.e., individuals and their families, as a protection for them against any defined risk. These plans include group education, mortgage, group health, etc. The beneficiary receives the financial benefits arising from death and permanent disability.

RE-TAKAFUL (TAKAFUL REINSURANCE)

After going through the two products of Takaful, let us now understand the emerging concept of Re-takaful.

At present the Takaful industry is very young. It requires insurance to mitigate the risk of its loss. Therefore, it chooses the re-takaful schemes. Re-takaful is a reinsurance of Takaful business on Islamic principles. It is a form of insurance whereby an insurance company can transfer to another insurer (the reinsurer) all or part of its liabilities against the agreed-upon portion from the insurance contribution. This enables the insurance company to protect itself against the risk of insolvency.

Historically, the concept of conventional reinsurance started in the seventeenth century B.C. along with the conventional insurance. The first document known as reinsurance goes back to 1370 A.D. However, the real reinsurance started at the beginning of the nineteenth century after insurance had been spreading steadily for a long time. Cologne Reinsurance Company, founded in 1853 A.D., was the first specialised reinsurance company.

When this concept became successful, the Takaful companies felt a great need for reinsurance. Therefore, some re-takaful companies were established, such as the Islamic Reinsurance Company founded in 1985 A.D. in Bahrain; B.E.S.T. Re in Tunisia; Islamic Takaful & Retakaful in Bahamas; the Arab Reinsurance Group (Arig) established the Islamic Reinsurance Company Takaful Re in Dubai .

Re-takaful has two motives. The first is the inability of direct insurance companies to insure property whose financial value is very high such as huge airplanes, large factories, luxurious buildings, very big stores and so on. The second motive is to increase the capacity of

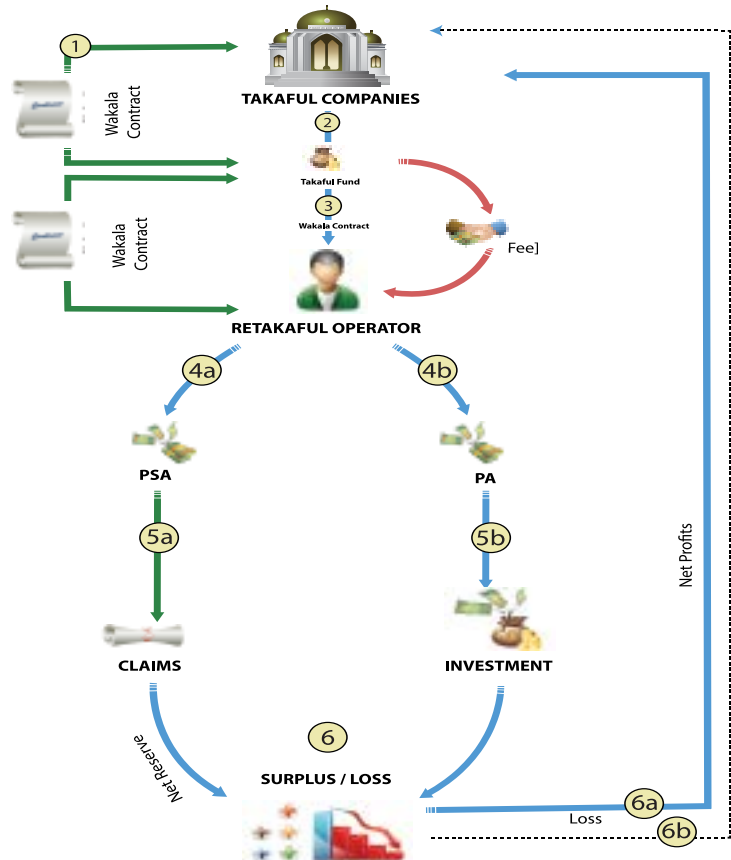


General Takaful entails indemnification for actual injury, and comprises insurance against fire, car accidents, airplane accidents, liability, and breach of trust. It provides protection on a short term basis, normally covering a period of one year. It commonly provides protection for property loss or damage, liability arising from damage caused by the insured to a third party and accidental death or injury to a third party. The Takaful Operator acts as a manager

direct insurance companies in the area of accepting risks in order to increase their gains.

The issue that arises is whether a Takaful company can reinsure or transfer its risk to another conventional reinsurance company. Current practice indicates that many Takaful operators have reinsured the risk with conventional reinsurance companies. As stated, this is because existing Re-takaful companies are not sufficiently capitalised to assume most of the risks that primary Takaful operators have underwritten.

RE-TAKAFUL STRUCTURE (WAKALA MODEL):



RE TAKAFUL MODEL - WAKALA

Mechanism of Wakala Takaful model:

1. The Re-Takaful Participants enter into a Wakala contract with the Re-Takaful Operator. As per the contract, the Re-Takaful Participants are the Principal and the Re-Takaful Operator is the Agent.
2. The Re-Takaful Participants entrust their monies to the Re-Takaful Operator as contribution into Takaful fund under the contract of tabarru.
3. The Re-Takaful Operator is entitled to a predetermined Wakala fee, which is deducted from the contributions paid by the Re-Takaful Participants.
4. Re-Takaful Operator manages the monies contributed by the Re-Takaful Participants in Takaful Fund and maintains two separate accounts, namely Participant's Account (PA) and Participant's Special Account (PSA). The amount from PA is invested in a Shariah-compliant business. The insured losses, if any, can be claimed by the Re-Takaful Participants from the PSA.
5. The Net Reserves (i.e. Total Donation - Claims - Operational Expenses) from PSA and the Net Realisation (i.e. Total Investment

Family Takaful offers a combination of protection and long term savings, usually covering a period of more than one year. It provides financial benefits if the insured is inflicted by a tragedy as well as potential investment profits. Risks covered include premature death, illness and permanent disability, and regular income during retirement.



DIFFERENCES BETWEEN INSURANCE AND TAKAFUL

S. No.	Insurance	Takaful
1	In conventional insurance, the relationship between the fund operator and the participants is that of insurer and insured.	In takaful, there is no such relationship as the fund belongs to the participants and the operator just manages on their behalf.
2	In conventional insurance, the premium is considered as the income to the insurance company.	In takaful, the premium is considered as the donation, which is a unilateral transaction.
3	Conventional insurance contract is a financial exchange contract.	Islamic insurance contract is not a financial exchange contract.
4	The aim of conventional insurance operation is profit making.	The aim of Islamic insurance operations is to share and distribute the risk.
5	In conventional insurance the surplus is treated as the profit to insurance company.	In Islamic insurance, the surplus belongs to the policyholders, therefore, is distributed among them or given to charity.
6	The return on investment in conventional insurance exclusively belongs to the insurance company.	In Islamic insurance the return on investment, in case of Mudaraba model, is shared between Mudarib and Tabarru / Takaful Fund.
7	In conventional insurance the elements of Gharar, Maysir and interest exist.	Islamic insurance is free of the elements of Gharar, Maysir and interest.
8	The Company in Conventional insurance does not adhere to the principles of Shariah.	The Company in Islamic insurance adheres to the rules of Shariah and the guidelines of its Shariah Board.

Profit- Operational Expenses) from PA are transferred to Surplus. And the surplus or loss is completely transferred only to the Re-Takaful Participants. Further, it is the responsibility of the Re-Takaful Operator to distribute the surplus or loss to the Re-Takaful Participants as per their contributions.

SNAPSHOT OF WHAT WE HAVE LEARNED:

In this module, we have learned about:

- **Takaful:** Takaful is an Arabic term derived from the root word kafala or takafala, to guarantee or to mutually guarantee. Literally, it means mutual help and assistance. It is based on the system of ta'awun (mutual assistance) and tabarru' (gift, donate), whereby the



In group Takaful, participants will have the policy for a group, i.e., individuals and their families, as a protection for them against any defined risk. These plans include group education, mortgage, group health, etc. The beneficiary receives the financial benefits arising from death and permanent disability.

Re-takaful is a reinsurance of Takaful business on Islamic principles. It is a form of insurance whereby an insurance company can transfer to another insurer (the reinsurer) all or part of its liabilities against the agreed-upon portion from the insurance contribution. This enables the insurance company to protect itself against the risk of insolvency.



associated is shared among a group of people voluntarily. We have seen the legitimacy, basic features, Shariah Guidelines and a brief history of Takaful.

- **Tawwun:** Taawun is an Arabic word denoting mutual assistance and mutual cooperation. It is a basic principle of economic enterprise in Islam. This concept unites the individuals and a group of individuals for mutual cooperation and help to deal with arising problems and issues. Islam has always encouraged the concept of taawun in a society.
- **Tabarru:** A tabarru contract is a unilateral contract, wherein the consent and consideration from an offeree or recipient are not required to make the contract valid, and which is normally meant for gratuitous purposes.
- **Contribution:** It is the amount, which the participant donates, along with its related profits, for the benefit of the Takaful scheme.
- **Takaful Amount:** It is the amount paid by the company out of the Takaful account at the occurrence of the risk insured.
- **Risk insured against:** It is the probable, legally acceptable, accident.
- **Participants:** Participant is a person who accepts the Takaful scheme, signs the related Takaful policy and undertakes to observe its consequent commitments. It may be referred to as the insured, the insured for and the policyholder.
- **Takaful Account:** It is the account established by the company by virtue of its articles of association, to accommodate the contribution of the participants and the returns thereon as well as the reserves. Such account has an independent financial liability towards its own claims and commitments, though it is represented by the company for all its affairs. This account is also known as the Takaful fund, the policyholders account or the portfolio of the participants group.
- **Participant's Account (PA):** The amount from PA is invested into a Shariah-compliant business.
- **Participant's Special Account (PSA):** The insured losses, if any, can be claimed by the Participants or their family (in case of the death) from the amount in PSA.
- **Surplus:** The surplus comprises residual contribution of the participants (the insured) in addition to the reserves and profits, after deducting all expenses and indemnity amounts (paid or payable during the same year). The residual amount, thus computed, is considered as surplus, rather than profit.
- **Wakala, Mudaraba and Waqf :** contracts are used to design the different types of Takaful Models.
- **General Takaful:** General Takaful entails indemnification for actual injury, and comprises insurance against fire, car accidents, airplane accidents, liability, and breach of trust. It provides protection on a short term basis, normally covering a period of one year. It commonly provides protection for property loss or damage, liability arising from damage caused by the insured to a third party and accidental death or injury to a third party.
- **Family Takaful:** Family Takaful offers a combination of protection and long term savings, usually covering a period of more than one year. It provides financial benefits if the insured is inflicted by a tragedy, as well as potential investment profits. Risks covered include premature death, illness and permanent disability, and regular income during retirement.
- **Re-takaful:** It is a reinsurance of Takaful business based on Islamic principles. It is a form of insurance whereby an insurance company can transfer to another insurer (the reinsurer) all or part of its liabilities against the agreed-upon portion from insurance contribution. This enables the insurance company to protect itself against the risk of insolvency. We have seen the structure and mechanism of Re-Takaful business.



ZAKAT

Learning Objectives:

After completing this module the reader will be able to:

- Understand the meaning of Zakat and its legitimacy derived from the primary sources of Islam.
- Know about the Wealth that is subjected to Zakat, the Nisab and Zakat rate for each category of wealth.
- Identify the Shariah conditions for Zakat for both an individual and a company.
- Know about the beneficiaries of Zakat.
- Understand methods adopted to calculate Zakat for an individual and a company.
- Practically calculate the Zakat on subjected categories of wealth.





INTRODUCTION

There are five pillars in Islam. They are Iman (belief), Salah (prayer), Zakat (obligatory charity), Sawm (fasting) and Hajj (pilgrimage). Zakat is the third of these five pillars. It immediately follows Salah in the Holy Quran.

The Quran frequently uses the term Infaq-fi-Sabilillah, meaning spending in the way of Allah, for Zakat (Mandatory charity) and Sadaqat (Optional charities). It is also proclaimed that whatever one spends in the way of Allah is considered as a Qard-al-Hasan to Allah, or benevolent loan in the name of Allah, the repayment of which He has made incumbent upon Himself. In addition, it is declared that whatever one gives by way of charity is rewarded many times more in return and the dividends are guaranteed by Allah.

It does not mean that Allah is in need of our alms or loans (May Allah forgive us for even a fleeting thought like this). He definitely needs no lending for Himself. It is, in fact, part of His mercy and wisdom that He tells us to spend for our own good, in our own cause and to our own advantage declaring this as a spending in the way of the Lord.

Whatever we do to redress or alleviate the miseries of orphans, widows, the handicapped, wayfarers, the needy, and the grief-stricken of our community, will not be an act of generosity towards them as such, but it will be recorded as a loan in Allah's account. We have to demand nothing from them in return, but He has taken upon Himself to reward us for our good deed and express His gratefulness. In a broader perspective, if a person spends for the good of society, then he will ultimately benefit directly or indirectly. It is this wisdom that Allah so concisely reveals in the Holy Quran.

It is to be noted that in the case of Zakat, there is also a general order and command to shun stinginess and greed, as these are the root causes of all ills, and spend in the way of Allah to help others meet their essential needs. Even those who possess / own the wealth less than the Nisab are not prevented from spending in the way of Allah, and the Zakat-payers are not prevented from paying other than the prescribed minimum amount and denying the society the benefit of their affluence and generosity.

LEGITIMACY OF ZAKAT AND ITS PRINCIPLES

Meaning of Zakat:

The word Zakat in Arabic means 'purity' and 'cleansing'. The act of apportioning a certain amount of money from one's personal assets is termed as Zakat. This act helps the payers in purifying their wallet/purse and cleansing themselves. The one who fails to pay the Zakat makes one's wealth and one's own self impure.

According to AAOIFI, Zakat is the right which becomes due in certain types of wealth and disbursable to specific categories of recipients.

Divine Commands regarding Zakat:

The word 'Zakat' occurs 30 times, in different places in the Quran. But there are three separate injunctions in three different chapters, where it is commanded to pay the Zakat. They are as follows: Allah (SWT) says in the Holy Quran,

“O you who believe! Spend of the good things which you have (legally) earned, and of that which We have produced

from the earth for you, and do not aim at that which is bad to spend from it, (though) you would not accept it save if you close your eyes and tolerate therein. And know that Allah is Rich (Free of all needs), and Worthy of all praise (Al Quran - 02:267). And it is He Who produces gardens trellised and untrellised, and date-palms, and crops of different shape and taste (their fruits and their seeds) and olives, and pomegranates, similar (in kind) and different (in taste). Eat of their fruit when they ripen, but pay the due thereof (it's Zakat according to Allah's Orders 1/10th or 1/20th) on the day of its harvest, and waste not by extravagance. Verily, He likes not Al-Musrifun (those who waste by extravagance) (Al Quran - 06:141). And those who hoard up gold and silver [Al-Kanz: the money, the Zakat of which has not been paid] and spend them not in the Way of Allah, announce unto them a painful torment. On the Day when that (Kanz: money, gold and silver the Zakat of which has not been paid) will be heated in the Fire of Hell and with it will be branded their foreheads, their flanks, and their backs, (and it will be said unto them): "This is the treasure which you hoarded for yourselves. Now taste of what you used to hoard" (Al Quran - 09:34-35). As-Sadaqat (here it means Zakat) are only for the Fuqara' (the poor), and Al-Masakin (the needy) and those employed to collect (the funds), and to attract the hearts of those who have been inclined (towards Islam), and to free the captives, and for those in debt, and for Allah's Cause, and for the wayfarer (a traveller who is cut off from everything); a duty imposed by Allah. And Allah is All-Knower, All-Wise (Al Quran - 09:60). Take Sadaqah (alms) from their wealth in order to purify them and sanctify them with it, and invoke Allah for them. Verily! Your invocations are a source of security for them; and Allah is All-Hearer, All-Knower (Al Quran - 09:103).

In the verses of the Holy Quran mentioned above, the believers are commanded to pay Zakat. In addition, the wealth subjected to Zakat as well as the beneficiaries of Zakat have been mentioned clearly. Further, those who deny paying Zakat are warned of chastisement in the life after death in the form of Hell-fire.

Zakat - An Apostolic Tradition:

Since time immemorial, it has been mandatory on all the Prophets (Peace be upon all of them) and their followers to observe Prayer and perform Zakat. Exemplified by the teachings of every Apostle, Islam - Allah's Religion - has never been without these two basic tenets. Let us see a few references with respect to each of the Prophets (Peace be upon all of them).

1. Prophet Ibrahim (Peace be upon Him): While mentioning Prophet Ibrahim and the Prophets that followed him, in the Quran Allah says: And We made them leaders, guiding (mankind) by Our Command, and We revealed to them the doing of good deeds, performing Salat (Iqamat-as-Salat), and the giving of Zakat and of Us (Alone) they were the worshippers (Al Quran 21:73).
2. Prophet Ismail (Peace be upon Him): The following has been said about Prophet Ismail (Peace be upon Him). In the Quran Allah says: And he used to enjoin on his family and his people As-Salat (the prayers) and the Zakat and his Lord was pleased with him (Al Quran - 19:55).
3. Prophet Moses (Peace be upon Him): In response to the prayer of

Melk-ut-Taamm means full ownership. The owner must have an ability to act freely with what he possesses, without having any outstanding obligations towards others. No Zakat is paid for the wealth, which is not in the possession of its owner, and the location of which is unknown.

Once the wealth in someone's possession, which is equal to or above the legal Nisab, has completed one Hijri Calendar year, i.e., Hawl, it shall be subject to Zakat payment, at the rate of 2.5%. If the solar calendar is used to calculate the Zakat, the rate of Zakat shall be 2.577%. It is to be noted that the wealth from agriculture, minerals and treasures is not subjected to the Hawl principle. On such categories of wealth Zakat is applicable on the day of their harvest and extract.



Prophet Moses (Peace be upon Him), Allah has pronounced the following commandments (verses). In the Quran Allah says: And ordain for us good in this world, and in the Hereafter. Certainly we have turned unto You." He said: (As to) My punishment I afflict therewith whom I will and My Mercy embraces all things. That (Mercy) I shall ordain for those who are the Muttaqun (the pious - See V.2:2), and give Zakat; and those who believe in Our Ayat (proofs, evidence, verses, lessons, signs and revelations, etc.) (Al Quran - 07:156).

4. Prophet Jesus Christ (Peace be upon Him): Jesus Christ (Peace be upon Him) preceded the Last of the Prophets of God, the Prophet Muhammad (Peace be upon Him). The Holy Quran says that Christ was also enjoined to observe Salah and Zakat. In the Quran Allah says: And He has made me blessed wheresoever I be, and has enjoined on me Salat (prayer), and Zakat, as long as I live" (Al Quran - 19:31).
5. Prophet Muhammad (Peace be upon Him): In the Islamic Shariah brought to us by the Prophet Muhammad (Peace be upon /him) both Salah and Zakat are mandatory duties. In Holy Quran Allah says: And perform As-Salat (Iqamat-as-Salat), and give Zakat and bow down (or submit yourselves with obedience to Allah) along with Ar-Raki'un (Al Quran - 02:43).

The discussion above reaffirms that the eternal religion of mankind, as preached and practiced by all the Prophets and messengers of God since the very beginning, was established on the two grand pillars of Salah and Zakat; and no community in the world has ever been exempted from these (uplifting) obligations.

Zakat in Sunnah or Hadith:

The term Sunnah refers to the traditions of the Prophet Muhammad (Peace Be upon Him) that include his sayings, actions and tacit approvals. Prophet Muhammad (Peace Be upon Him) is the last messenger and the last law bearer in the series of prophets and messengers. The tradition attributed to the Prophet Muhammad (Peace Be upon Him) is also known as Hadith. Let us refer to a few Ahadith from the many that emphasise the importance, rules and the procedure of paying Zakat. Narrated Ibn 'Umar: Allah's Apostle said: Islam is based on (the following) five (principles): 1. To testify that none has the right to be worshipped but Allah and Muhammad is Allah's Apostle. 2. To offer the (compulsory congregational) prayers dutifully and perfectly. 3. To pay Zakat (i.e. obligatory charity). 4. To perform Hajj. (i.e. Pilgrimage to Mecca) 5. To observe fast during the month of Ramadan. (Sahi Al Bukhari, Book #2, Hadith #7). Narrated Abu Huraira: A Bedouin came to the Prophet and said, "Tell me of such a deed as will make me enter Paradise, if I do it." The Prophet (p.b.u.h) said, "Worship Allah, and worship none along with Him, offer the (five) prescribed compulsory prayers perfectly, pay the compulsory Zakat, and fast the month of Ramadan." The Bedouin said, "By Him, in Whose Hands my life is, I will not do more than this." When he (the Bedouin) left, the Prophet said, "Whoever likes to see a man of Paradise, then he may look at this man." (Sahi Al Bukhari, Book #23, Hadith #480). Narrated Abu Sa'id Al-Khudri: Allah's Apostle said, "There is no Zakat on less than five camels and also there is no Zakat on less than five Awaq (of silver). (5 Awaq = 22 Fransa Riyals of Yemen or 200 Dirhams.) And there is no Zakat on less than five Awsuq. (A special measure of food grains, and one Wasq equals 60 Sa's.) (For gold 20, Dinars i.e. equal to 12 Guinea English. No Zakat for less than 12 Guinea (English) of gold or for silver less than 22 Fransa Riyals of Yemen.) (Sahi al Bukhari, Book #24, Hadith

#526). Narrated Abu Huraira: Abu Bakr said, "By Allah! If they (pay me the Zakat and) withhold even a she-kid which they used to pay during the life-time of Allah's Apostle, I will fight with them for it." 'Umar said, "It was nothing but Allah Who opened Abu Bakr's chest towards the decision to fight, and I came to know that his decision was right." (Sahi Al Bukhari, Book #24, Hadith #536). Narrated Abu Huraira: The Prophet said, "The Hour (Day of Judgment) will not be established till your wealth increases so much so that one will be worried, for no one will accept his Zakat and the person to whom he will give it will reply, 'I am not in need of it'." (Sahi al Bukhari, Book #24, Hadith #493).

The above-mentioned five ahadith from the hundreds of ahadith of Prophet Muhammad (Peace be upon Him) along with that said by Abu Bakr, related to Zakat, clearly reflect the importance and significance of the Zakat in Islam and Muslim society.

WEALTH SUBJECTED TO ZAKAT:

Zakat is obligatory on the following commodities or heads:

1. Gold
2. Silver
3. Currencies: It includes Cash-in-hand, Quasi Cash, Cash Receivables,
4. Bank Balances, Sukuk, Funds, etc.
5. Trade Articles: These include anything that is offered for sale such as Commercial Goods, Livestock, Agricultural produce, etc.
6. Livestock: This includes Camels, Cows and Goats owned but are not for trade.
7. Agricultural Produce: This includes Food-grains, Fruits and Vegetables.
8. Minerals: This includes all stuff of this kind extracted from earth or the sea in solid, liquid or gaseous form.
9. Treasures (Rikaz)

WEALTH EXEMPTED FROM ZAKAT:

Zakat is not obligatory on the following commodities or heads:

1. Wages, Salaries and Income from free occupations at the time of receiving leased assets, whereas, it is obligatory on that portion of such income which remains unexpended for the whole year.
2. Fixed assets that are not acquired for trade such as leased assets, whereas, it is obligatory on the remaining portion of the income generated by such assets.
3. Public Wealth (State Properties) or the Insurance funds of Public Institutions.
4. Charitable Waqf.

PAYER OF ZAKAT:

All Muslims who own wealth, as prescribed in the Nisab, are to pay Zakat. There are few conditions stipulated in Shariah in this regard. They are as follows:

1. The person must be a Muslim
 2. The wealth has reached the Nisab.
 3. A minimum duration of one year (Hawl) has passed since ownership of the wealth concerned.
 4. The owner of the wealth is known.
 5. The wealth is fully owned (Melk-ut-Taamm).
 6. When a person dies, their Zakat due must be paid from the inheritance before distribution. In Islamic law, when a person dies, three payments are made before his wealth (inheritance) is distributed to his heirs.
- a. Debts which include Zakat that is due and owed



In case of Mother Company and its subsidiaries, the Zakat is first calculated by subsidiaries, and then the mother company would pay its share of Zakat in proportion to its shareholding in the subsidiary. The remaining part of Zakat of the subsidiary is paid by the other parties or directly by the subsidiary.

Zakat is not obligatory on operational assets and on the income generating assets if such assets are not acquired for trade. However, Zakat is obligatory at the end of the year, on the unexpended portion of the rental / income generated by adding that portion of the income to other Zakatable assets. It is to be noted that the Zakat has to be levied on the exact amount of Zakatable assets per share.



- b. Wasiyyah – the will (should not exceed one third of the total wealth of the deceased)
- c. Expenses incurred for his burial

Basic Conditions for Zakat to become obligatory:

To facilitate the payment of Zakat Islam laid down a set of conditions which, if they apply, Zakat becomes due. These conditions are as follows:

- **Absolute Ownership (Melk-ut-Taamm):** Melk-ut-Taamm means full ownership. The owner must have an ability to act freely with what he possesses, without having any outstanding obligations towards others. No Zakat is paid for the wealth, which is not in the possession of its owner, and the location of which is unknown. The following types of wealth are considered Melk-ut-Taamm:
 - Wealth of a person (a minor, a ward or a charge) who is placed under guardianship. When the owner of the wealth is a minor, it is obligatory for the guardian to pay Zakat on the minor's behalf.
 - Wealth that is seized illegally. The payment of the Zakat is obligatory (Wajib) for wealth that has been seized illegally upon the wealth when it is returned to the owner of the wealth.
 - Wealth that cannot be located or lost. For example animals that have strayed and are lost are not considered Melk-ut-Taamm. If they reach the Nisab, Zakat will have to be paid for them only after they have been found.
 - Wealth that is loaned to others and has not become a bad debt. Zakat has to be paid for all the years during which it was loaned. However, in case of bad debt, Zakat has to be paid from the day it has been recovered or returned.
 - Wealth that is in foreign hands or faraway places even though it is difficult to administer them.
 - Wealth that is owned through the signing of a contract although the wealth is not yet received and is with the seller on behalf of the purchaser.
- **Reaching Nisab:** Nisab is the minimum amount or the threshold limit for Zakat. If the wealth does not meet the Nisab or does not exceed the minimum amount, then Zakat is not obligatory.
- **Wealth Exceeding Basic Needs:** Personal possessions and other necessary personal properties are not subject to Zakat payment, such as one's house, clothing, tools of one's craft or means of transport such as cars for personal use, and furniture. The same applies to money earmarked for payment of one's debt, for a debtor needs such money to avoid imprisonment and humiliation.
- **Expiry of One Year (Hawl) on Possession of Wealth:** Hawl means a year. This is applied in calculation of Zakat amount as the assessment period. Zakat is payable only if the owner has owned the wealth for twelve months of Hijri Calendar. Once the wealth in someone's possession, which is equal to or above the legal Nisab, has completed one Hijri Calendar year, i.e., Hawl, it shall be subject to Zakat payment, at the rate of 2.5%. If the solar calendar is used to calculate the Zakat, the rate of Zakat shall be 2.577%. It is to be noted that the wealth from agriculture, minerals and treasuries is not subjected to the Hawl principle. On such categories of wealth Zakat is applicable on the day of their harvest and extract.

Categories of Zakat Beneficiaries:

The Holy Qur'an specifies the categories of those who are eligible for support from funds generated through Zakat. Allah says, As-Sadaqat (here it means Zakat) are only for the Fuqara' (the poor), and Al-Masakin (the needy) and those employed to collect (the funds), and

to attract the hearts of those who have been inclined (towards Islam), and to free the captives, and for those in debt, and for Allah's Cause, and for the wayfarer (a traveller who is cut off from everything); a duty imposed by Allah. And Allah is All-Knower, All-Wise (Al Quran 09:60).

The above verse specifies the heads prescribed for the disbursement of Zakat. It explains who from among the society members deserves to be helped and what the noble quarters that should be supported from the Zakat funds are. There are eight categories of beneficiaries of the Zakat system, mentioned in the above Quranic verse. Let us briefly explain them one by one.

1. **Al-Fuqara (Faqir):** According to the Shariah, 'Faqir' is a person who is dependent on others for subsistence. This category includes everyone who may be in need of help, whether they are permanently disabled due to some physical incapacity or old age; or are temporarily in need of assistance, but capable of standing on their own feet if provided with timely support, such as orphaned children, widows, the unemployed or those afflicted by disease or accident.
2. **Al-Masakin (Miskin):** A Miskin is a person who is suffering from Maskanah or is in more distress than the ordinary poor. The basic quality of this category of the deserving is described by the Prophet Muhammad (Peace be upon Him) as self-esteem, which prevents them from begging in spite of their need and a lack of resources to sustain themselves and their family.
3. **Al-Amilin (Amil):** These are people employed to collect and distribute Zakat and Sadaqat (regular and normal charities) and maintain a record of accounts.
4. **Muallafat-al-Qulub** (Those whose hearts are to be reconciled): This expression is derived from the infinitive Talif-al-qalb, which means to win the hearts of the people.
5. **Fil-Riqab (To free those in bondage):** Zakat funds can also be used for the freedom and emancipation of slaves, and to redeem and help the prisoners of war and their beleaguered families.
6. **Al-Gharimin (Those burdened with debt):** This category includes those who find themselves unable to repay a loan with their available means. They can be helped to restore their economic freedom and dignity.
7. **Fi-Sabilillah (In the Way of Allah):** This includes all the efforts and struggles for the sake of Allah's Cause. All those who are engaged in such efforts may be given assistance from Zakat funds - it could be to cover the expenses of their journey, or to provide them with the means of transport, and so on. Such assistance may be provided even to those who are otherwise well-off and do not need any financial assistance.
8. **Ibn-al-Sabil (The Wayfarer):** Even a traveller who is rich is entitled to receive help out of Zakat funds if the person is in need of such help during the journey.

Zakat is payable only to the deserving people of the Islamic community. Nobody is allowed to pay Zakat to the eight categories of people mentioned in the Quran, if they fall under any one of the following circumstances:

- Neither can a son pay Zakat to his father, nor can a father pay Zakat to his son.
- A husband cannot give Zakat to his wife (but a wife can give Zakat to her husband).
- One cannot give Zakat to those close relatives whose maintenance and care are obligatory according to the Shariah, or to their legal heirs.
- A non-Muslim cannot be paid from the funds of Zakat.



In case of Bonds, Zakat is payable from the principal (cost of the bond). In case of Sukuk, the owners should pay Zakat on the basis of the underlying assets of the Sukuk. If the Sukuk are held as the trust (Amanah) by the institution, then the institution should pay Zakat only on their share of profit. In case of Funds, Zakat has to be paid on the basis of the underlying assets of the fund.

The Non-current Liabilities include the debt arising from the purchase of the non-Zakatable fixed assets on debt. Therefore, they should not be deducted from the Zakat base.



Benefits of Zakat System:

Actual benefits of paying Zakat are known to only Allah (SWT). However, a few of the benefits of paying Zakat, as pointed out by the scholars, are mentioned for reference:

1. Redistribution of wealth in the economy to the specific category of people of the society.
2. It provides financial help by way of food, clothes and shelter for the poor and needy.
3. It is a form of assistance to those in debt by settling the debts.
4. It prevents the poor from resorting to criminality by robbing or stealing for food.
5. It bridges the gap between the rich and the poor and reduces envy among the poor against the rich.
6. It cleanses the soul of selfishness and greed as well from being self-centered.
7. It teaches the Muslim to feel responsible towards the poor in society.
8. It reminds the rich that the wealth is entrusted by Allah and belongs to Allah.
9. It provides an opportunity for the poor and the needy to elevate them from their state of poverty through provision of small capital for business.
10. It teaches every Muslim to have the best of qualities: generosity, solidarity, love, kindness and concern for all.
11. It is a means to eradicate poverty and spread prosperity in the community.

ZAKAT BASE FOR COMPANIES AND INSTITUTIONS

AAOIFI has issued a detailed standard on the Zakat calculation in case of Islamic banks, companies and other financial institutions. Under this head, we have referred the standard in four sub-headings.

General Principles for Zakat Calculation:

The institution or company or business shall pay Zakat under any of the stated cases: a) Enactment of an enforceable Zakat Law, b) Stipulation of commitment to pay Zakat in the articles of association, c) Issuance of Zakat commitment resolution by the general assembly. In the absence of any of the stipulated conditions, payment of Zakat shall become the responsibility of the shareholders. In this case, the company or institution has to indicate the amount of Zakat payable per share or per given balance in investment account.

In case of Mother Company and its subsidiaries, the Zakat is first calculated by subsidiaries, and then the mother company would pay its share of Zakat in proportion to its shareholding in the subsidiary. The remaining part of Zakat of the subsidiary is paid by the other parties or directly by the subsidiary.

Zakat on Fixed Assets:

Fixed assets include operational fixed assets [such as the premises of the institution and its equipments, intangible assets (patent rights) and moveable assets acquired for operations] and income-generating fixed assets [such as Mustughallat (real estate properties transportation vehicles, etc), real estate investments, capital projects, investment in shares (with the aim of retaining them)].

Zakat is not obligatory on operational assets and on the income generating assets if such assets are not acquired for trade. However, Zakat is obligatory at the end of the year, on the unexpended portion of the rental / income generated by adding that portion of the income to other Zakatable assets. It is to be noted that the Zakat has to be

levied on the exact amount of Zakatable assets per share. If it is not possible then the amount is reached through estimation. If there are no zakatable assets in a company, then Zakat is obligatory on the remaining part of the net income at the end of the year.

Zakat on Liquid or Current Assets:

Liquid Assets of the institutions include Cash in Hand, Gold and Silver assets in any form, Bank Balances (Current Account and Investment Account), Bonds Sukuk, Funds, Articles of Trade, Amounts retained for Documentation of the Deal and Receivables.

In case of Cash in Hand, Zakat is assessed on the basis of its value; and on Gold and Silver assets, Zakat is assessed on the basis of their net weight or value.

In case of Bank Balances, the institutions should pay Zakat from their current account with other institutions or banks. The owners (institutions or companies) of the investment accounts should pay Zakat from the balances as well as the profits. In cases where the accounts are trust based (Amanah), the institution should pay Zakat only on their share of profit and on the accounts that earn interest. Zakat is payable from the principal, while the interest should be donated for charitable purposes.

In case of Bonds, Zakat is payable from the principal (cost of the bond). In case of Sukuk, the owners should pay Zakat on the basis of the underlying assets of the Sukuk. If the Sukuk are held as the trust (Amanah) by the institution, then the institution should pay Zakat only on their share of profit. In case of Funds, Zakat has to be paid on the basis of the underlying assets of the fund.

Articles of trade include anything that is offered for sale such as shares for the sake of trading, raw materials, commodity stocks, goods in progress, works under implementation, goods in transit, goods to be sold by others on commission, goods retained for the credit, intangible rights prepared for trade, etc. Zakat is obligatory on all the articles of trade. The articles of trade subjected to Zakat have to be valued at their cost price or market price, whichever is higher. Zakat on articles of trade can be paid in cash or kind.

The amount retained by the institution for Documentation of the Deal include the amount paid by the client to the institution in order to confirm their binding pledge against any obligation, initial security paid for entering bids, cash security, down payment (Urbun), etc. Zakat shall be paid by the client or the owner of the stated amounts annually. In case of down payment (Urbun) the seller shall pay the Zakat from the amount paid by the buyer.

In case of Receivables, the institution shall pay Zakat on the debt owed to it except in the case of Bad debt or doubtful debt, where it has to pay for one year after the collection of such debts. The institution can postpone Zakat on its outstanding debts until full or partial collection. On collection, the organisation has to pay the amount due for the previous period. Zakat should be paid on the amounts payable to the institution against goods and services.

Zakat on Liabilities:

Liabilities are further categorised into Current liabilities and Non-Current (Long-term) Liabilities. The Current liabilities include the balances of current accounts, amounts payable to the creditors,



Provisions related to fixed assets are not deductible from Zakat assets. Provisions related to current assets (valued on Market Value) are not considered as part of liabilities to be deducted from Zakatable assets. However, if the current assets are valued on Book Value then the difference between the book value and market value pertaining to the provisions should be deducted from Zakatable assets.

Beneficiaries of the Zakat system: There are eight categories of beneficiaries of the Zakat system. They are Al-Fuqara (Faqr), Al-Masakin (Miskin), Al-Amilin (Amil), Muallafat-al-Qulub (those whose hearts are to be reconciled), Fil-Riqab (to free those in bondage), Al-Gharimin (those burdened with debt), Fi-Sabilillah (in the Way of Allah) and Ibn-al-Sabil (the Wayfarer).



creditors of sold goods of Salam and Istisna, creditors of purchased goods of Istisna, payment papers (which includes bills and order bonds issued to importers of deferred goods and services), short-term loans and overdrafts, accrued expenses, prepaid income from undelivered services, due taxes, security amounts paid by the clients. All the current liabilities should be deducted from the Zakat base.

And the Non-current Liabilities include the debt arising from the purchase of the non-Zakatable fixed assets on debt. Therefore, they should not be deducted from the Zakat base.

Zakat on Provisions and Reserves:

Provisions represent the amounts retained from revenues at the end of the financial period so as to cater for probable shortage of assets or to meet unforeseen commitments of the institution. Provisions related to fixed assets are not deductible from Zakat assets. Provisions related to current assets (valued on Market Value) are not considered as part of liabilities to be deducted from Zakatable assets. However, if the current assets are valued on Book Value then the difference between the book value and market value pertaining to the provisions should be deducted from Zakatable assets.

Reserves are the amounts deducted from profits by virtue of law (statutory reserves) or as required by the articles of association of the institution or on the basis of decision of the general assembly (voluntary reserves).

As per Shariah, both types of the reserves shall not be deductible from the Zakat assets because they are not considered to be the debt obligation of the institution, although they are considered as liabilities. Since reserves are owned by the institution, they should be subjected to Zakat as part of Zakatable assets in case of applying the Net Assets method of Zakat assessment.

Methods to Calculate the Zakat for an Institution:

There are two methods to calculate the Zakat for an institution or company. They are as follows:

Net Assets Method:

Zakat base = [Zakatable Assets] - [Liabilities payable during the financial year as at the date of the balance sheet + All installments of liabilities of the financial year which will become due during the coming financial period + Rights of the holders of non-restricted Investment Accounts + Minority Rights + Sovereign rights + Waqf rights + Charitable rights + Rights of the non-profit earning organizations that have no specific owner]

Zakatable assets include: Cash and the like, receivable (minus) Doubtful Debts, Assets prepared for Trading (such as Goods, Financial Papers and Real Estate), and Financing Assets (Mudaraba, Musharaka, Salam, Istisna ...). Deduction from financial assets include, Fixed Assets relating to them as well as deductible allocations.

Net Investment Assets Method:

Zakat base = [Paid up Capital + Reserves + Provisions which have not been deducted from assets + Retained Profits + Net Income + Liabilities which are not payable during the current financial period as at the date of the Balance Sheet + Total installments of the coming financial period + Net Fixed Assets and additional investments which are not for trade such as real estate for leasing + Carried forward losses].

CHART SHOWING NISAB AND ZAKAT RATE			
S. No	Commodity	Nisab	Zakat Rate
1	Gold	85 Grams of Pure Gold	2.5%
2	Silver	595 Grams of Pure	2.5%
3	Currency	Value equal to 85	2.5%
4	Trade Articles	Equal to Value of 85 Grams of Pure Gold	2.5%
5	Livestock		
	Camels	1-4 5-9 10-14 15-19 20-24 25-35 36-45 46-60 61-75 76-90 91-120 121-129 130-139 140-149 150-159 160-169 170-179 180-189 190-199 200-209 210-219 220-229 230-239 240-249 250 and above	Nothing 1 Goat 2 Goats 3 Goats 4 Goats Bint Makhad Camel (at the second year of age) Bint Laboon Camel (at the third year of age) Hiqqah Camel (at the fourth year of age) Jathaa'h Camel (at the fifth year of age) 2 Bint Laboon 2 Hiqqah 3 Bint Laboon 1 Hiqqah + 2 Bint Laboon 2 Hiqqah + 1 Bint Laboon 3 Hiqqah 4 Bint Laboon 1 Hiqqah + 3 Bint Laboon 2 Hiqqah + 2 Bint Laboon 3 Hiqqah + 1 Bint Laboon 4 Hiqqah or 5 Bint Laboon 4 Hiqqah + 4 Bint Laboon 2 Hiqqah + 3 Bint Laboon 3 Hiqqah + 2 Bint Laboon 4 Hiqqah + 1 Bint Laboon 1 Hiqqah for every 50 Camels and 1 Bint Laboon
	Cows	1-29 30-39 40-59 60-69 70-79 80-89 90-99 100-109 110-119 120-129 130 and above	Nothing Tabee'a or Tabee'ah (at second year of age) Musinnah (at third year of age) 2 Tabee'a or 2 Tabee'ah Musinnah + Tabee'a or Tabee'ah 2 Musinnah 3 Tabee'a or 3 Tabee'ah Musinnah + 2 Tabee'a or 2 Tabee'ah 2 Musinnah + Tabee'a or Tabee'ah 3 Musinnah or 4 Tabee'a or 4 Tabee'ah 1 Tabee'a or 1 Tabee'ah for every 30 Cows and 1 Musinnah for every 40 cows
	Goats	1-39 40-120 121-200 201-399 400-499 500 and above	Nothing 1 Goat 2 Goats 3 Goats 4 Goats 1 Goat for every 100 Goats
6	Agricultural		
	Non-irrigated	653 Kilograms	10%
	Irrigated Land	653 Kilograms	5%
	Partially	653 Kilograms	7.5%
7	Minerals	Value equal to 85	2.5%
8	Treasure (Rikaz)	85 Grams of Pure Gold	20%

NOTE: THE WEALTH FROM AGRICULTURE, MINERALS AND TREASURES IS NOT SUBJECTED TO THE HAWL (COMPLETION OF ONE YEAR) PRINCIPLE. ON SUCH CATEGORIES OF WEALTH, ZAKAT IS APPLICABLE ON THE DAY OF THEIR HARVEST AND EXTRACT.



And the Non-current Liabilities include the debt arising from the purchase of the non-Zakatable fixed assets on debt. Therefore, they should not be deducted from the Zakat base.



CALCULATIONS:

After going through the legitimacy, Zakat principles for individuals and the institution, Nisab and Zakat Rate chart, let us now understand the practical procedure to calculate Zakat with an example. It is to be noted that all the values in the examples are on the basis of assumption.

Calculation of Zakat on Pure Gold:

Quantity of Pure Gold Owned	120 Grams
Duration	1 Lunar Year
Nisab for Pure Gold	85 Grams
Zakat Rate	2.5%
Total Zakat Payable	$120 \times 2.5\% = 3 \text{ Grams}$
Zakat Payable (if paid in cash @ rate 1 Gram of Gold = USD 50)	$3 \times 50 = \text{USD } 150$

Calculation of Zakat on Mixed Gold:

Quantity of Mixed Gold Owned	150 Grams
Duration	1 Lunar Year
Criterion of Purity (14,18,22 or 24 Carat)	18
Pure Gold in terms of 24 Carat	$150 \times (18/24) = 112.50 \text{ Grams}$
Nisab for Pure Gold	85 Grams
Zakat Rate	2.5%
Total Zakat Payable	$112.50 \times 2.5\% = 2.812 \text{ Grams}$
Zakat Payable (if paid in cash @ rate 1 Gram of Gold = USD 50)	$2.812 \times 50 = \text{USD } 140.62$

Calculation of Zakat on Silver:

Quantity of Pure Silver Owned	1,000 Grams
Duration	1 Lunar Year
Nisab for Silver	595 Grams
Zakat Rate	2.5%
Total Zakat Payable	$1,000 \times 2.5\% = 25 \text{ Grams}$
Zakat Payable (if paid in cash @ rate 1 Gram of Silver = USD 1)	$25 \times 1 = \text{USD } 25$

Calculation of Zakat on Currency:

Quantity of Currency Owned	USD 100,000
Duration	1 Lunar Year
Nisab for currency (Value equal to Pure Gold)	85 Grams
Zakat Rate	2.5%
Total Value in terms of Gold (@ 1 Gram = USD 50)	$100,000/50 = 2,000 \text{ Grams}$. (Hence, above the Nisab)
Total Zakat Payable	$100,000 \times 2.5\% = \text{USD } 2500$

Calculation of Zakat on Trade Articles:

Quantity of Cloth	100,000 Meter
Market Selling Price of Cloth	USD 2 / Meter
Total Value of Cloth	$100,000 \times 2 = \text{USD } 200,000$
Duration	1 Lunar Year
Nisab for Trade Articles (Value equal to Pure Gold)	85 Grams
Zakat Rate	2.5%

Total Value in terms of Gold (@ 1 Gram = USD 50)	$200,000/50 = 4,000$ Grams. (Hence, above the Nisab)
Total Zakat Payable	$200,000 \times 2.5\% = \text{USD } 5,000$

Calculation of Zakat on Livestock:

Quantity of Camels (Nos)	100
Duration	1 Lunar Year
Nisab for Livestock (Camel)	91-120 (range)
Zakat Rate	2 Hiqqah (Hiqqah is a camel at the fourth year of age)
Zakat Payable (if paid in cash @ Market Selling Price 1 Hiqqah = USD 400)	$2 \times 400 = \text{USD } 800$

Calculation of Zakat on Agricultural Produce:

Quantity of food grains produced or harvested	2,000 Kilograms
Market Selling Price	USD 10 / Kilograms
Nisab for Agricultural Produce	653 Kilograms
Zakat Rate (for Irrigated land)	5%
Zakat Payable	$2,000 \times 5\% = 100$ Kilograms
Zakat Payable (if paid in cash @ 1 Kilogram of Food grains = USD 10)	$100 \times 10 = \text{USD } 1,000$

Calculation of Zakat on Minerals:

Quantity of Petroleum Oil Extracted	100,000 Litres
Market Selling Price of Petrol	USD 1.5 / Litres
Total Value of Petroleum Oil	$100,000 \times 1.5 = \text{USD } 150,000$
Nisab for Minerals (Value equal to Pure Gold)	85 Grams
Zakat Rate	2.5%
Total Value in terms of Gold (@ 1 Gram = USD 50)	$150,000/50 = 3,000$ Grams. (Hence, above the Nisab)
Total Zakat Payable	$150,000 \times 2.5\% = \text{USD } 3,750$

Calculation of Zakat on Treasure (Rikaz):

Quantity of Gold Extracted	600 Grams
Nisab for Treasure (Value equal to Pure Gold)	85 Grams
Zakat Rate	20%
Total Zakat Payable	$600 \times 20\% = 120$ Grams (on the day it is recovered)
Zakat Payable (if paid in cash @ rate 1 Gram of Gold = USD 50)	$120 \times 50 = \text{USD } 6,000$

Calculation of Zakat on Shares (Investment):

Quantity of Shares (Investment)	1,000
Value of Shares	USD 100,000
The zakatable assets of the Company who shares	70%
Duration	1 Lunar Year
Zakatable Value of Shares	$70\% \times 100,000 = 70,000$
Nisab for Cash (Value equal to Pure Gold)	85 Grams
Zakat Rate	2.5%





Total Value in terms of Gold	70,000/50 = 1,400 Grams.
(@ 1 Gram = USD 50)	(Hence, above the Nisab)
Total Zakat Payable	70,000*2.5% = USD 1,750

Calculation of Zakat on Shares (Trading):

Quantity of Shares in possession (Trading)	10,000
Value of Shares	USD 100,000
Duration	1 Lunar Year
Nisab for Cash (Value equal to Pure Gold)	85 Grams
Zakat Rate	2.5%
Total Value in terms of Gold	100,000/50 = 2,000 Grams.
(@ 1 Gram = USD 50)	(Hence, above the Nisab)
Total Zakat Payable	100,000*2.5% = USD 2,500

Calculation of Zakat on Sukuk:

Quantity of Bonds in possession	1,000
Value of Bonds (Principal)	USD 150,000
Duration	1 Lunar Year
Nisab for Cash (Value equal to Pure Gold)	85 Grams
Zakat Rate	2.5%
Total Value in terms of Gold	150,000/50 = 3000 Grams.
(@ 1 Gram = USD 50)	(Hence, above the Nisab)
Total Zakat Payable	150,000*2.5% = USD 3,750

Note: In case of interest based bonds, Zakat is calculated on only the principal value and the total interest amount will be given to charity.

Calculation of Zakat on Mutual Funds:

Quantity of Units in possession	1,200
Net Asset Value of Units	USD 12,000
Duration	1 Lunar Year
Nisab for Cash (Value equal to Pure Gold)	85 Grams
Zakat Rate	2.5%
Total Value in terms of Gold	12,000/50 = 240 Grams.
(@ 1 Gram = USD 50)	(Hence, above the Nisab)
Total Zakat Payable	12,000*2.5% = USD 300

Calculation of Zakat on Bank Accounts:

Cash at Bank	USD 100,000
(Minimum Balance during the period)	
Duration	1 Lunar Year
Nisab for Cash (Value equal to Pure Gold)	85 Grams
Zakat Rate	2.5%
Total Value in terms of Gold	100,000/50 = 2,000 Grams.
@ 1 Gram = USD 50	(Hence, above the Nisab)
Total Zakat Payable	100,000*2.5% = USD 2,500



SNAPSHOT OF WHAT WE HAVE LEARNED:

In this module we have learned about:

- Zakat: The word Zakat in Arabic means 'purity' and 'cleansing'. The act of apportioning a certain amount of money from one's personal assets is termed as Zakat.
- An Apostolic Tradition: Allah has commanded every able Muslim to pay Zakat. Zakat happened to be an Apostolic Tradition. Prophet Muhammad (Peace be upon Him) also commanded to pay Zakat in various Ahadith.
- Wealth Subjected to Zakat: Wealth that is subjected to Zakat is Gold, Silver, Cash, Livestock, Agricultural produce, Minerals and Treasuries. We have seen the conditions under which, if they apply, Zakat becomes due.
- Nisab: Nisab is the minimum amount or the threshold limit for Zakat. If the wealth does not meet the Nisab or does not exceed the minimum amount, then Zakat is not obligatory. We have seen the different rates applicable on the wealth subjected to Zakat if it exceeds the Nisab.
- Beneficiaries of the Zakat system: There are eight categories of beneficiaries of the Zakat system. They are Al-Fuqara (Faqr), Al-Masakin (Miskin), Al-Amilin (Amil), Muallafat-al-Qulub (those whose hearts are to be reconciled), Fil-Riqab (to free those in bondage), Al-Gharimin (those burdened with debt), Fi-Sabilillah (in the Way of Allah) and Ibn-al-Sabil (the Wayfarer). We have briefly seen the description to each of the category of Zakat Beneficiaries. We have also seen the benefits of Zakat System.
- Shariah Principles applicable on the Zakat Calculation for a company with respect to the Fixed Assets, Current Assets, Liabilities, Provisions and Reserves.
- Net Asset Method and Net Investment Asset Method for calculating Zakat on company or business.

Provisions related to fixed assets are not deductible from Zakat assets. Provisions related to current assets (valued on Market Value) are not considered as part of liabilities to be deducted from Zakatable assets. However, if the current assets are valued on Book Value then the difference between the book value and market value pertaining to the provisions should be deducted from Zakatable assets.



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WAQF (Endowment)

Learning Objectives:

After completing this module the reader should know:

- The definition and meaning of the Waqf.
- The history and development of Waqf.
- The basic features, elements, structures and different types of Waqf.
- The Shariah conditions prescribed for the institutions, properties and the beneficiaries of Waqf.





INTRODUCTION

Waqf (or habs) is an Arabic word, which means preventing something from movement. In Shariah it refers to the act of making a property invulnerable to any disposition that leads to transfer of ownership, and donating the usufruct of that property to beneficiaries.

LEGITIMACY OF WAQF

The legitimacy of Waqf is derived from the following verses of the Holy Quran:

In the Quran Allah says:

“It is not Al-Birr (piety, righteousness, and each and every act of obedience to Allah, etc.) that you turn your faces towards east and (or) west (in prayers); but Al-Birr is (the quality of) the one who believes in Allah, the Last Day, the Angels, the Book, the Prophets and gives his/her wealth, in spite of love for it, to the kinsfolk, to the orphans, and to Al-Masakin (the poor), and to the wayfarer, and to those who ask, and to set slaves free, performs As-Salat (Iqamat-as-Salat) and gives the Zakat, and who fulfill their covenant when they make it, and who are patient in extreme poverty and ailment (disease) and at the time of fighting (during the battles). Such are the people of the truth and they are Al-Muttaqun” (Al Quran 02:177). “By no means shall you attain Al-Birr (piety, righteousness - here it means Allah’s Reward, i.e. Paradise), unless you spend (in Allah’s Cause) of that which you love; and whatever of good you spend, Allah knows it well” (Al Quran 03:92).

The legitimacy of Waqf is also supported by Ahadith of the Prophet (Peace be upon Him) and the practices of His companions (May Allah be pleased with them). Three of those ahadith are mentioned here for reference: “Abu Huraira (May Allah be pleased with him) reported Allah’s Messenger (May peace be upon Him) as saying: When a man dies, his acts come to an end, but three, recurring charity, or knowledge (by which people) benefit, or a pious son, who prays for him (for the deceased)” (Sahih al Muslim Hadith#4005). “Narrated Ibn ‘Umar: Umar bin Khattab got some land in Khaibar and he went to the Prophet to consult him about it saying, “O Allah’s Apostle I’ve got some land in Khaibar better than which I have never had, what do you suggest that I do with it?” The Prophet said, “If you like you can give the land as endowment and give its fruits in charity.” So Umar gave it in charity as an endowment on the condition that it would not be sold nor given to anybody as a present and not to be inherited, but its yield would be given in charity to the poor people, to the Kith and kin, for freeing slaves, for Allah’s Cause, to the travellers and guests; and that there would be no harm if the guardian of the endowment ate from it according to his need with good intention, and fed others without storing it for the future.” (Sahih al Bukhari, Book #50, Hadith #895). “Narrated Ibn ‘Umar: In the lifetime of Allah’s Apostle, Umar gave in charity some of his property, a garden of date-palms called Thamgh. ‘Umar said, “O Allah’s Apostle! I have some property which I prize highly and I want to give it in charity.” The Prophet said, “Give it in charity (i.e. as an endowment) with its land and trees on the condition that the land and trees will neither be sold nor given as a present, nor bequeathed, but the fruits

are to be spent in charity.” So ‘Umar gave it in charity, and it was for Allah’s Cause, the emancipation of slaves, for the poor, for guests, for travellers, and for kinsmen. The person acting as its administrator could eat from it reasonably and fairly, and could let a friend of his eat from it provided he had no intention of becoming wealthy by its means” (Sahih al Bukhari, Book #51, Hadith #26).

Shariah Status on Waqf:

Waqf has been emphasised by both the Sunnah (Prophetic traditions) and Ijma’a (consensus of Muslim jurists). Waqf is a binding commitment; therefore, declaring a property as Waqf would spontaneously deprive its donating owner the right of ownership.

There is a consensus among the fuqaha’ (Muslim jurists) on the definition of Waqf which means the confinement of property (ayn) from ownership and the dedication of its usufruct to charitable purposes.

DEVELOPMENT OF WAQF - A BRIEF HISTORY

The origin of the Waqf is traced to the Prophet Muhammad (Peace be upon Him) and his companions. Of the two mosques, Quba Mosque and the mosque of the Prophet Muhammad (Masjid Al Nabawi) are examples of Waqf. Moreover, Umar bin Khattab (May Allah (SWT) be pleased with him) has donated a piece of land in Khaibar as Waqf.

However, the institution of Waqf began to develop in the First Century AH and assumed a vivid legal form in the Second Century AH. Henry Cattán, in his book, “Law in the Middle East”, stated that “the institution of Wakf has developed with Islam and there is no evidence that such a complex system of appropriating usufruct as a life-interest to varying and successive classes of beneficiaries existed prior to Islam.

Henry Cattán further observed that “the close resemblance between “Trust” and “Wakf” naturally leads to an enquiry as to whether the English Trust was derived from the Islamic Wakf. There is no doubt that the Wakf is the earlier of the two institutions. The legal theory of Wakf was developed during the eighth and ninth centuries and there are Wakfs today that were established more than one thousand years ago.”

The early description of Waqf doctrines is found in Mudanwana of Sahnun in which he has collected the opinion of Malik of Ibn Qasim and of other ancient authorities of Medina. The book: Kitab Ahkam al-Waqf by Hilal contains authentic information on the doctrines of Abu Hanifa, of Abdu Yusuf and other early authorities.

The earliest pious foundations in Egypt were charitable gifts, and not in the form of a Waqf. The first mosque built by ‘Amr ibn al-’As is an example of this: the land was donated by ʿAysa b. Kulthunum, and the mosque’s expenses were paid by Bayt al-Mal (state treasury). The earliest known Waqf, founded by financial official Abu Bakr Muhammad b. ʿAlī al-Madharai in 919 (during the Abbasid period), is a pond called Birkat ʿAbash together with its surrounding orchards, whose revenue was to be used to operate a hydraulic complex and feed the poor.

There are several types of Waqf of which the most important are the charitable Waqf (al Waqf al-khairi), the family Waqf (al-Waqf al-ahli), the joint Waqf (al-Waqf al-mushtarak) and self-dedicated Waqf (al-Waqf ala al-nafs).

Joint Waqf refers to the case in which the property is donated to family as well as charitable purposes, and the income or usufruct here is shared accordingly. It is a Waqf created by a founder to support both the public and their family, i.e., the founder dedicates a part of their property to their family and another part to the public.



The earliest description of Waqf in India is found in a rare book, *Insha-i-Mahru* written by Aynul Mulk Multani, which contains letters written by him primarily to serve as models for elegant official correspondence. Nevertheless, it throws light on the social, economic and political life of that period. Letter number sixteen describes Wakfs of Multan classified as: a) Those created by “Salateen-e-Maaziah”, i.e., “earlier kings”; and b) Those created by “Danishmandane Mashaikh” and Um’ara, i.e., men of wisdom, saints and nobles. The author of the book says that Sultan Muizuddin Sam, one of the Ghaurid Sultans, dedicated two villages in favour of Jama Masjid of Multan and handed its administration to the Sahik-al-Islam. After the establishment of Delhi Sultanate in 1206 AD many more Waqfs were created. A description of Ibn Battuta offers evidence regarding the mode of administration of Waqf by Mutawallis during the Sultanate period.

CHARACTERISTICS OF WAQF

There are three important features of Waqf as agreed by Muslim jurists. They are as follows:

Irrevocability:

There is a consensus among Muslim jurists that a founder cannot revoke the dedication if the property has already been declared as Waqf. This means that a Waqf is irrevocable once a founder declares his or her property as Waqf, and their heirs cannot change its status. So the Waqf property will continue to benefit the beneficiaries and at the same time the founder will continue to get rewards from Allah even after death. However, Imam Abu Hanifah is of the opinion that the founder of the Waqf has the right to return the Waqf property to their ownership and can also sell it (i.e. the Waqf property is revocable by its Waqif, the one who created the Waqf).

Perpetuity:

The majority of Muslim jurists believe that the Waqf must be perpetual once it is created. This is to ensure that no confiscation of Waqf property will take place either by the government or by individuals and those regular and continual areas such as mosques, hospitals, orphanages, schools, etc., of the Muslim society will stay there forever.

Inalienability:

The property of Waqf is transferred to Allah, although the usufruct derived from it can benefit man. All Muslim jurists agree that no one can ever become the owner to alienate it and that Waqf property is thus in nature, like a ‘frozen asset’. It cannot be the subject of any sale, disposition, mortgage, gift, inheritance, or any alienation whatsoever.

It can be said that these three conditions will ensure the continual benefit of the Waqf property for the present and future generations, and keep rewarding its founder until the Day of Judgment.

TYPES AND CLASSIFICATION OF WAQF

There are several types of Waqf of which the most important are the charitable Waqf (al Waqf al-khairi), the family Waqf (al-Waqf al-ahli), the joint Waqf (al-Waqf al-mushtarak) and

self-dedicated Waqf (al-Waqf ala al-nafs). Let us briefly introduce each of these:

Waqf al-Khairi (Charitable Waqf):

A Waqf is said to be charitable when its income or usufruct is dedicated to a charitable purpose. It is an endowment made by the founder to support the common good and welfare of the poor and the needy in the society. Usually, the founder creates such Waqf in the form of buildings such as schools, hospitals, orphanages guest-houses or by providing basic infrastructure, dedicating books, enclosing lands for use as cemeteries, dug-wells, etc.

Waqf al-Ahli (Family Waqf):

A family Waqf is one in which the income or usufruct is reserved for specifically described persons, usually family members, children or grandchildren and relatives. The income or usufruct of such Waqf goes to a charitable purpose when none of these persons for whom the Waqf was created is existent.

Waqf al-Mushtarak (Joint Waqf):

Joint Waqf refers to the case in which the property is donated to family as well as charitable purposes, and the income or usufruct here is shared accordingly. It is a Waqf created by a founder to support both the public and their family, i.e., the founder dedicates a part of their property to their family and another part to the public.

Waqf al-Nafs (Self-dedicated Waqf):

In case of self-dedicated Waqf, the donor retains the income or usufruct of the donated property during their lifetime, and indicates the charitable purpose which shall be entitled to the income or usufruct of the Waqf after their death.

BASIC ELEMENTS OF WAQF

There are three basic elements of a Waqf. They are: Form of donation, the waqif (the donor) and the donated property.

Form of the Waqf:

The form of Waqf includes only 'offer' and it does not necessitate 'acceptance'. If someone offers a property as Waqf, it is accepted even if a legally competent beneficiary rejects the Waqf that has been earmarked for them. In case of rejection by the beneficiary, the Waqf shall still remain valid and the share of the rejecting beneficiary should go to charitable purposes. A Waqf can be formed verbally, in writing, or in any form of disposition which is normally considered as indicating it. A Waqf can be declared as effective starting from a future date, as when the donor declares their property to become Waqf starting from the following year. In principle, Waqf should be eternal. Nevertheless, temporary Waqf is also permissible when the donor desires to get back their property after a specific period.

Waqif (Donor):

The donor (waqif) can be a natural or legal person. If the donor (waqif) is a legal person, then the general assembly should make the Waqf decisions and not the board of directors. The donor (waqif) must be legally eligible to dispose of their property. Waqf is the decision of a person whose legal



competence is restricted because insanity is invalid, except when they declare their property as Waqf for themselves as long as they are alive. The validity of the Waqf decision of a person whose legal competence is restricted because of indebtedness depends on the position of their creditors. When the creditors refrain from confirming the Waqf of the indebted person, the Waqf becomes invalid.

Beneficiary of the Waqf:

The Waqf should not be made for a non-Shariah purpose. The Waqf can also be made for the benefit of the rich. It is not necessary that the Waqf beneficiary should be present at the time of declaring the Waqf. In case where the beneficiary or beneficiaries of the Waqf are no longer existent, the benefits of the Waqf should go to charity.

SHARIAH PRINCIPLES RELATED TO WAQF

Principles of Waqf Property:

The Waqf property can be a real estate along with permanent furniture and fittings. It can be movable assets, whether such movable assets are part of a real estate or independent. It can be money, and the income generated from utilisation of the money is to be spent on beneficiaries, while retaining the principal amount. It can be Shariah-compliant Shares or Sukuk and the income earned by these shares or Sukuk is to be spent on the Waqf beneficiaries. In case of liquidation, the Shariah rulings on Istibdal (exchange of Waqf property) should be applied. The Waqf property should be Shariah-compliant and known, and the waqif should be the sole owner of the property in which nobody else should have a right of disposition at the time of establishing the Waqf. If the waqif themselves have the option of disposing of the property, then the Waqf shall become valid, and the option will be spontaneously cancelled. The Waqf has a legal personality and financial liability which makes it capable of giving and accepting commitment. However, the legal personality of the Waqf is quite separate from the personality of its manager. Waqf can be a common property, whether such property is divisible or not. The whole common property in this case (not shares or Sukuk), can be leased out for rent. The share of the Waqf in the common property can also be leased out for rent. When the Waqf superintendent or the Waqf partner asks for the division of an indivisible Waqf, the refraining party should be forced to accept selling. The income obtained from selling the Waqf in this manner should be used for purchasing a Waqf property of the same kind. If such request for division is made in case of a divisible Waqf, the refraining party should be forced to accept division. Waqf can be a floor in a building. It can also enjoy easement rights (haq al-irtifaq) in a building that has not yet been constructed. The Waqf can enjoy the right of Taalli (transcendence) when the upper floor is declared as Waqf while the owner of the lower floor is unable to perform construction. The lower floor in such case can be built at the cost of the Waqf (on permission of the concerned authorities) and the cost reimbursed to the Waqf from the income generated through its leasing. Waqf can be a usufruct of an asset which the waqif acquires through rent. The waqif can lease the asset once again, and the proceeds go to the Waqf beneficiaries only when the owner of the property does not deprive the lessee of the right of subleasing.

The Waqf property should be Shariah-compliant and known, and the waqif should be the sole owner of the property in which nobody else should have a right of disposition at the time of establishing the Waqf



Principles for the Waqf Contract:

The waqif has the right to make their Waqf subject to all conditions which do not contradict with Shariah, and their conditions shall be as enforceable as Shariah conditions. The conditions of every waqif must be understood with due consideration to the prevailing norms in their environment. The designated superintendent could be an individual, a group of people, or an institution. Regarding the form of the Waqf, the waqif can make a condition that their debts should be settled from the Waqf income after their death, or they may stipulate that the income of their Waqf should go to them first as long as they are alive, then to their family, and finally to charitable purposes. Another condition of the waqif could be that the Waqf income has to be spent first on any member of their family who becomes poor, and then on charitable purposes. A condition stipulated by the waqif is invalid when it comprises a Shariah banned element, or when it violates the Shariah rulings on Waqf or causes harm to the Waqf property. In such cases, the condition should be rejected and the Waqf shall remain valid. A condition stipulated by the waqif also becomes invalid when it tends to hinder the interests of the Waqf, or jeopardises the process of benefiting from it. When the waqif stipulates that the Waqf should benefit from that particular Waqf property, then the Waqf can be benefitted either through residing or by leasing, and vice versa.

Principles for the Waqf Supervision and Management:

Supervision and management of Waqf should observe Shariah rulings on Waqf. The conditions of the waqif which do not contradict with Shariah or hinder the interests of the Waqf as perceived by the judiciary should be observed.

The tasks of a Waqf Superintendent are as follows:

- Management, maintenance and development of the Waqf.
- Leasing of the assets or usufruct of the Waqf.
- Development of the Waqf properties either directly in
- Shariah sanctioned methods of investment, or through
- Islamic financial institutions.
- Increasing the Waqf money by investing it through Mudaraba and other similar forms.
- Changing the operational form of the Waqf assets with the aim of maximising the benefits that result to the Waqf and its beneficiaries.
- Defending the rights of the Waqf, ensuring its sustainability, payment of fees to agents in case of law suits filed against the Waqf, and payment of expenses for documentation of the assets and the rights of the Waqf.
- Settlement of the debts of the Waqf.
- Payment of the entitlements of beneficiaries.
- Replacement of the Waqf either by selling it for cash and purchasing a new asset, or exchanging it with a new asset, subject to the conditions of Istibdal (exchange).
- Safeguarding the Waqf properties against occupation or seizure by others.
- Using solidarity insurance to safeguard the Waqf assets, whenever possible.
- Preparation of the Waqf accounts, and submission of statements and reports to the concerned authorities.

Waqf can be a floor in a building. It can also enjoy easement rights (haq al-irtifaq) in a building that has not yet been constructed. The Waqf can enjoy the right of Taalli (transcendence) when the upper floor is declared as Waqf while the owner of the lower floor is unable to perform construction. The lower floor in such case can be built at the cost of the Waqf (on permission of the concerned authorities) and the cost reimbursed to the Waqf from the income generated through its leasing.



Establishing a debt obligation on the Waqf is permissible through Shariah acceptable borrowing, deferred payment purchase or any other Shariah acceptable mode of financing. Establishing the debt through any of these modes has to be for the sake of maintaining and developing the Waqf, as per a condition stipulated by the waqif, or on permission of the legal authorities, and due to necessity. In establishing the debt, due consideration should also be given to the ability of the Waqf to bear such debt and sufficiency of its income for repayment.



The Waqf superintendent should not do the following:

- Neglect the conditions of the waqif.
- Lease the Waqf to themselves or to one of their dependant sons - even if such leasing is at a higher rate than the normal rent - except through the judiciary. They should not also lease the Waqf to any of their direct relatives (usool and frooa') or to their spouse, for less than the normal rent of similar property. In this case, even minor injustice (ghobn) is not forgivable, although it is forgivable in leasing to nonrelatives.
- Use the Waqf income for increasing the Waqf properties, except when this is done in fulfillment of a condition stipulated by the waqif.
- Mortgage the Waqf assets for a debt to be obtained for the Waqf or the beneficiaries, provided that the waqif has stipulated a condition against it.
- Borrow for the Waqf, except in fulfillment of a condition stipulated by the waqif, or on permission of the legal authorities, and in case of necessity. In borrowing for the Waqf the following should be observed:

Establishing a debt obligation on the Waqf is permissible through Shariah acceptable borrowing, or deferred payment purchase, or any other Shariah acceptable mode of financing. Establishing the debt through any of these modes has to be for the sake of maintaining and developing the Waqf, as per a condition stipulated by the waqif, or on permission of the legal authorities, and due to necessity. In establishing the debt, due consideration should also be given to the ability of the Waqf to bear such debt and sufficiency of its income for repayment. These restricted forms of establishing debt obligations on the Waqf do not include the case when the Waqf superintendent pays a certain amount of money from their own sources for an interest which concerns the Waqf, and the Waqf has sufficient income to be resorted to for settlement of such debt.

Cases which justify borrowing for the Waqf, when borrowing is not sanctioned by a condition stipulated by the waqif:

- (a) Need for maintenance or necessary development of the Waqf and absence of sufficient Waqf income for that.
- (b) Payment of financial commitments - if any - when the Waqf does not have sufficient funds.
- (c) Inability to pay the wages of the employees working in the Waqf or those who serve its purposes, and fear from endangering the benefits of the Waqf.

Borrowing should not be for the sake of spending on the beneficiaries of the Waqf.

In principle, the income of the Waqf of a specific mosque is to be spent in its own interests. If there is still an excess income which has not been spent, it is permissible to transfer such amount to another mosque that does not have enough income to cover its expenses, or the cost of its maintenance and renovation. By virtue of public guardianship the judiciary has the authority of overseeing the supervision and management of the Waqf, preservation of its assets, and development of its sources. The judiciary has also the right of investigating the overall status of the Waqf, looking into

any complaints raised against the Waqf superintendent or any other party, and subjecting the Waqf superintendent to disciplinary action.

Principles of Leasing Waqf Assets:

In principle, a long period of leasing should not be the normal practice for Waqf assets, except for obvious interest, and provided that a variable rent, linked to an accurate and well known index, is going to be sought. Waqf assets or usufruct should not be leased at less than the rent of similar property. When leasing at a lower rent is inevitable, it should be considered in view of the actual necessity. If there happens to be a new tenant who can pay the rent of similar property, then the Waqf superintendent has the right to terminate the previous contract, unless the old tenant accepts the rent increment. If the normal rent for the Waqf in question has risen because of developing the Waqf land and constructing a new building on it at the cost of the Waqf, the tenant is obliged to accept rent increment. If land development and construction of facilities is done at the cost of the tenant, then the person is not bound to accept the rent increment. A lease contract can be signed with the aim of keeping the Waqf land in the hands of the tenant as long as the tenant pays the normal rent for similar property as it changes according to circumstances. This type of contract is known as (hikr) and is subject to the following conditions:

- The Waqf has no income to be used for its development.
- There is no person willing to have fixed term rent and make advance payment so as to be spent on developing the Waqf.
- Istibdal (exchange) of the Waqf is not possible.
- Haq al-qrar (right to stay) which a tenant deserves when the person pays at the time of signing the lease contract a lump sum amount, known as (kardar) for development of the Waqf, and a rent which is below the rent of similar property. This form of Waqf leasing is permissible when dictated by necessity, and if there is no tenant willing to pay the normal rent for similar property along with a lump sum for developing the Waqf. In some countries this contractual form is known as (al-khulu).

Principles for the Development of Waqf Assets:

It is permissible to invest Waqf income, in the following cases:

- As per a condition stipulated by the waqif.
- During the waiting period (prior to identification of beneficiaries).
- Excess income, after payment to beneficiaries.
- Investment in these cases should be done through Shariah permitted methods such as Mudaraba, Musharaka, Murabaha, Leasing and Salam, and low risk investments.
- For development of the Waqf land, the following is permissible:
- Application of the Istisna through (B.O.T) contracts.
- Application of diminishing Musharaka, where the Waqf and the financing partner construct a building or facility through joint financing (excluding the Waqf land), and the Waqf gradually owns the facility.
- Application of Lease Ending with Ownership for a



In principle, the income of the Waqf of a specific mosque is to be spent in its own interests. If there is still an excess income which has not been spent, it is permissible to transfer such amount to another mosque that does not have enough income to cover its expenses, or the cost of its maintenance and renovation.

specifically described property to be delivered in the future. In this case the Waqf land is leased (through Musataha Contract) to the financier who constructs a building on it and delivers it to the Waqf to execute the lease contract.

- At the end of the contracting period, the Waqf becomes the owner of the building.

All appropriate means should be adopted for the development of a Waqf, with due consideration to Shariah rulings on Waqf and the conditions stipulated by waqifs, as well as present day requirements. Help in this regard should be sought from Islamic financial institutions, specialised in Waqf investments.

In the absence of sufficient amounts for maintenance and renovation of a leased Waqf asset, the Waqf superintendent has the right to allow the tenant to make such maintenance and renovation, against having the priority to continue as a tenant of the Waqf asset until getting full repayment of their debt.



Principles for the Maintenance of Waqf Assets:

Maintenance, Renovation and Replacement of Waqf Assets, and Allocation of Reserves for that Purpose:

- Spending on maintenance reparation and renovation of the Waqf assets should precede distribution of the Waqf income among beneficiaries.
- In this connection, due consideration should be given to the technical schedules of periodical maintenance.
- Maintenance and reparation of Waqf assets also do not require a prior condition to be stipulated by the waqif.
- Maintenance and renovation requirements (maintenance reserves) should be retained from the waqif income every year even if the waqif has not stipulated such a condition.
- The reserve, thus deducted, can be invested in a safe and easy-to-liquidate form of investment, and the returns be added to the principal amount.
- The beneficiaries should have no right to the maintenance reserve, unless part of it turns out to be in excess of actual needs.
- In the absence of sufficient amounts for maintenance and renovation of a leased Waqf asset, the Waqf superintendent has the right to allow the tenant to make such maintenance and renovation, against having the priority to continue as a tenant of the Waqf asset until getting full repayment of their debt.
- Solidarity insurance should be used for maintenance or renovation of the Waqf assets.

Making Allocations for Replacement of Waqf Assets:

It is permissible to deduct from the Waqf income (after distribution to beneficiaries) periodical amounts commensurate to the economic lifetime of the depreciating Waqf assets, so as to use the accumulated amount for replacement of these assets (depreciation allowance).

Principles for the Exchange (Istibdal) of Waqf Assets:

Istibdal refers to the process of selling the Waqf asset and purchasing a new one instead, so as to maximise the interest of the Waqf. Istibdal can take place according to a condition stipulated by the waqif, or when the Waqf becomes ruined (even if prevented by the waqif). Istibdal, in such cases, takes place by selling the Waqf property and purchasing a new one instead, so as to maintain the Waqf as it was before. Istibdal

is also permissible when there is no way of benefiting from the Waqf (e.g. the Waqf has been in a deserted area), or due to fear of seizure of the Waqf by others, or when benefitting from the Waqf becomes extremely difficult. Istibdal should be subject to the following conditions:

- The Waqf must have reached the stage of generating no income, while there is no money for its development.
- There should be no excessive injustice in the sale price.
- Istibdal should meet the satisfaction and interest of the Waqf.
- Istibdal should be permitted by the judiciary.
- If the Waqf is a real estate, it should also be exchanged for a real estate.
- When there is no risk of misuse, a real estate Waqf can be sold for cash, and the money kept with the judiciary until a new real estate is purchased.

SNAPSHOT OF WHAT WE HAVE LEARNED:

In this module we have learned about:

- **Waqf:** Waqf (or habs) is an Arabic word, which means preventing something from movement. In Shariah, it refers to the act of making a property invulnerable to any disposition that leads to transfer of ownership, and donating the usufruct of that property to beneficiaries. We have seen that the legitimacy of Waqf is derived from both Quran and Sunnah.
- **Irrevocability:** It is one of the characteristic features of Waqf. This means that a Waqf is irrevocable once a founder declares his or her property as Waqf, and their heirs cannot change its status.
- **Perpetuity:** It is one of the characteristic features of Waqf. It means the Waqf must be perpetual once it is created.
- **Inalienability:** It is one of the characteristic features of Waqf. All Muslim jurists agree that no one can ever become the owner to alienate it and that Waqf property is thus in nature, like a 'frozen asset'. It cannot be the subject of any sale, disposition, mortgage, gift, inheritance, or any alienation whatsoever.
- **Waqf al-Khairi:** It is one of the types of Waqf. A Waqf is said to be charitable when its income or usufruct is dedicated for a charitable purpose.
- **Waqf al-Ahli:** It is one of the types of Waqf. A family Waqf is a Waqf in which the income or usufruct is reserved for specifically described persons, usually family members, children or grandchildren and relatives.
- **Waqf al-Mushtarak:** It is one of the types of Waqf. Joint Waqf refers to the case in which the property is donated to the family as well as charitable purposes, and the income or usufruct is shared accordingly.
- **Waqf al-Nafs:** It is one of the types of Waqf. In case of self-dedicated Waqf, the donor retains the income or usufruct of the donated property for himself as long as he/she is alive
- Form of the Waqf, Waqif and the Beneficiary of Waqf are three basic elements of a Waqf.
- Specific Shariah Principles for Waqf Property and Contract. Principles for Supervision, Management, Leasing, Development, Maintenance and Exchange of Waqf Assets.



Istibdal refers to the process of selling the Waqf asset and purchasing a new one instead, so as to maximise the interest of the Waqf. Istibdal can take place according to a condition stipulated by the waqif, or when the Waqf becomes ruined (even if prevented by the waqif).

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Glossary

Word Translation-English	Arabic Form	Definition
Ajr or Ujrah	أجر وأجرة	A payment or compensation such as commission, fees or wages charged for services.
Muqayyadah	مقيدة	Literally means 'restricted'. It is used for the investment contract for example, Mudaraba if the investment there under is strictly to be made in the specified business.
Al Quran	القرآن	It is a divine book and the word of Allah (SWT), revealed as the final revelation and guidance to His final Prophet and Messenger Muhammad (Peace be upon Him). It contains 114 chapters containing more than 6000 verses.
Al Waqf Al-Khairi	الوقف الخيري	A Waqf whose income or usufruct is dedicated for a charitable purpose.
Al-A'amilin, (Sing. Al A'amil)	العاملين، (واحد: العامل)	Literally it means workers, those who perform a task. As a term it is used for 'Zakat Collectors' who are also one of the beneficiaries of Zakat.
Al-Amin	الأمين	One who holds honestly the trusts of other people; trustworthy.
Al-Aqilah	العاقلة	Kin or persons of relationship who share responsibility. Mutual help, which was an arrangement of mutual help or indemnification customary in some tribes at the time of the Prophet Muhammad (peace be upon him). This is a foundation doctrine based on which Islamic insurance practices, known as Takaful, have been developed.
Al-Darb Fil Al-Ard	الضرب في الأرض	It means to make a journey (to earn money).
Al-Fuqara'a, (Sing. Al-Faqeer)	الفقراء، (واحد: الفقير)	Pl. Faqir is a person who is dependent on others for his/her subsistence.
Al-Gharimin, (Sing. Al-Gharim)	الغارمين، (واحد: الغارم)	The debtors who do not have money to repay their debt. They fall under one of the eight groups entitled to receive Zakat.
Al-Istisna Al-Muwazi	الاستصناع الموازي	Parallel Istisna. (See the definition of Istisna).
Al-Masakeen, (Sing. Miskeen)	المساكين، (واحد: المسكين)	The needy people. They are also entitled to receive Zakat.
Al-Muslem	المسلم	The buyer of a commodity under Salam contract is known as Al-Muslem or Rab al-Salam. (See the definition of Salam).
Al-Muslam Fihi	المسلم فيه	Al-Musalam Fihi is the subject of sale in a Salam Contract. (See the definition of Salam).

Glossary

Word Translation-English	Arabic Form	Definition
Al-Muslam Ilaihi	المسلم إليه	The seller of a commodity under Salam contract is known as Al-Muslam Ilaihi. (See the definition of Salam)
Al-Waad	الوعد	Literally, it is a promise or an undertaking. Under Islamic finance transactions it is always issued unilaterally by one party in favor of other. A 'Promise' is sought by a party who wishes to secure its position or to have certain rights available to it in a transaction.
Al-Waqf Ala Al-Nafs	الوقف على النفس	A type of waqf in which the donor retains the income or usufruct of the donated property for himself as long as he/she is alive. (See the definition of Waqf).
Al-Waqf Al-Ahli	الوقف الأهلي	A waqf in which the income or usufruct is reserved for specifically described persons, usually family members, children or grandchildren and relatives. (See the definition of Waqf).
Al-Waqf Al-Mushtarak	الوقف المشترك	A waqf in which the property is donated to family as well as charitable purposes, and the income or usufruct here is shared accordingly. (See the definition of Waqf).
Amanah	أمانة	Literally it means trust, reliability, trustworthiness, loyalty, honesty etc. Technically, it is an important value of Islamic society in mutual dealings; it also refers to deposits in trust. A person may hold property in trust for another; it entails the absence of any liability for loss, except for breach of duty.
Amin	أمين	Trustworthy
Aqd (Pl. Uqood)	عقد (جمع: عقود)	Contract
Aqd al Tabarru	عقد التبرع	A contract of donation out of one's own free will without any compulsion or obligation. It is the backbone of Takaful (Islamic Insurance) system.
Arbabul Maal, (Sing. Rab-al Maal)	أرباب المال, (واحد: رب المال)	The owners of the Mudaraba capital.
Asabiyya	عصبية	It refers to social solidarity with an emphasis on unity, group consciousness and sense of shared purpose, and social cohesion.
Ayn (Pl. A'ayaan)	عين (جمع: أعيان)	Tangible Monetary Wealth. A physical asset.
Bay Al-Wafa	بيع الوفاء	Buy-back, sale and repurchase, a contract with the condition that when the seller pays back the price of goods sold, the buyer returns the goods to the seller.
Bai al Salam / Bai-al Mafalis / Ba'i-al Salaf	بيع السلم / بيع المفاضيل / بيع السلف	A type of sale where the full purchase price of the

Glossary

Word Translation-English	Arabic Form	Definition
		goods is paid in advance at the time of contract; the goods are not available for immediate delivery but can be delivered at a specified time in the future.
Baitul-Mal	بيت المال	Public Treasury in the Islamic State.
Ba'i	بيع	Stands for "sale". It is often used as a prefix in referring to different sales-based modes of Islamic finance, such as Murabaha, Istisna, and Salam Sales.
Bay Al-Muqayada	بيع المقايضة	Exchange of goods with goods. A Barter Sale.
Bay Al-Sarf	بيع الصرف	Sale of monetary value for monetary value. In modern banking and financial system it is referred to the Currency Exchange transaction. From Shariah point of view the different denominations of the same currency cannot be exchanged except on par with their spot delivery. Two different currencies, however, can be exchanged on any value the parties are agreed on provided both the currencies are delivered on spot.
Ba'i' Al-Mutlaq	بيع المطلق	Conclude a sale without any option to rescind.
Ba'i Bithaman A'ajil	بيع بثمن آجل	This contract refers to the sale of goods on a deferred payment basis; A Deferred Payment Sale.
Bint Laboon	بنت لبون	A camel at the third year of age.
Bint Makhad	بنت مخاص	A camel at the second year of age.
Dayn	دين	A Debt which comes into existence either through lending and borrowing transaction or by executing any sale contract where the consideration is deferred.
Ena	بيع العينة	A form of sale where the Seller sells the goods/commodity to a Buyer on deferred payment basis and in turn, the Buyer sells back the same goods/commodity on spot payment basis to the same Seller for a lesser price on which it purchased from the Seller.
Al Faqir (Pl. Al Fuqara'a)	الفقير (جمع: الفقراء)	A poor person who is dependent on others for his/her subsistence.
Fi-al-Riqab	في الرقاب	Those in bondage such as slaves, prisoners of war etc.
Fiqh	الفقه	Literally it means understanding. As a term it refers to the whole corpus of Islamic jurisprudence which deals with all aspects of life - religious, political, social, commercial, economic etc.

Glossary

Word Translation-English	Arabic Form	Definition
Fi-Sabilillah	في سبيل الله	It stands for "In the Way of Allah". This includes all the efforts and struggles for the sake of Allah's Cause. It is one of the heads which the Zakat is spent for.
Al Fuqaha'a (Sing. Al Faqeeh)	الفقهاء (واحد: الفقيه)	Muslim Jurists
Gharar	غرر	Literally it stands for hazard, jeopardy and danger. In Islamic finance it refers to an element in a contract which leads to the uncertainty and vagueness which is not permissible in Shariah. The prohibition on gharar is often used as the grounds for criticism of conventional financial practices such as short selling, speculation and derivatives.
Ghobn	غبن	Misappropriation or defrauding others in respect of specifications of the goods and their prices.
Hadith (Pl. Ahadith)	حديث (جمع: أحاديث)	A record of the sayings, doings and tacit approval to an action of the Prophet Muhammad (peace be upon him).
Hajj	حج	Pilgrimage to Makkah. Hajj is the fifth pillar of Islam and it is a duty on every Muslim who is financially and physically able to carry it out, at least once in his/her lifetime.
Halal	حلال	That which is permissible by the Shariah, valid earnings, etc.
Hamish Jiddiyyah	هامش جدية	Earnest money, a deposit paid by the client (buyer) to the seller before concluding a contract of sale. It is also referred to as 'Security Money'.
Haq Al-Irtifaq	حق الإرتفاق	Easement rights
Haq Al-Qrar	حق القرار	Right to stay
Haram	حرام	Unlawful in Islam. Anything which is explicitly prohibited by the Shariah.
Hawala	حوالة	Literally, it means transfer; legally, it is an agreement by which a party shifts its obligations or transfers its rights to someone. It also simply refers to money transfer.
Hawl	حول	It is a term used to denote a time period (i.e. a Complete Lunar Year), one of factors which determines the Zakat obligation.
Hijri	هجري	Name of the Islamic lunar calendar which started from the migration of Prophet Muhammad (peace be upon him) from Makkah to Madinah. The months of the Islamic calendar are: 1. Muharram. 2.

Glossary

Word Translation-English	Arabic Form	Definition
		Safar. 3. Rabii al-Awal. 4. Rabii al-Akhira. 5. Jumada al-Awal. 6. Jumada al-Akhira. 7. Rajab. 8. Shaban. 9. Ramadan. 10. Shawal. 11. Dhul Qida. 12. Dhul Hijjah
Hiqqah	حنة	A camel at fourth year of age.
Ibn-Al-Sabil	ابن السبيل	It refers to 'traveler' or 'wayfarer'. Ibn-Al-Sabil falls under the category which is entitled to get the benefit of Zakat.
Ijarah	إجارة	An Islamic lease contract.
Ijarah Mowsufa-Fi-Al-Dhimmah	الإجارة الموصوفة في الذمة	It is a contract of lease for an unidentified but specified asset / property. This is a type of lease where the contract is signed between the Lessor and Lessee before the subject of lease comes into existence. This lease contract, however, is binding on the parties and it clarifies the specifications of the lease asset in details, delivery date, lease period, Rental amount and the frequency of the rental payments.
Ijarah Muayyanah	إجارة معينة	It is a lease of any identified asset / property.
Ijarah Muntahia Bittamleek	الإجارة المنتهية بالتملك	It simply means to 'Lease to Own'. In Islamic finance, it refers to a type of lease where the lease asset is transferred at the end of lease to the Lessee unlike the normal lease where the Lessee returns the asset to the Lessor at the end of lease period.
Ijma'a	إجماع	Consensus, usually on a given issue as represented by the agreement of the jurists. It has traditionally been recognised by most Muslim jurists as an independent source of Islamic jurisprudence.
Ijtihad	إجتihad	Literally, it means effort, exertion, and diligence. It is a very commonly used Islamic jurisprudence terminology which refers to 'Independent or innovative legal reasoning or interpretation (by qualified Islamic legal scholars) to formulate a ruling on a given issue on the basis of evidence found in the sources of Shariah.
Illah	علة	The attributer of an exchange or event that entails particular divine ruling cases possessing that attribute- cause of prohibition of specific exchange contracts. Illah is the basis for applying analogy for determining permissibility or otherwise of any transaction.
Iman	الإيمان	Iman (belief) is the first pillar of Islam. It precisely includes the belief in the oneness of Allah, the Prophet hood and the life after death.

Glossary

Word Translation-English	Arabic Form	Definition
Infraq-Fi-Sabilillah	الإنفاق في سبيل الله	Spending in the way of Allah for Zakat (Mandatory charity) and Sadaqat (Optional charities).
Islam	الإسلام	Literally, it means 'Submission' which dictates that a believer submits to the will of Allah (Almighty God), conforming inwardly and outwardly to His laws. It is the only religion which Allah sent to the mankind through all of His messengers and prophets. Islam was completed by the final revelation of Allah to His final prophet Muhammed (peace be upon him) in the form of Quran.
Istibdal	الاستبدال	Exchange. Commonly used for the exchange of physical assets.
Istisna	الاستصناع	This is a kind of a Sale transaction of an item which requires manufacturing and construction. Under Istisna an asset is sold before it comes into existence because the Seller is required to transform the raw materials into a specified asset through the process of manufacturing or construction. Istisna can be used for financing the manufacture or construction of machineries, houses, plant, projects, bridges, roads and highways.
Jatha'h	جذع	A camel at fifth year of age.
Jizia	جزية	A tax imposed on non-Muslims who are under the full responsibilities of a Muslim country.
Kafala	كفالة	Literally, the Kafala means Surety, Guarantee or Security. Legally, a third party who takes the responsibility of paying the debt of an original debtor is called the guarantor or 'Kafeel' in Arabic.
Khalifa	خليفة	Vicegerent or Viceroy of Allah.
Kharaj	خراج	In Islamic law, kharaj refers to a tax on agricultural land.
Khiyar Al-Shart	خيار الشرط	An option to a buyer to cancel an executed sale transaction within a specified time period. This option is automatically called off either due to the lapse of the specified time period or if Buyer has sold the purchased item to a third party.
Madahib (Sing. Madhab)	مذاهب (واحد: مذهب)	They are the schools of thought in Fiqh (Islamic Jurisprudence) characterized by differences in the methods or approaches by which a Shariah law is interpreted. There are four well known schools of Islamic Hanabali, Hanafi, Maliki and Shafi'i.
Madina	مدينة	The second holiest city in Islam located in the Kingdom of Saudi Arabia. This is also known as the

Glossary

Word Translation-English	Arabic Form	Definition
		city of Prophet Muhammed (peace be upon him) as he migrated to it from his birth place, Makkah.
Makkah	مكة	The holiest city in Islam located in the Kingdom of Saudi Arabia where the Kaaba is situated in the center of Masjid Al Haram. Makkah is also the birth place of Prophet Muhammad (peace be upon him).
Melk-at-Taamm	ملك التام	Melk-at-Taamm means full ownership. The owner must have an ability to act freely with what he possesses. No Zakat is paid for the wealth, which is not in the absolute ownership (Melk-at-Taamm) of its owner.
Miskin (Pl. Masakin)	مسكين (جمع: مساكين)	A Miskin is a person who is suffering from Maskanah or distress more than the ordinary poor. A Miskin is one of the eight categories of the Zakat beneficiaries.
Muallafat-Al-Qulub	مؤلفة القلوب	Those whose hearts are to be reconciled. It is also one of the eight categories of the Zakat beneficiaries.
Muamalat	المعاملات	Trades between the human beings which cove all types of financial or non-financial dealings.
Mudaraba	مضاربة	A Mudaraba is a type of partnership, whereby the investor (the 'Rab ul Maal') provides capital to another party/entrepreneur (the 'Mudarib') in order to undertake a business activity. While profits are shared on a pre-agreed ratio between the parties, the loss is solely borne by the investor. The mudarib loses its time and efforts.
Mudarib	مضارب	The mudarib is the entrepreneur or investment manager in a Mudaraba who invests the investor's funds in a project or portfolio in exchange for a share in the realized profit.
Mufawdhah	مفاوضة	It is a partnership in which the parties are equal in all respects, such as funds contribution, management rights, liabilities, etc.
Muhal Alaihi	محال عليه	The ultimate payer to whom the payment obligation is transferred by the original debtor in a Hawala contract.
Muheel	محيل	The transferor of the payment obligation in a Hawala contract. The one who is the creditor in a Hawala Contract is called 'Muhal' (محال).
Maqassah	مقاصة	A set-off. It is the discharge of a debt receivable

Word Translation-English	Arabic Form	
		against a debt payable
Murabaha	مرا بحة	A Sale transaction where the Seller discloses the cost of acquiring the goods and its profit to a Buyer.
Musaqa	مسا قة	It is a contract of irrigation where the owner of a farm / orchard shares the produce with one who irrigates it.
Musawama	مسا ومة	It is a Sale transaction where the Sale Price is determined by a negotiation between the Seller and the Buyer. Unlike Murabaha, there is no need for the Seller to disclose its cost of purchase to the Buyer.
Musharaka	مشاركة	It is partnership between two or more parties who contribute their capital or combine their asset, labour or liabilities with an aim to make the profit. In Musharaka the profit is shared as per an agreed ratio whereas the losses are shared in proportion to the capital of each partner.
Musharaka Mutanaqisa	مشاركة متناقصة	A type of Musharaka (Partnership) where a partner gradually purchases the share of other partner who quits the Musharka after the sale of his all shares in a Musharaka (Partnership) business.
Musinnah	مسنة	A cow at third year of its age.
Mustasne	مستصنع	The purchaser in an Istisna Contract.
Mustawd'e	مستودع	The person entrusted with an asset to take care of it.
Mustawriq	مستورق	A person buying merchandise at a deferred price in order to sell it in cash.
Mustughallat	مستغلات	All the moveable and immovable properties like factories, buildings, ships, aircrafts, and vehicles etc. which are kept not for trade or sale but to generate income thereupon.
Mutawalli	متولى	A trusty of a Waqf also known as "Qayyem" (قيم).
Muwd'e	مودع	The proprietor of the thing which is entrusted to some other person under Wadia contract.
Muzara'a	مزارعة	Share-cropping: an agreement between parties in which one person agrees to till the land of the other person in return for a part of the produce of the land.
Nisab	نصاب	A threshold limit for the prescribed wealth meeting of which obligates the payment of zakat. The Nisab

Glossary

Word Translation-English	Arabic Form	Definition
		is different for different types of wealth.
Qardh	قرض	A loan.
Qard Hasan	قرض حسن	A virtuous loan. Loan in the meaning of a virtuous loan that is interest-free and extended on goodwill basis, mainly for welfare purposes, the borrower is only required to pay back the borrowed amount.
Qayyem	قيم	A trustee.
Qiyas	قياس	The process of analogical reasoning as applied to the deduction of juridical principles from the Qur'an and the Sunnah (the normative practice of the community). With the Qur'an, the Sunnah, and ijma (scholarly consensus), it constitutes the four sources of Islamic jurisprudence.
Rab Al-Salam	رب السلم	The buyer of a commodity under Salam contract also known as Al-Muslem.
Rab-Al-Maal	رب المال	Owner of capital. In a Mudarabah contract, the person who invests the capital.
Rahn	رهن	Pledge or Mortgage. Technically, a security given for the payment of a debt.
Riba	ربا	Usury or Interest. In simple terms riba covers any benefit gained on money lent - whether the interest is fixed or floating, simple or compounded, and at whatever rate. Riba is strictly prohibited in Islam.
Riba Al-Fadl	ربا الفضل	It is a type of Riba (Usury) which takes place in a barter sale where a commodity is exchanged for the same type of commodity but unequally in amount like 10 kgs of wheat is exchanged for 12 kgs of wheat. Riba al-fadl was prohibited by Prophet Muhammad (peace be upon him) to forestall Riba from creeping into the economy. Also known as Riba al-buyu.
Riba Al-Nasi'ah	ربا النسيئة	It is another kind of Riba (Usury) which is charged from a borrower on the loan due a period granted by the lender for the repayment of the loan amount. It is also known as 'Riba al Jahiliyyah'.
Ribh	ربح	Profit.
Rikaz	ركاز	Ancient wealth found hurried in land.
Sadaqah (Pl. Sadaqaat)	صدقة (جمع: صدقات)	Charity. An act of charity or Anything given away in charity in the name of Allah.
Saftija	سفتجة	A credit instrument issued to a creditor to enable

Glossary

Word Translation-English	Arabic Form	Definition
		him to use or encash it at another predetermined venue and at the future date.
Saha-E-Sittah	الصحاح الستة	A body of six most authentic books in which hadith were collected and compiled by different scholars using the method of biographical analysis.
Sakk (Sing. Sukuk)	صك (جمع: صكوك)	It is the Arabic name for financial certificates, but commonly refers to the Islamic equivalent of bonds. <i>As per AAOIFI Sukuk are "certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity"</i>
San'e	صانع	The manufacturer or constructor (Seller) in an Istisna Contract.
Sawm	صوم	Sawm (fasting) is the fourth pillar of Islam. It is obligatory on every Muslim to observe fasting in the month of Ramadan every year.
Shariah	شريعة	Shariah literally means the path to the watering place. In technical and legal usage, however, Shariah refers to the commands, prohibitions, guidance and principles derived from the primary sources of Islam, the Qur'an and Sunnah.
Sharikat Al-Melk	شركة الملك	Partnership of ownership, which comes into existence either automatically in the case of inheritance or optionally when two or more person purchase common shares in an asset.
Sharikatul Al-Inan	شركة العنان	Contractual Partnership.
Shirka or Shirakah	شركة أو شراكة	Partnership. A contract between two or more persons who launch a business or financial enterprise to make profit. In the present Islamic banking and finance terminology, Shirkah may include both Mudarabah and Musharaka and various other Musharaka like business and commercial partnerships.
Shirkat Al-Aqd	شركة العقد	A contract between two or more persons who launch a business or financial enterprise to make profit. Generally, it is termed as 'Shirkah'.
Sukuk Al-Intifa	صكوك الانتفاع	These Sukuk are issued for the purpose of leasing out tangible future assets and for collecting rentals so that the usufruct of the described future asset passes into the ownership of the holders of the Sukuk.
Sukuk Al-Khadamat Al-Mawsufah-Fi-Al-Dhimmah	صكوك الخدمات الموصوفة في الذمة	These Sukuk are issued for the purpose of providing future services like certain prescribed educational

Glossary

Word Translation-English	Arabic Form	Definition
		benefits from any university and obtaining fee in the form of subscription income so that holders of the Sukuk become owners of the services.
Sukuk Al-Manfaah	صكوك المنفعة	These Sukuk are issued by the owner of an existing asset with the aim of subleasing the usufruct and receiving rentals.
Sukuk Al-Mugharasa	صكوك المغارسة	These Sukuk are issued to use the funds raised through subscription in an agricultural project such as planting trees and undertaking the work and expenses required by such plantation.
Sukuk Al-Musaqa	صكوك المساقاة	These Sukuk are issued to use the funds raised through subscription in an irrigation project such as providing irrigation to fruit bearing trees, spending on them and caring for them.
Sukuk Al-Muzaraa	صكوك المزارعة	These Sukuk are issued to use the funds raised through subscription in a cultivation project.
Sunnah	السنة	Literally, custom, habit or way of life. Commonly understood as the sayings and living example of the Prophet Muhammad (peace be upon him) as recorded in the books of Hadith. Sunnah is a legislative source along with The Qur'an.
Taawun	تعاون	A principle of mutual assistance.
Taalli	تعلي	Transcendence. It is a right to build over a land or an upper floor over an already constructed building.
Tabarru	تبرع	Act of charity out of one's own free will without any compulsion or obligation. Islamic Insurance (Takaful) is based on the mutual Tabarru.
Tabe'e or Tabee'ah	تبيع أو تبعية	A cow at second year of age.
Takaful	تكافل	Mutually Guarantee. It is backbone of Islamic insurance.
Tawarruq	التورق	Acquiring cash through trade activities. Technically, according to the Muslim jurists, tawarruq can be defined as an act of buying a commodity at a deferred price, in order to sell it in cash at a lower price.
Tawarruq Fiqhi	التورق الفقهي	Classical tawarruq- This type of tawarruq is defined as person (mustawriq) buying merchandise at a deferred price in order to sell it in cash at a lower price. Usually, he sells the merchandise to a third party with the aim of obtaining cash without any prearrangement with the Seller.

Word Translation-English	Arabic Form	Definition
Tawarruq Munazzam	التورق المنظم	Organized tawarruq- This type of tawarruq' is defined as when a person (mustawriq) buys merchandise from a local or international market on a deferred price basis. Usually, he sells the merchandise to a third party with the aim of obtaining cash with prearrangement between all the parties.
Tawliyyah	تولية	Tawliyyah is sale on which the commodity is sold at purchase price without making profit.
Uqubat	عقوبات	Punishments in or as per Islamic law
Urboun	عربون	A down payment or deposit paid by a buyer for a sale with a right to take the delivery of the purchased goods at a certain time after paying the full agreed purchase price to the Seller. If the buyer does not complete the purchase or backs out for any reason, the Seller has the option to forfeit the deposit.
Wajib	واجب	Obligatory, compulsory, mandatory.
Wakala	وكالة	Literally, it means Agency.
Wakil	وكيل	Agent
Waqf	وقف	It literally means 'hold', 'confinement' or 'prohibition'. Technically, appropriation or tying-up of a property in perpetuity so that no propriety rights can be exercised over their use. An endowment of charitable trust in the meaning of holding certain property and preserving it for the confined benefit for a certain charitable objective and prohibiting any use or disposition of it outside that specific objective.
Awqaf	أوقاف	Pl. of Waqf also used as a name of the institution which looks after the Waqf Properties
Waqif	واقف	The one who created the Waqf
Warak	ورق	Silver minted into dirhams
Wasiyyah	وصية	Will. Bequest. or Will (according to Islamic law a person cannot bequeath more than one third of his total inheri-tance nor can he bequeath in favour of his heirs).
Wadhia	وضعية أو بيع الوضعية	Sale below the cost price or at a discounted price.
Zakat	زكاة	Lit: blessing, purification, increase or cultivation of good deeds. An obligatory contribution or tax which is prescribed by Islam on all Muslim persons having wealth above an exemption limit at a rate fixed by the Shariah. Zakat is the third pillar of Islam. According to the Islamic belief Zakat purifies wealth and souls. The objective is to take away a part of the wealth of the well-to-do and pay it to the Islamic state in the absence of which distribute it among the poor and needy. It is levied on cash, cattle, agricultural produce, and valuable assets, capital invested in industry or business or any other forms that could be termed as wealth.





MARIFA