Islamic Finance

Theory & Practice

3rd Edition

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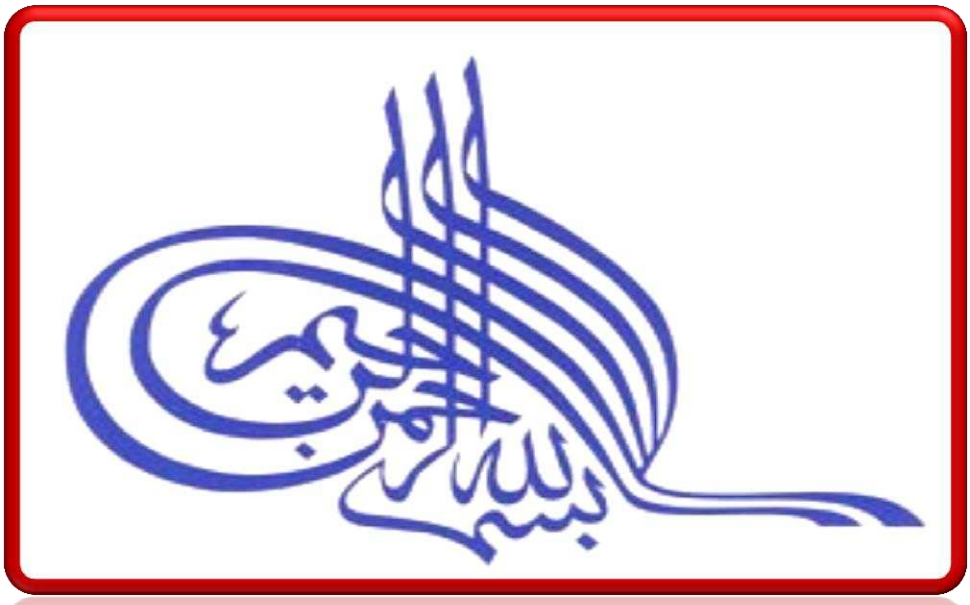
بسم الله الرحمن الرحيم

This book is written by an accountant; not by a *Mufti* (Jurist in Islamic Law); for general understanding in the area of Islamic finance and Must not be assumed *Fatwa* (Juristic opinion) on the Subject. Reader is requested to consult the original Sources; or a *Mufti* for Determination of *Haram & Halal* (prohibited & permitted) in a particular situation.

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To

Inquisitive minds; in search of truth, knowledge and justice

PREFACE

This book is the result of five years teaching of Islamic finance course to MBA Finance students. This book is written with a clear focus on learning of Islamic banking & finance by accounting, banking, business and finance students/professionals. Resources available, so for, on the subject have focused on the legal side and very negligible work is available on the financial front for a common user. This book is written in financial perspective, and the author has focused upon financial impacts, generated by application of Islamic financial laws. However, a summary of Islamic commercial laws of each chapter has been provided. Author has adopted balance sheet method to inculcate the knowledge; hence, understanding of elementary balance sheet is recommended to get maximum out of this book.

This book is divided into five parts. Part-1 presents an update on Islamic finance, why and how Islamic banking started; What is current status; Meaning and prohibition of Riba (Interest & Usury) as reported in revealed books (Bible and Qur'an).

Part two is about asset-backed financing provided by IFIs. It includes trading (selling) modes of financing including Murabaha, Salam, and Istisna'a; it also includes Ijarah financing. At the start of part two, a summary of Shari'a rulings about sales is reported. Chapter two is about the Murabaha (cost plus profit) the most widely used financing tool by Islamic Financial Institutions (IFIs) world over and Muajjal (deferred sale). The average share of Murabaha is above 40% in portfolios of IFIs. Murabaha is a very useful tool to replace overdraft and short to medium term financing. Chapter two discusses the basic rules of Murabaha, necessary steps involved and comparative study with conventional short-term loans including bank overdraft facility. Chapter three is about Bai-Salam; a form of sale contract whereby IFIs purchase goods for spot payment with deferred delivery. Practically it is used in the financing of agricultural needs of farmers. Chap-

ter four is about Istisna'a. This mode of financing is designed to transact business through an order to manufacture and/or supply. It is a sales contract except the existence of subject matter. This tool of financing is useful for infrastructure projects. Chapter five is about Ijarah; a rental contract whereby IFIs lease an asset for a specific rent and period to the client. Ijarah is very useful in replacement of leasing. The average share of Ijarah is 18% in portfolios of IFIs.

Part three of the book deals with profit and loss sharing modes of financing including Musharaka, diminishing Musharaka and Mudaraba. A special section is devoted to discussing the causes of lesser application of Musharaka in operations of IFIs, in addition to Shari'a rulings and financial impact. Chapter seven is about Diminishing Musharaka; a form of gradually declining partnership between an IFI and clients; generally used to finance real estates. Under diminishing Musharaka, I have discussed the basic Shari'a rulings, Islamic house financing, comparative study of conventional and Islamic mortgages and installment calculation under different assumptions for house financing. Chapter eight is about Mudaraba. Under this scheme of financing, IFIs provide capital to financially weak but skillful people to do the business and share the outcome with IFIs.

Part four is about deposits management. Chapter nine presents various types of deposits collected by IFIs and profit sharing mechanism. Concepts of daily product and weight-age based profit systems are elaborated.

Part five of the book presents special topics in Islamic Finance. In this part areas of liquidity management and Islamic insurance are discussed. Under Islamic capital market two dedicated chapters have been included; each for equities and Sukuk. Shari'a compliance of equity securities, trading rules, and valuation mechanism discussed under equity chapter. Chapter-11 on Sukuk includes origin, development, types and Sukuk process along with Shari'a rulings. Chapter 12 offers solutions for cash finance provision to customers by IFIs. The last chapter has focused on Islamic insurance.

The third edition is the outcome of very encouraging response by the academic community to earlier editions. In this edition due attention has been given to present material in a reader-friendly mode in addition to a thorough review of content, exercises and figures. In this edition Islamic capital market is re-written by

including separate chapters on equities and Sukuk. Also, a special chapter is devoted to Islamic insurance. Updated figures on the global volume of assets, regional shares, equity funds and Sukuk are also part of this edition. Also, more examples included in the text to make the concept clear. In appendix guidance for the establishment of Islamic bank and appointment of Shari'a advisor as provided by the local central bank is included. An increased number of true/false, multiple choice questions and mini cases are also forming part of updated edition.

This book is useful for MBA/BBA students as a three credit hour course as well as for banking/finance students and practitioners of Islamic banking & finance. It is also useful for accounting & finance professionals, trainers in Islamic banking, regulators, investors, corporate managers and the general public, interested in understanding Islamic finance. I hope this book will serve its purpose through imparting knowledge of Islamic banking & finance among accounting, business and finance graduates as well as practitioners of Islamic financial system, investors, and the general public.

I am thankful to Allah SWT (God) for granting me health, courage, wisdom and knowledge to complete this task. I am also thankful to everyone who assisted me at any stage of my life including my parents, teachers, and family. My wife and kids deserve special thanks for their patience during completion of this book.

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He spent summer 2013, at Harvard University to attend a short course on reading and writing strategies and two conferences [including a three days conference on emotional intelligence]. As a part of research activities, he spent summer 2012, in Kent Business School, the University of Kent at Canterbury, England, where he delivered an introductory seminar on Islamic Banking.

He became Associate Member of Institute of Cost & Management Accountants of Pakistan in 2001 and Fellow Member in 2007. He achieved the presidential award for securing an overall first position in AJK PSC in 1998. He was awarded Best University Teacher Award (BUTA) by Higher Education Commission (HEC)-Pakistan. He has 18 years of professional/managerial and teaching experience at SCCBA (Sialkot), RIU, BU, ICMA-Pakistan and FSM (Islamabad). He has vast experience in financial and tax consultancy. His research areas include Valuation of Assets, Earnings Management, capital structure, market efficiency and Islamic financing. His research has been published in national and international journals of repute. He has published 13 journal articles and presented six papers at international conferences. He has traveled around the world including U.A.E., U.K. & U.S.A. His research is accessible from his research page at social sciences research network SSRN http://ssrn.com/author=454519. For comments & suggestions please contact: hanifacma@gmail.com.

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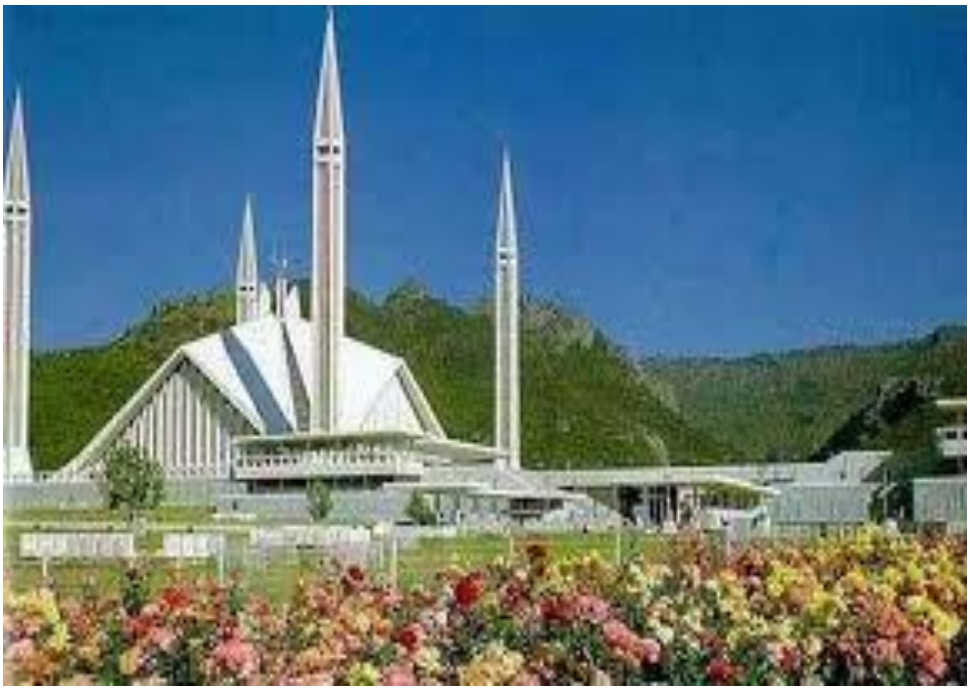
ACRONYMS

AAOIFI:	Accounting & Auditing Organization of Islamic Financial Institutions
AED:	United Arab Emirates Dirham
AIML:	Al-Meezan Investment Management Limited
DIFC:	Dubai International Financial Centre
DM:	Diminishing Musharaka
FAS:	Financial Accounting Standard
IBI:	Islamic Banking Institution
IDB:	Islamic Development Bank
IFA:	Islamic Fiqh Academy
IFI:	Islamic Financial Institution
IIFM:	International Islamic Financial Market
OIC:	Organization of Islamic Conference
PKR:	Pakistani Rupee
PLS:	Profit & Loss Sharing
SBP:	State Bank of Pakistan
SS:	Shari'a Standard
TMCL:	Time Multiple Counter Loan
NRR:	Normal Rate of Return
IBLI:	Inflation Based Loan Indexation
PTC:	Participation Term Certificate
TFC:	Term Finance Certificate
BPs:	Basis Points

BRIEF CONTENTS

DETAILED CONTENTS

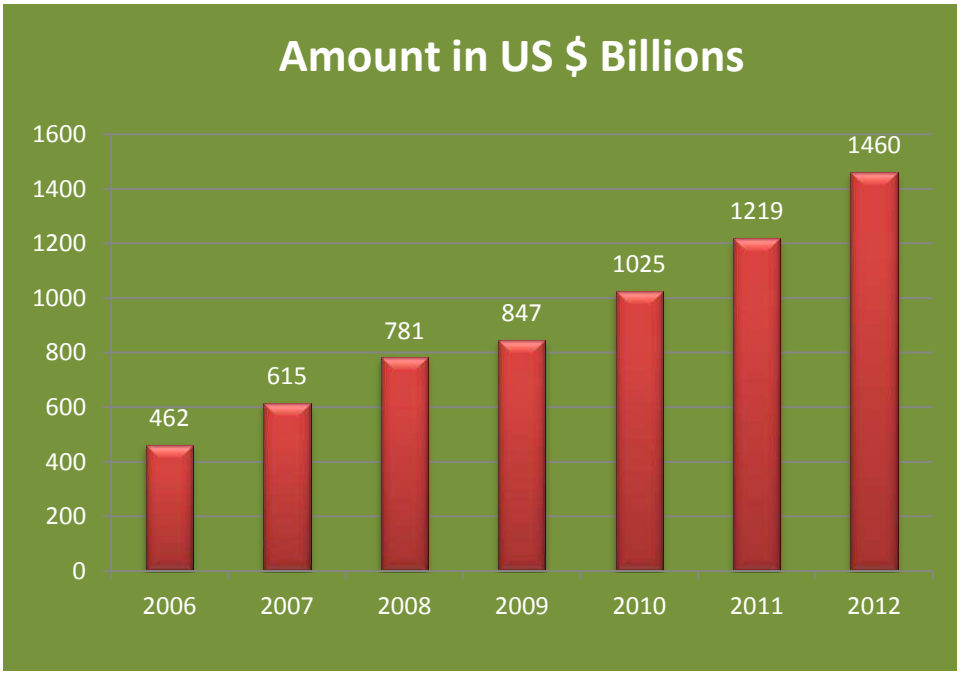
Part-1
Islamic Finance



Faisal Masjid, Islamabad

Chapter 1

Islamic Finance: An Update



Growth in Assets under Islamic Finance [globally] in last seven years

Islamic Finance is faith based which is regulated by principles of Islamic financial laws. Interest (the base of conventional banking) is prohibited by Islamic law hence operations of Islamic banking are different from conventional banking although both types of banking fulfill the same needs of customers. In financing customers' needs, Islamic banks use either trading modes or profit and loss sharing modes of financing. Islamic banking was started in last quarter of 20th century to cater the needs of Muslims around the world, although it is not limited to Muslims only. It has shown tremendous growth and expansion worldwide. Global assets under Islamic financial system have reached to the figure of US $ 1, 460 billion by the end of 2012, consisting of above 300 institutions. The Middle East is the center of Islamic Finance with a major share of global financial assets.

Learning objectives

After going through this chapter reader should be able to understand and interpret the following:

Why had Islamic banking?

How Islamic banking was developed?

What is present status of Islamic banking?

What have revealed injunctions about the prohibition of interest (Riba)?

What are criticisms and challenges for Islamic banking?

What are salient features of Islamic Finance?

What are differences in conventional and Islamic Finance?

What are financing models under Islamic financial system?

1.1. Introduction

Societies are built by certain ideologies and formation of Muslim society is based on Islamic ideology. To understand the institution building in a society, understanding of the ideology and philosophy of life (and death) is a prerequisite. There are three principles (Asool-ud-Din) of Islamic religion as under. Muslims believe in the oneness of Allah (God) the sole creator of this universe, prophethood (Messengers of Allah came to the world to reform the society), and Day of Judgment (everyone has to answerable for his deeds before Allah). Qur'an is the revealed book of Allah. According to the religion of Islam life of every believer is regulated through the revelations (Qur'an & Sunnah). To extract legal order from Qur'an & Sunnah, religious clerics conduct research and come up with a solution of existing problem keeping in view the objectives of Shari'a (Islamic law). Objectives of Shari'a include safety of faith (Hifz e Eimaan), the safety of life (Hifz e Jaan), the safety of wealth (Hifz e Maal), the safety of intellect (Hifz e Aqal) and safety of next generation (Hifz e Nasal) [Siddiqi, 2000]. While it is settled opinion of Muslim jurists that any sphere of life of believers, either directly regulated through revelations or juristic opinion by experts in Shari'a (if the direct order is not found in revelations), hence, financial matters have no exception.

Capitalism is a dominant economic system prevailing (complete or partial) in almost every society of the world including Muslim countries. According to capitalism, factors of production include land, labor, capital and organization. Rewards for three of the production factors (i.e. land, labor, and capital) are fixed while the reward of an entrepreneur is variable depending upon the outcome of the underlying project. The reward for three factors of production is risk-free and cannot be negative; however entrepreneur's reward can be zero or even negative. Although the underlying project is completed by the participation of all the factors of production, however in the case of reward, the share of three of them (land, labor and capital) is fixed; irrespective of the outcome. If a huge profit is earned it belongs to entrepreneur (after servicing other factors of production) and if a heavy loss is suffered that is also borne by the entrepreneur.

According to Shari'a [Islamic Law] reward for an entrepreneur is not fixed, hence, it is a similarity in capitalism and Islamic financial system. However, difference lies in fixation of reward for capital. According to Islamic financial system reward for capital is also variable and not predetermined. For Muslims practice of true capitalism in its original form does not suit well because it contradicts with faith. An ordinary Muslim is very much confused about his economic matters; because the business world is dominated by capitalism especially interest-based banking. On one side is the cherished dream of development and a better life while on the other hand is faith in Allah, which demands abide by the Shari'a.

Sources of law in Islam have categorized (into four) keeping in view the changing needs of society.

Why Islamic Finance?

1. About 60% of global population is people of book [Followers of Abrahmic Religions] including Jews, Christians and Muslims and dealing in interest is Haram for them
    a. Muslim population around the Globe is 1,977 Millions accessed on May 31, 2012 [http://muslimpopulation.com/World/]
    b. Christian Population around the globe is 1,955 Millions accessed on May 31, 2012 [http://www.religiouspopulation.com/World/]
    c. Jewish population around the World is 13.3 Millions, accessed on May 31, 2012 [http://www.simpletoremember.com/vitals/world-jewish-population.htm]
2. Conventional Banking led to financial crisis due to lack of support from real assets
3. Islamic Banking is asset based financing, hence can serve as hurdle in the way of financial crisis
4. Islamic Banking is equity based financing which discourage the passive behavior of Investors/depositors
5. Islamic banking is based on principles of Profit and loss sharing, hence risk and reward is shared by capital providers, leading to active participation in managing and monitoring of underlying project.
6. Avoidance of Gharar (uncertainty); Absolute risk of outcome [Ayub, 2007; Mansoori, 2007 & Ghazi, 2010]
7. Avoidance of Myser and Qimar (Game of chance) [Holy Qura'n 2:219 & 5: 90]
8. Promotion of only Halal (Permitted) Business; A landmark book by Qaradawi 1960

Two are the prime sources (Qur'an & Sunnah) while two are derivations/ inferences i.e. Ijma'a (consensus opinion of clerics) and Qiyas (individual opinion of a cleric). Qur'an (the revealed book of Islam) is at the top in order, and if guidance in a matter is not discussed in Qur'an then Sunnah (includes actions, sayings & approvals of Prophet Muhammad PBUH) is consulted. If no guidance found in Sunnah relating to the underlying matter, then Ijma'a (consensus opinion of experts in Shari'a) is consulted and finally if nothing exists in Ijma'a relating to the underlying issue then Qiyas (individual opinion of an expert in Shari'a) is allowed.

Room for the difference in opinion for an individual exists in two sources of law i.e. Sunnah and Qiyas. In the case of Sunnah reporting authority of a Hadith (tradition) can be questioned and Ulema (clerics) of Islam have done a very good job by categorizing Hadiths as weak and strong on the basis of reporting evidence. However in the case of Qiyas, one can have a difference of opinion based on solid arguments not violating any principle of Shari'a and specifically matching with the objectives of Shari'a.

Prohibition of Riba (usury and interest) has proven in three sources of law repeatedly (Qur'an, Hadith, and Ijma'a) hence no question of having a difference of opinion as for prohibition of Riba is concerned, according to Shari'a.

First in Qur'an four sets of verses have been identified dealing with the charging of Riba[1] (30:39, 4:161, 3:130, & 2:275-281).

Second several Hadiths clearing the meanings of Riba in various transactions have been reported (khan, 1989).

Third resolutions of the council of Islamic Fiqh Academy are very much about to qualify the status of Ijma'a on the issue of Riba.

Fourth there are several Ulema, who declared both usury and commercial interest Haram (Unlawful) (e.g. see Usmani 1999, 2002 & Usmani 2003, Qarzawi 1960, Maudoodi 1961, Rehman, Siddiqi 2006, Chapra, Zaman 2010, Ayub 2007).

[1] Reported in the order of revelation. First Surah (chapter) number then Aya (verse) number.

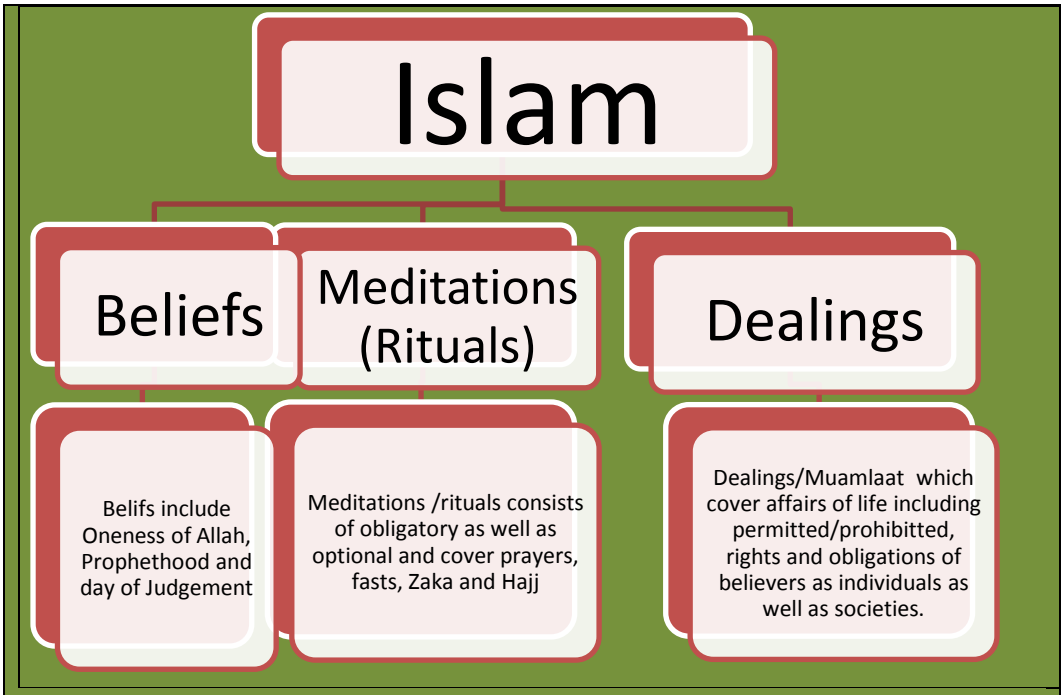
As discussed earlier one can have a difference of opinion in two sources of law i.e. Sunnah and Qiyas and not in Qur'an and Ijma'a hence it is very much clear now that Riba [usury & commercial interest] is Haram (Prohibited) undoubtedly because we found the evidence in Qur'an, Sunnah, and Ijma. However there exists an opinion that commercial interest is not included in the definition of Riba, I have presented a detailed account on Riba in the second section of this chapter.

Interest is the foundation on which the organization of modern commercial as well as central banking is running and prospering. The important role of these institutions in running the modern economies cannot be undermined. Keeping in view the prohibition of interest and importance of banking in the economy, Muslims (clerics & professionals) decided to search for an alternative and after due consideration, they came up with the idea of Islamic banking. Islamic banking is not the dealing in money like conventional banking. It is dealing in goods and services.

Perhaps all efforts and experiences done in this regard are not well documented and accessible; however some of the efforts are presented hereunder, which paved the way for the establishment of modern Islamic banking. The first voice we hear from literature about the prohibition of commercial interest in Subcontinent was Syed Modoodi in the 1930s. Later on after establishment of Pakistan, he wrote a landmark book titled *sood* [Interest]. Practically first Islamic bank was established at a very low scale in Mitghamar [Egypt] 1963. It is also said that at the same time an Islamic bank was also offering services in Karachi, but the author could not find a written source. In the same years, Malaysia started Haj financing program [Tabanh Haji], which proved very successful and paved way for the establishment of a full-fledged Islamic bank.

An Introduction to Islam

The religion of Islam is the last message of a chain of prophets appeared in The Abrahamic generation and known as the last message of God (Allah) to humanity. Prophet Muhammad (PBUH) was born in the city of Makkah in the year 571 A.C. We can divide the religion of Islam objectively into three sections including Beliefs (Aqayed), Meditations/rituals (Ibadaat) and dealings (Muamalaat).



Beliefs

To start with beliefs, Islam teaches its followers to have belief in unity (oneness) of Allah; that God is one. To become a Muslim one has to state loudly that there is no God except Allah (God). Who is the God of Muslims? God of Muslims (Allah) is the same God which is God of Jews and Christians.The God, which remained the Deity of Humanity starting from Prophet Adam to Prophet Muhammad (PBUT). At present three nations are known as people of the book including Jews, Christians, and Muslims.These three religions are known as Abrahamic religions, and their God is only One (Allah). So this is a commonality among these three nations that they believe in the same God.

A second belief which Islam teaches to its followers is the concept of Prophethood…it is stated that above 100,000 Prophets came to the world to reform the societies at different points in time in various regions of the world since beginning, and a Muslim is required to believe in Their [Prophets']truthfulness… It means Muslims are required by their religion to accept Muses (Prophet of Jews) and Jesus (Prophet of Christians) as the true Prophets [PBUT] of God….so this is the second similarity in these three Abra-

hamic nations.
Third is the concept of the day of judgment…A day when all the human being has to face the course of justice, and everyone has to be accountable for his/r actions before The Lord….On that day people with good deeds will be rewarded by paradise and people with bad deeds will go to hell…this is also a commonality among Abrahamic nations.
However there is a difference between Muslims and others, and that is, others do not accept the Muhammad as Prophet of God; while Muslims believe in the finality of Prophet Hood and recognize Muhammad as the last Prophet [PBUH] of God, Qur'an is the last and final book of God.

Meditations/Rituals

Meditations/Rituals can be categorized as obligatory and optional. Five times prayer [Salah] including early morning, afternoon, pre-dusk, post-dusk and pre-midnight/pre-sleeping [Fajjar, Zohar, Asar, Maghrib, and Ishaa] is obligatory. However one can continue as much s/he likes to perform prayers and reward is promised by God.
The second form of meditation/ritual is Fasting [Soam]. One month [of Ramadhan as per lunar calendar] Fasting for a full day from dawn to dusk is obligatory for Muslims. Other Abrahamic nations do fast, however, the differences lies between fasting of Muslims and others including timings of eating, and what to avoid during fast. Muslims can eat twice in a day [pre-dawn and post dusk], also Muslims are not allowed to eat or drink anything during the day while they are fasting. One can increase the number of fasts during the lifetime and reward is promised by God.
The third type of meditation/ritual is payment of Zakat.i.e 2.5% of total wealth annually should be given away as charity. 2.5% of wealth spending in charity is obligatory and one can increase the amount of spending in charity and reward is promised by Lord.
Furth type of meditation/ritual is Hajj [visit of Makkah during specific days]. Once in the life, it is compulsory. However one can increase the number of visits as much, God promises /He likes and reward.
Two of the meditations/rituals [Ibadaat] Hajj & Zakat are obligatory on rich sections of the society. Hajj and Zakat are obligatory on those individuals who can afford financially while prayer and fasts are for all with certain concessions in extreme cases.

Dealings

Dealings is the translation of Arabic word Muamalaat which includes lawful and prohibited, rights and obligations of a believer. In the case of lawful and prohibited, Islam

has guided about prohibited and rest is lawful [Qrdawi 1960]. Islam covers the whole life of a believer; hence, a believer has to seek the guidance from religion in every aspect of his life. The feature of Islam to provide a list of prohibited and declaring the rest as lawful has made the religion of Islam a very practical system of life even after passing above 1,400 years. Life is moving ahead, and many new things are emerging. For a believer, every new thing is easy to adopt unless it clearly falls in prohibited list.

On this principle of prohibited and lawful, Muslims have adopted the modern financial system with certain modifications. There are certain practices in modern financial system which are contradicting with the principles of Islamic code of life including following:

1. Interest is prohibited in Islamic law. There are four sets of verses in Holy Qur'an about Riba [interest & usury]. Also, there are many traditions [Ahadith] reported in the books of traditions.
2. Gharar [absolute risk] in business/commercial transactions is prohibited, hence, transactions of existing modern insurance, futures and forwards are against the Islamic law.
3. Myser & Qimar [game of chance of winning and losing] is also prohibited in Islamic law.
4. Prohibited businesses [e.g. businesses include liquor, pork, pornography, promotion of adultery, etc.]

To address these issues, Muslims came up with the idea to reform the existing financial system in the light of Islamic teachings; hence modern Islamic financial system emerged. Islamic financial system is based on the objectives of Shari'a, which is equally beneficial for Muslims & non-Muslims. Anybody who finds it appropriate financial solution can adopt Islamic finance. Islamic financial system addresses many commonalities among Abrahamic nations and also carries certain checks to avoid or, at least, reduce the speed towards a financial crisis, primarily due to asset based financing. Islamic finance links the financial sector with the real sector, hence very encouraging news are emerging about Islamic financial system[2].

[2] Vatican has issued a statement favoring Islamic finance; Japan has made amendment in laws to provide level playing field for Islamic finance; Hongkong has changed law to facilitate Islamic law; Iran and Sudan has switched total economy to Islamic finance; Fast growth in assets under Islamic finance have been depicted in Pakistan, Bangladesh, Saudi Arabia, United Arab Emirates and UK.

Table.1 Country wise share in Assets under Islamic financing (US $ Billions)

Country	**2007**	**2008**	**2009**	**2010**	***No. of firms***
Iran	235.30	293.20	315.00	388.00	*27*
S. Arabia	92.00	127.90	138.00	151.00	*26*
UAE	49.10	84.00	86.00	94.10	*21*
Kuwait	63.10	67.60	69.00	79.70	*30*
Bahrain	37.40	46.20	45.00	57.90	*33*
Qatar	21.00	27.50	35.00	52.30	*19*
Jordan	03.30	04.60	05.00	05.90	*10*
Syria	00.60	03.80	06.00	08.70	*03*
Iraq	NA	03.80	NA	NA	*01*
Turkey	15.8	17.8	23.00	28.00	04
Total Middle East	**517.60**	**676.40**	**722.00**	**865.60**	**174**
Sudan	05.30	07.20	09.30	12.10	*13*
Egypt	05.70	06.30	07.20	07.90	*02*
Total NA	**11.00**	**13.50**	**16.50**	**20.00**	**15**
Malaysia	67.10	86.50	103.00	133.4	*39*
Indonesia	03.40	03.40	07.00	10.50	*26*
Brunei	02.70	03.20	03.30	03.80	*01*
Total Far East	**73.20**	**93.10**	**113.30**	**147.70**	**66**
Bangladesh	05.70	07.50	09.40	11.70	*16*
Pakistan	06.30	05.10	06.20	05.70	*23*
Total South Asia	**12.00**	**12.60**	**15.60**	**17.40**	**39**
United Kingdom	18.10	19.40	19.00	19.00	06
Switzerland	NA	NA	NA	06.60	02
Total Europe	**18.10**	**19.40**	**19.00**	**25.60**	**08**
Others	**07.20**	**07.10**	**10.00**	**10.30**	**35**

(Source: The Banker as quoted by IFSL, 2012)

The milestone in the development and implementation of Islamic financial system was the conference of Finance Ministers of Organization of Islamic Conference (OIC), December 1973, in Jeddah, whereby the decision to establish Islamic Development Bank (IDB) was taken place. Islamic Development Bank was established and formally opened in October 1975 with the purpose "*to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shari'ah i.e., Islamic Law*" [IDB Web]. IDB Uses loan financing, technical assistance, leasing, installment sales, Istisna'a, lines of financing, equity participation, Murabaha and profit sharing as financing models while extending financial services to its customers/members. IDB either shares profit; charge profit or service fee to recover expenses of bank as a reward for the provision of financing and technical services.

With the establishment of IDB, Islamic finance started expanding with support from OIC member communities and research works started to present an alternative banking model free from interest. In 1980 first ever landmark report on "Elimination of Riba from the Economy" came on the surface, written by Council of Islamic Ideology [CII] Pakistan. CII report got political support from the Pakistani government and Pakistan started Islamisation process of the economy in the early eighties. Meanwhile, a revolution took place in Iran; and Iran switched its operations to interest-free banking, economy-wide. At the same time, certain institutions started Islamic

Islamic Development Bank

Up to June 1992 capital of IDB was just 2 billion Islamic Dinars [ID], which is now reached to ID 30 billion with a paid up capital of ID 15 billion. IDB has 56 members with the basic criteria to have OIC membership. IDB's head office is located in Jeddah, KSA with four regional offices in Morocco, Malaysia, Kazakhstan and Senegal. IDB Bank extends loans to its member countries for the financing of infrastructural and agricultural projects such as roads, canals, dams, schools, hospitals, housing, rural development, etc. both in the public and private sectors, which have an impact on the economic and social development of the member countries concerned and are accorded priority by the Governments concerned.

banking in Gulf region including Faisal Islamic Bank, Albaraka Islamic Bank, and Dubai Islamic Bank.

Figure-1 Region wise % share in Global Assets under Islamic financing

Sources: Calculated by Author; Figures taken from IFSL-2013

With the ever expanding industry of Islamic financial services, an advisory/regulatory body was required to provide guidance. In 1991 Accounting & Auditing Organization of Islamic Financial Institutions [AAOIFI] was established with the mission to standardize and harmonize Islamic finance practice and financial reporting in accordance with Islamic law, globally. It is registered in the state of Bahrain. AAOIFI has two boards known as Shari'a standard board which approves Shari'a standards while accounting & auditing standard board approves A&A standards. By November 2007, AAOIFI has issued 41 Shari'a standards, and by June 2008, 23 accounting standards, five auditing standards, six governance standards and two codes of ethics were issued.

During last quarter of 20th-century serious efforts were made for promotion of Islamic financial system in Muslim societies as well as throughout the world in general. This journey has been continuing in the 21st century as well. By the end of 2012, estimated global volume of assets under Islamic finance has reached to

Under conventional financial system financier is earning risk free return in the form of interest while under Islamic financial system opportunity of risk free return does not exist hence increasing the risk exposure of IFIs.

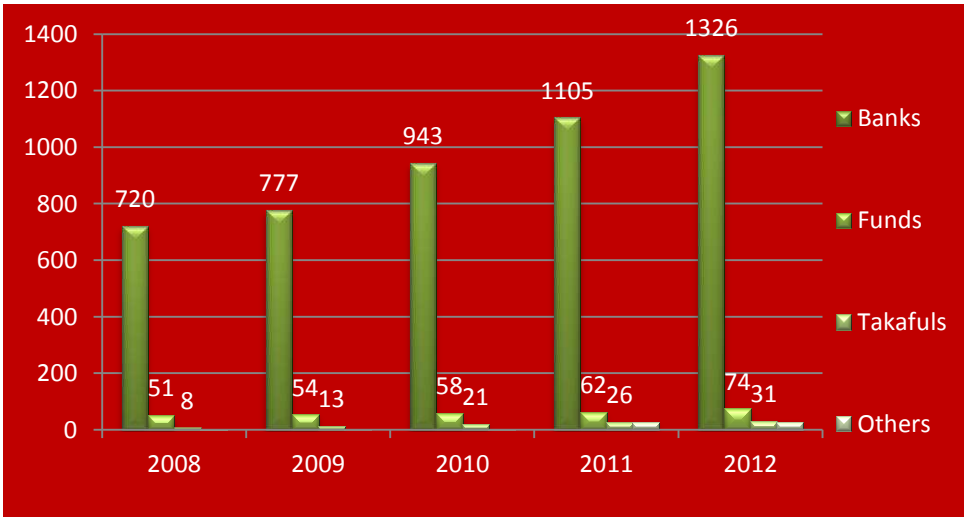
US$ 1,460 Billion (IFSL, 2013) with operations in more than 50 countries consisting of above 300 institutions. Islamic finance had shown tremendous growth in 2007 & 08; an era of the economic downturn in developed countries including the United States and Europe. Assets of Islamic finance had grown at the rate of 38% and 25% in 2007 and 2008 respectively, an era of economic recession in developed economies. Persian Gulf area is the center of Islamic financial system with a share of 74% followed by Fareast 17% and balance from rest of the world is contributed in Shari'a compliant assets (IFSL, 2013). Table-1 depicts the country wise and Figure-1 presents region wise share in assets under Islamic financial system.

Badshahi [Royal] Masjid, Lahore

Islamic banking and conventional banking are different in their philosophy as well as operations. Islamic banks are not dealers of money hence, no provision of financing in hard currency is available while conventional banks provide hard cash as loans by charging interest. Likewise Islamic banks cannot promise of a risk-free return to depositors while conventional banks are providing predetermined return (risk-free) to depositors. Islamic banks are traders of goods and services and not the loan houses as for financing is concerned while conventional banks are lenders of cash. This difference is being reflected at the operational level as well (e.g. Islamic banks do not issue interest based credit cards while conventional banks do). Islamic banks use financing tools being used in trade including Murabaha (cost plus profit), Ijarah (rental arrangement), Bai-Salam

(spot payment with the deferred delivery of goods), Bai-Muajjal (deferred sale), Istisna'a (order to manufacture/supply) and diminishing Musharaka (house financing). On the other hand, if financing is required in cash form then Islamic banks use profit and loss sharing modes including Musharaka (partnership in capital) and Mudaraba (partnership in capital and skill).

Figure 2- Global Volume of Assets under Islamic Finance US $ Billions



Source: Calculated by Author Figures taken from IFSL-2013

Use of profit and loss sharing tools as financing modes changes the philosophy of doing the business of banking. Under the conventional financial system, the financier is earning a risk-free return in the form of interest while under Islamic financial system opportunity of risk-free return does not exist, consequently, increases the risk exposure of Islamic Financial Institutions (IFIs). Doing business according to principles of profit and loss sharing is difficult given the dominance of interest based banking and non-conduciveness of existing business environment. Under profit and loss sharing system result of the underlying project is shared by IFIs, depicted through financial reports. It is well documented in the financial literature that earnings are managed (manipulated) by opportunistic

managers to gain some preset objectives. Hanif, 2010, documented that Literature on earnings management has identified various motives behind earnings manipulation including e.g. a particular reference point to be achieved (Burgstahler, 1997, and Guan, et. al., 2008); avoiding technical default on debt covenants (Sweeney, 1994, Gaun, et. al., 2008,); reduction in transactions costs (Burgstahler, 1997); tax considerations (Baralexis, 2004); attracting better price at public offerings (Teoh, et. al., 1998, and Iqbal, et. al., 2009); better management compensation (Wang, et. al., 2008, Dechow and Sloan, 1991); beating financial analysts' forecast (Kasznik, et. al., 2002); and hiding poor performance of management (Beneish, 2001).

In recent years, Islamic financing has started expansion in other business sectors in addition to banking only. Figure-2 shows ever increasing volume of assets in equity funds and Takaful. Although it was started as mere an alternative option of Halal financing, now it has become a complete financial solutions industry and expanding day by day. According to an estimate [IFSL-2013], the Global volume of assets would be 2 trillion, by the end of 2014, under Islamic finance given the ever-increasing interest of customers in this stream of financial services.

1.2. Riba (Interest and Usury)

In Arabic terminology, Riba is used for an incremental amount charged over a transaction of the loan as a predetermined return. Charging of usury and interest is Haram in Abrahamic religions including Judaism, Christianity and Islam. Charging of additional predetermined amount (usury, interest) on loans had never got support in ethics/religions. Interest charging is forbidden by at least all known revealed religions including Judaism, Christianity and Islam. Following are six verses cited by Usmani, (1999), from Old Testament of The Bible.

1. "Thou shalt not lend upon usury to thy brother; usury of money, usury of victuals, usury of anything that is lent upon usury." [Deuteronomy 23:19]

2."Lord, who shall abide in thy tabernacle? Who shall dwell in thy holy hill? He that walketh uprightly, and worketh righteousness and speaketh the truth in his

heart. He that putteth not out of his money to usury, nor taketh reward against the innocent." [Psalms 15:1, 2, 5]

3. "He that by usury and unjust gain increaseth his substance, he shall gather it for him that will pity the poor." [Proverbs 28:8]

4. "Then I consulted with myself, and I rebuked the nobles, and rules and said unto them, Ye exact usury, every one of his brother. And I set a great assembly against them." [Nehemiah 5:7]

5. "He that hath not given forth upon usury, neither hath taken any increase, that hath withdrawn his hand from iniguity, hath executed true judgment between man and man, hath walked in my statues, and hath kept my judgments, to deal truly; he is just. He shall surely live, said the Lord God." [Ezekiel 18:8.9]

6. "In thee have they taken gifts to shed blood; thou hast taken usury and increase, and though hast greedily gained of thy neighbors by extortion, and hast forgotten me, said the Lord God." [Ezekiel 22:12]

According to Usmani, 1999, "The word *riba* used in the Holy Qur'an carries the same meaning [as word Usury] because the verse of Surah An-Nisaa explicitly mentions that *riba* was prohibited for the Jews also".

In The Holy Qura'n, four sets of verses are about Riba (interest) revealed on different occasions. Translation of the verses[3] is presented here in the order of revelation.

1. The first verse is in Surah Al-Rum 30:39 whereby displeasure of Allah is disclosed for interest based practices. "And whatever *riba* you give so that it may increase in the wealth of the people, it does not increase with Allah."

2. The second verse is in Surah An-Nisaa 4:161 where interest charging was disclosed as a sinful act of Jews. "And because of their charging *riba* while they were prohibited from it."

3. The third verse is part of Surah Al-i-'Imran 3:130 whereby prohibition of Riba (interest) was declared "O those who believe do not eat up riba doubled and redoubled."

4. The last set of verses revealed is reported in Surah Al-

Old Testament of The Bible contains six verses dealing with prohibition and disapproval of interest

[3] Translation adopted from Usmani, 1999.

Baqarah 2:275-281 whereby severe punishment is declared for those dealing in interest and also persuaded for charity, deferment of loans from miser persons and even write-off as alms.

"Those who take interest will not stand but as stands whom the demon has driven crazy by his touch. That is because they have said: 'Trading is but like riba'. And Allah has permitted trading and prohibited riba. So, whoever receives an advice from his Lord and stops, he is allowed what has passed, and his matter is up to Allah. And the ones who revert back, those are the people of Fire. There they remain forever" [2:275]

"Allah destroys *riba* and nourishes charities. And Allah does not like any sinful disbeliever" [2:276]

"Surely those who believe and do good deeds, establish Salah and pay Zakah, have their reward with their Lord, and there is no fear for them, nor shall they grieve"[2:277]

"O those who believe, fear Allah and give up what still remains of the *riba* if you are believers" [2:278]

"But if you do not, then listen to the declaration of war from Allah and His Messenger. And if you repent, yours is your principal. Neither you wrong, nor be wronged" [2:279] "And if there be one in misery, then deferment till ease. And that you leave it as alms is far better for you, if you really know" [2:280]

"And be fearful of a day when you shall be returned to Allah, then everybody shall be paid, in full, what he has earned. And they shall not be wronged." [2:281]

There are two types of Riba discussed in literature including usury [consumption loans] and interest [productive loans]. What is meant by Riba used in the revelations? Whether it is usury? Interest? Or both? In this section, I will explore the meaning of term Riba as used in Arabic language and literature about its prohibition. In Arabic terminology, Riba is a synonym for the term interest used in conventional banking operations covers both consumption loans [usury] and productive loans [commercial interest]. Riba means charging predetermined additional

amount on a loan extended based on length of the credit period. Certain quarters are of the view that Riba which is prohibited by revelations is the Usury (interest charged on consumption loans), and the term does not cover banking interest (interest charged on productive loans). This point was debated in detail during the Supreme Court (Pakistan) hearing and concluded that there was no difference between usury and interest as for prohibition is concerned. Following are some further citations (definitions) extracted from literature to clarify the meanings of word Riba used in Holy Qur'an.

1. In the words of Imam Abubakr Al-Jassas (D.380 AH)[4] "The riba of Jahiliyya [period of ignorance] is a loan given for stipulated period with a stipulated increase on the principal payable by the loanee [the debtor]."

2. Extract from the decision of Supreme Court of Pakistan is presented as under, "It is thus clear that the permissibility of interest can neither be based on the financial position of the debtor, nor on the purpose for which money is borrowed, and, therefore, the distinction between consumption loans and productive loans in this respect is contrary to the well-established principles" (Usmani, 1999 Para 72). While deciding the issue of banking interest as permitted or prohibited in Islam, Supreme Court (Pakistan) declared that "Any additional amount over the principal in a contract of loan or debt is the riba prohibited by the Holy Qur'an in several verses" (Usmani, 1999 Para 242).

3. Islamic Fiqh Academy India[5] explains "Riba (interest) is a very important term in the Islamic terminology showing disapproval and it refers to the instrument by which a loaner [creditor] charges some amount lump sum or in installments over and above his principal amount from the loanee [debtor] and thus increases his wealth manifold without participating in the business process of profit and loss".

[4] As cited by Usmani, (1999)

[5] http://ifa-india.org/english/arabic_Words.html accessed on 20th March, 2010.

4. Siddiqi, (2004), concluded that unanimous view of Muslims throughout history remained is--- any excess charge in a contract of loan is riba ---- and bank interest has no exception.

5. Islamic Fiqh Academy (IFA), Jeddah, of OIC representing the collective wisdom of Shari'a experts, is of the view that any increase stipulated in a contract of loan irrespective whether consumption loan or productive loan is Riba prohibited by Allah (SWT). Iqbal, & Molyneux, documented "The equivalence of riba to interest has always been unanimously recognized in Muslim history by all schools of thought. In conformity with this consensus the Islamic Fiqh Academy of the Organization of the Islamic Conference (OIC) has recently issued a verdict in its Resolution No. 10(10/2) upholding the historical consensus on the prohibition of interest" (p. 9; IFC/2000)[6].

Instructions are clear. No ambiguity is left. If a person believes in Revelations then s/he should avoid charging interest and seek the pleasure of Allah (SWT). It is the responsibility of all true believers in God (Jews, Christians, and Muslims) to give up interest based transactions from their personal lives immediately and input their energies collectively to design promote and implement a financial system free of interest. Following conclusions are drawn from above citations; First Interest is prohibited by all revealed religions and charging of interest is Haram (unlawful) for at least Jews, Christians and Muslims. Second; as for prohibition of interest is concerned, there is no difference in commercial loans and consumption loans at all and bank interest is haram (unlawful).

While it is clear from the above citations that dealings in interest based transactions are *Haram* (unlawful) including conventional banking; the important role of commercial banks cannot be rejected in the modern economy; so the change in the philosophy and design of commercial banking was required to meet the reli-

The equivalence of riba to interest has always been unanimously recognized in Muslim history by all schools of thought.

[6] http://www.globalwebpost.com/farooqm/writings/islamic/r-i-consensus.html accessed on March 20th 2010.

Under Islamic financial system Sukuk are ownership certificates and not mere debt securities hence all risks and rewards are shared by Sukukholders.

gious obligation. Referring to the above citations, it is further concluded that what is prohibited through revelations, is the pre-determined charge on capital (risk-free return), and not the profit on capital (involving risk) invested (2:275). Muslim Jurists are of the opinion/view that reward for capital should be linked with the outcome of the underlying project if financing facility is being extended and/or reward should be obtained through trades involving sales and purchases.

1.3. Salient Features of Islamic Finance

Although the practice of charging interest by conventional banking was a major factor which led to the development of Islamic banking, however, it is not only the avoidance of interest which can make a conventional bank as Islamic. When we talk about Islamic banking us means following of Islam in all spheres of business including e.g. but not limited to:-

1. The principal activity of the customer of Islamic financial institutions (IFIs) must not be prohibited by Islamic Shari'a. To mention few, Islamic banks cannot receive the deposit or extend financing for the business of liquor, pornography and pig farming.

2. Under partnership business (Musharaka & Mudaraba) IFIs cannot limit their share in profit only to safeguard the capital. IFIs are required by Islamic law to share loss as well. Furthermore, loss in partnership must be shared according to equity stake; however, profit can be shared in any ratio subject to the limit for sleeping partner whose share cannot be more than proportionate equity stake (Khan 1989, page 71; Usmani 2002, page 87; Ghazi 2010, page 386; Khan 2007, page 307 & Shari'a standard 12).

Underlying principle in issue of Sukuks is that illiquid assets should dominate in the portfolio against which Sukuks are issued.

3. Islamic banks have to follow the principles of sales and purchase as given by Shari'a including five *khiyars* (stipulations). According to Usmani, 2002, Five khiyars include, Khiyar e Shart (option to rescind contract within specific period), Khiyar e Roiyyat (option to inspect the article prior to purchase), Khiyar e Aib (option to return defective goods), Khiyar e Wasf (option to return low-quality goods if do not carry the required function), Khiyar e Ghaban (option to return goods when charged price higher than market by deceiving buyer).

4. Islamic bank cannot claim additional amount from a customer in case of default in payment at due date; because it falls in the circle of riba. However to penalize the defaulters, Ulema (clerics) have allowed IFIs to charge a cash penalty; but same cannot form part of the income of IFIs rather it goes into charity account maintained and supervised by Shari'a board of the bank.

5. Islamic banks cannot service depositors like conventional banking with a predetermined return. Deposits are taken as interest-free loans (current accounts) and refunded on demand and/or on the principle of profit and loss sharing. If any IFI accepts deposits in current account as Amanah (trust), then principles of Amanah shall prevail including no guarantee of refund and no right to invest. It is not encouraged to collect deposit under Amanah contract to protect the interest of depositors as well as the bank. Deposits for return are collected through Mudaraba contract, and actual outcome

Differences Between Conventional & Islamic Finance

1. Financing for Halal businesses only
2. Equity based financing: Profit as well as loss sharing under Partnership
3. Asset based Financing: Dealing in goods and service
4. Avoidance of Gharar [uncertainity], Myser and Qimar [game of chance]
5. Interest free operations
6. On deposits no risk free return
7. Shari'a compliance by investee is must to invest in shares
8. Asset based Sukuk carrying profit and loss sharing
9. Leasing through rental contract
10. House financing is combination of leasing and partnership

To penalize the defaulters, Ulema (clerics) have allowed IFIs to charge a penalty; but same cannot form part of income of IFIs rather it goes into charity.

of operations is shared with depositors. Through the creation of specialized deposits (Restricted Mudaraba) for sectoral investments including real estates, agricultural products, oil sector, civil work projects, etc. IFIs can even provide a superior return to their depositors.

6. Islamic banks cannot avoid Shari'a compliance in their operations on the excuse of non-conduciveness of existing legal & business framework(e.g. Islamic banks cannot demand interest on interbank deposits, and statutory cash reserves maintained with a central bank). Certainly this makes the job of practitioners of Islamic financial system challenging.

7. Islamic banks cannot enter into transactions of futures and forwards, gambling, and any other mode of doing business which contradicts with injunctions of Shari'a.

8. For IFIs avenues are very limited to create required liquidity at the same time to earn some revenue by investing in the short term and liquid securities. IFIs cannot invest in interest based government securities, short-term loans, bonds and money at call and short notices because of interest based transactions. Mandatory reserve with a central bank is maintained by IFIs free of any interest-based earnings.

9. Islamic bank must avoid Gharar (uncertainty) in its business transactions (Ayub 2007, page 57; Mansoori 2007, page 179; Ghazi 2010, page 237).

10. Islamic banks must avoid Myser and Qimar (speculation) or any game of chance (Ghazi 2010, Ayub 2007). Myser is prohibited by Holy Qur'an [2: 219 and 5: 90]

11. Prohibition of interest and usury in financial dealings. Al-Qur'an (30:39, 4:161, 3:130, & 2:275-281).

12. As for investments in marketable securities are concerned again IFIs are not free to invest in any equity security due to two reasons. First Halal business of the underlying firm is required. Second financial operations of the underlying firm should be interest-free. Keeping in view the dominance of conventional

To protect the interest of consumer Islamic law has given five options to buyer including option to return within specific period; if low quality goods; defective goods supplied; if substantial higher than market price charged and option to inspect prior to purchase.

banking and existing business practices one can conclude very safely that a very negligible number of firms meet both conditions. Islamic banks are not free to invest in the equity of any company rather have to check the Shari'a compliance of the company before investment. Meeting of following tests is required to declare a security as Shari'a compliant (KMI-2008).

a. The core business of the company should be Halal (not prohibited by Islamic Law such as liquor, pork, and pornography, etc.)

b. Illiquid assets should be at least equal to 20% of total assets of the company. Shares of a company merely dealing in liquid assets are not Shari'a compliant hence, IFIs cannot invest.

c. The ratio of all interest based debts including preferred stock should be less than 40% of total assets of the company.

d. The ratio of non-Shari'a compliant investments to total assets of the company should be less than 33%.

e. Revenue from noncompliant investments should be less than 5% of total revenue of the company, and even then IFIs are required to purify their earnings by spending this noncompliant revenue as charity.

f. Market price per share should be greater than the net liquid assets per share.

13. Recently IFIs have created an avenue to meet their liquidity requirement in the form of Sukuk (Islamic Bonds) whereby servicing is fixed like conventional bonds however such types of Sukuk can be issued against Ijarah receivables. Under Ijarah Sukuk, the initially asset is given on rent to the customer for an agreed period and rentals while ownership remains with IFI. To meet liquidity requirements IFI issues Sukuk (bonds) to the investors equal to the value of the asset. Hence, ownership of the asset is transferred to Sukuk holders. While it is known the rentals of the asset under Ijarah so the return on investment is predetermined and known with certainty to the investors. Sukuk of Murabaha cannot be sold except at par being sale of loans. Other types of Sukuk (Musharaka etc.) are not carrying fixed return although tradable in the secondary securities market. The underlying principle in the issue of Sukuk is that illiquid assets should dominate in the portfolio against which

Islam is the state religion of Pakistan and any law repugnant to the injunctions of Islam is void as per constitution of Pakistan.

Excessive inflation which we face in less developed countries including some Muslim societies is not the direct consequence of paper currency rather it is financial indiscipline of the governments of these countries.

Sukuk are issued. Under Islamic financial system Sukuk are ownership certificates and not mere debt securities hence all risks and rewards are shared by Sukukholders [details are in Sukuk chapter].

14. Musharaka and Mudaraba are the sources of financing available to Islamic banking which can play the role of catalyst in the uplifting living standard of unserved/underserved large population in underdeveloped countries including Muslim countries by providing opportunities for self-employment. Mudaraba financing can replace the venture financing and could be used successfully in the promotion of new ideas generated by skillful graduates, lacking finances.

1.4. Challenges/Perceptions

With the advent of modern Islamic banking and speedy growth through application of business skills, well versed in business but lacking in relevant knowledge of Islamic finance, many questions raised by various quarters. It is pertinent to address certain objections/issues raised by experts in conventional finance, experts in Islamic law [lacking awareness of modern banking system] and (maybe) common men.

1. First is by the time of revelation paper currency was not in circulation hence injunctions about coins cannot be implemented on paper currency. The most important issue is the devaluation of paper currency due to inflation. Certainly one loses his wealth due to inflation if kept in currency. Equally; wealth is lost if given as Qarz e Hasna (charity loan) giving zero return rather negative return if currency devalued due to inflation. This is a very valid argument, and I analyzes it in two parts. First is Excessive inflation which we face in less developed countries including some Muslim societies is not the direct consequence of paper currency rather it is financial indiscipline of the governments of these countries. After all, why such a massive figure of inflation is not hitting developed world. Discipline is required in government spending, borrowings and issue of currency. Second as for mild inflation is concerned that requires debate and settlement. The

case for indexation of loans as per actual inflation in the economy is being debated at various forums among the Shari'a scholars and we expect an early outcome. [For details on the topic of indexation please see "Indexation of loans by Mohay ud Din Hashmi" chapter in book " Institutions of collective Juristic opinions, Concept, Evolution and Practical ways" [Ijtamai Ijtihad kay idarey; tasawer , Irtaqa aor amaly tareekay; in Urdu language], Institute of Islamic Research, International Islamic University, Islamabad, Pakistan.]

2. The second issue is the lack of trust which is vital between IFI and customer to put sharing models into practice. Musharaka and Mudaraba can only work if customer discloses his earnings honestly in a transparent way. This argument is also very valid and carries some empirical support as well. By looking at portfolios of IFIs, it is evident that sharing modes are not as much practiced as others. We must accept this fact that trust deficit exists among customers and IFIs. However, we cannot conclude impracticability of sharing modes of financing due to (1) deposits are accepted by IFIs under sharing modes and succeeded in building trust in the eyes of depositors (2) corporate world is working under sharing modes. An investor who purchases the shares of a company becomes the limited partner of that company; hence, sharing modes of doing business are not totally foreign to the business world.

Challenges for Practitioners of Islamic Finance

1. Use of Kibor as bench mark for profit
2. Use of par value in selling of shares of IFI in House financing
3. Use of par value in purchase of Sukuk at the time of redemption
4. Use of financial penalty in case of default by customer
5. Use of independent party guarantee of capital in case of Sukuk
6. Use of time value based computer software in calculation of installments
7. Very minor use of profit and loss sharing, Salam and Istisna'a modes of financing
8. Non availability of cash financing for day to day operations except through Musharaka

An investor who purchases the shares of a company becomes the limited partner of that company; hence, sharing modes of doing business are not totally foreign to business world.

3. Third is the similarity in products and even charges of IFIs with conventional banking. Undoubtedly IFIs are trying knowingly and willfully to match in products, services, costs and returns with conventional banks. This phenomenon exists due to (1) IFIs are lacking severely skilled human resources having the ability and understanding of philosophy of Islamic financial system (2) dominance of conventional banking with major market share even in Muslim societies (3) conventional banks are immediate competitors of IFIs hence an element of fear of losing customers is always there.

4. Fourth is a linkage of profit percentage charged by IFIs on their products with interbank offered rate (KIBOR, LIBOR, etc.). Certainly this is not appreciable that an institution claiming itself Shari'a compliant in its operations use the benchmark of interest for charging profit, however, using KIBOR as benchmark does not translate the transaction itself Haram [unlawful] (Usmani, 2003). Why are IFIs using KIBOR as a bench mark? The possible reasons include (1) IFIs are competing with conventional banks hence trying to be competitive in the market (2) lack of any other benchmark based on Shari'a compliant tools. One can hope with the increase in market share, IFIs would be able to develop their bench mark for profit.

5. Charging of cash penalty in case of default by the customer at the due date. Although cash penalty is not the only solution to handle the problem of default, however, it is allowed by Clerics due to poor governance and delayed provision of justice. If speedy justice can be provided then no need to impose a penalty on defaulter, however, one must appreciate that financial penalty is not the interest like conventional banks charge as it goes into charity account and not in the pocket of banks.

6. Use of single profit rate based upon IBOR is another challenge which industry faces. Ideally, market rates of each sector of the economy should be used by Islamic banks, but so for it is not achieved. At present same profit rate is charged for housing as well as an auto industry which delinks profits of IFIs from the market. Perhaps it is due to following of footsteps of conventional banking.

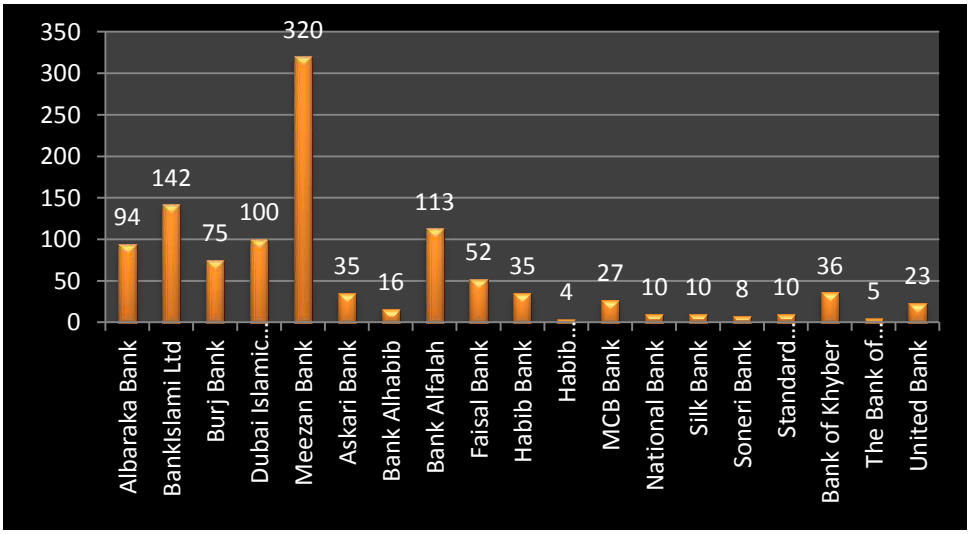
7. IFIs have not created so for specialized deposit schemes including housing, Ijarah, and Istisna'a, which can differentiate industry from conventional banking. According to the scheme, it is suggested to create restricted Mudaraba investment accounts where investment by banks is restricted to a particular industry, and actual return is shared with depositors.
8. Under Islamic financing cash financing is not offered to meet day to day requirements of industry, this is another challenge being faced by the industry to penetrate the market.
9. Another challenge is to deal in market value terms for the repurchase of Sukuk and selling of banks' equity shares under diminishing Musharaka. At present par value is used which is more in line with conventional banking than Islamic.
10. Another very serious challenge is addressing the perception issues of the market. There is a reasonable number of experts who think Islamic banking cannot meet the total needs of industry while there is a large number of masses who think Islamic banking is a mere change of name and there is no difference in conventional and Islamic banking.
11. Another challenge is the establishment of central Shari'a supervisory board which can guide industry globally. At present around ten Islamic indexes working globally, with different criteria's of Shari'a screening. Also, there are different versions of Islamic finance of Iran, Malaysia, Pakistan and other countries which demand the attention of policy makers to bring on the same page.

1.5. Islamic Banking in Pakistan

Pakistan has remained a chief proponent of Islamic banking because it is the only Muslim state which created on the basis of Islamic ideology. Islam is the state religion of Pakistan and any law repugnant to the injunctions of Islam is void as per constitution of Pakistan. The objective resolution was passed in 1949. Elimination of interest from the economy found a place in 1973 Constitution of Pakistan (Articles 2, 31, 37, 227). In early eighties Council of Islamic Ideology (CII) presented a blue print of interest-free banking in its report and country-wide efforts started to switch the economy towards the interest-free system. CII-1980

report on Elimination of Riba from the Economy is a landmark document in the history of Islamic banking which set out a detailed plan of conversion of the whole economy from conventional financial system to Islamic. However due to some reasons including dependence on foreign aids (concessional loans), the incapacity of trained human resources required to run the economy on an interest-free basis, financial indiscipline, corruption, political instability, etc. system could not run in its true spirit. Although all commercial banks started operation on profit and loss sharing, but the practice was not in line with theory. Certain quarters took the case in federal Shari'a court and order passed in 1991; declared interest based banking *haram* (unlawful).

Figure-3. Islamic Banking Branches in Pakistan on 30-06-2013



Source: SBP 2013

The government of Pakistan was obliged to abide by the order of higher judiciary. By looking at the overall situation, the government decided to respond through two-pronged strategies. On one hand a commission was set up for recommendations to Islamize the economy while on the other hand cases were pleaded in Supreme Court. Commission finalized its recommendations and Supreme Court given its decision in 1999 declaring the interest based banking ha-

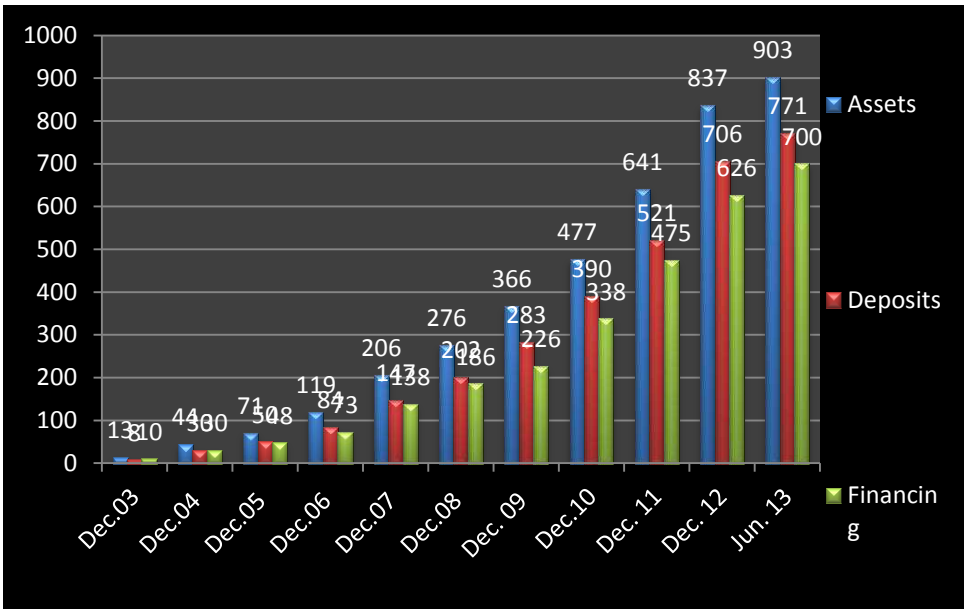
ram (prohibited) with instruction to the government to implement interest-free system in the economy.

By early 2000 onward a new strategy put into practice to Islamize the economy by state bank of Pakistan. Instead of moving abruptly towards the interest-free system (because the move made in the eighties was failed badly) it was decided to promote the Islamic banking in parallel to conventional banking. Islamic banking department (IBD) was established in the central bank to regulate the Islamic financial industry. IBD has done a great job so for in promotion and implementation of Islamic banking, although thrust is there for further promotion.

Islamic banking has shown tremendous growth in Pakistan in last ten years period (01/04-12/13). Islamic finance has grown at a rate of 28% in Pakistan for the last six years [2008-13]. By the end of June 2013, five full-fledged Islamic banks and 13-conventional banks with Independent Islamic Banking Branches are operating in Pakistan. Figure-3 depicts branch network; and figure-4 present the volume in PKR of assets, deposits, and financial disbursements of IFIs working in Pakistan (SBP, 2013). The number of branches has been increased from 17 to 1,115 within nine and half years [01/04 to 06/13] at an average annual increase of 72%. Assets crossed the figure of PKR 903 billion at an average annual rate of 62% while deposits reached to PKR Billion 772 at an average annual rate of 69% and financial disbursements and investments increased to PKR Billion 700 at an average annual rate of 60% during the period under review. Overall an average growth of 63% per annum[YoY] in the last nine and half years (01/04-06/13) was achieved by Islamic banking in Pakistan. In Pakistan, Islamic banks accept deposits either as interest-free loans or on profit and loss sharing basis and succeeded in getting the trust in the eyes of depositors. Average annual increase of 69% in deposits of IFIs working in Pakistan for last nine and half years is something cherishable. On the financing and investment side, modes of financing used by IFIs are categorized objectively as Shari'a based and Shari'a compliant (Hanif &

Iqbal, 2010)7. It is pertinent to describe briefly modes of financing suggested/used by IFIs in Pakistan.

Figure-4 Volume of Assets, Deposits and Investments under Islamic Banking in PKR Billions



Source: SBP-2013

A-Shari'a Compliant Financing

Shari'a compliant products mean the modes of financing where the return of financier is predetermined and fixed but within Shari'a constraints. The tools which are relatively harmonizing the operations of Islamic financial system with conventional banking includes Murabaha (cost plus profit sale), Ijarah (a rental arrangement), Bai Salam (spot payment for future delivery), Bai Muajjal (sale on deferred payment), Istisna'a (order to manufacture) and Diminishing Musharaka (house financing) are all Shari'a compliant products.

[7] Originally this classification was spoken by Prof. Khurshid on launching ceremony of RCIB.

A-1. Murabaha Financing

Murabaha is a cost-plus sale contract whereby disclosure of cost to the buyer is necessary. Under Murabaha arrangement customer requests to the Islamic Financial Institution (IFI) to purchase an asset for him (customer) and sell on deferred payment. An essential feature of Murabaha is that IFI must purchase the required commodity from supplier first and then sell to the customer. Bank charges a certain profit usually linked with Inter-Bank Offered Rate. Recovery could be agreed in installments or Balloon payment. The amount of installment or price of the asset cannot be (stipulated) increased or decreased in case of default or early payment (Shari'a standard 8). To create pressure on the client for prompt payment, a penalty is imposed upon customer as agreed in Murabaha contract. The amount of penalty for default in prompt payment recovered cannot be included in the income of IFI in any case and must be spent for charity (Usmani, 2002). Murabaha has successfully replaced the overdraft and short-term loans facility under conventional banking.

A-2. Ijarah Financing

Ijarah is a rental contract whereby IFI leases an asset for a specific rent

Meezan Bank Limited, a publicly listed company, was incorporated on January 27, 1997 and started operations as an investment bank in August that year. In January, 2002 in an historic initiative, Meezan Bank was granted the country's first full-fledged commercial banking license as a dedicated Islamic Bank, by the State Bank of Pakistan. The Bank's deposits grew at an average rate of 46% p.a. from December 2002 to December 2012 while its branch network grew from 6 branches in 2002 to 328 branches in October 2013, an average growth rate of 48% p.a**.** Meezan Bank awarded 'Best Islamic Bank in Pakistan' for 2013 by Asiamoney, Hong Kong
[*www.meezanbank.com*]

and period to the client. Ownership risks of the asset are born by IFI while expenses relating to use the asset are the responsibility of the client. The difference between Ijarah and sale is that ownership in Ijarah remains with lesser while in the case of sales it is transferred to the purchaser. Ending Ijarah in the sale of the asset is allowed by IFA through a separate contract at the completion of the term of the lease. The contract can be executed prior to purchase and possession of the asset. Consumables cannot be leased out. Right of lessee to use the asset is restricted to lease agreement or/and as per normal course of business. Lessee is liable for any harm to the asset caused by any misuse or negligence on his part. Rentals of joint property are shared according to equity. A joint owner can rent his share only to the co-partner. Inter Bank Rate can be used as a benchmark for the amount of rentals. At the completion of Ijarah term either asset is returned to IFI or purchased by the client (Shari'a standard 9). Ijarah has replaced the facility of leasing under conventional financial system successfully.

A-3. Diminishing Musharaka Financing

Diminishing Musharaka is a form of declining partnership between IFI and client generally used to finance real estates. When a customer requests to IFI for financing to purchase an asset IFI participates in the ownership of the asset by contributing required finance. A Certain portion (e.g.20%) must be contributed by the customer. Total equity of bank is divided into units of smaller amounts which are purchased by the client in installments. Under this mode of financing, one of the partners (client) promises to buy the equity share of the other partner (IFI) gradually until the title to the equity is completely transferred to him. Buying and selling of equity units must be independent of partnership contract and must not be stipulated in partnership contract. Generally, IFI rent out his share to the client and earns rentals. Any profit accruing on the property is distributed among the co-owners according to agreed ratio however losses must be shared in the proportion of equity (Shari'a standard 12). Diminishing Musharaka is used for house financing by IFIs and has replaced conventional mortgages successfully.

A-4. Salam Financing

Bai e Salam is a form of sale contract whereby IFIs purchase goods for spot payment with deferred delivery. Practically it is used in the financing of agricultural needs of farmers. Farmers sell their crops before harvesting to IFIs in order to get money to purchase seeds and fertilizers. Generally, spot price agreed is lesser than future the actual date of delivery, hence IFIs are making profit. As a matter of practice, IFIs are entering into a parallel Salam contract with the third party to sell the proceeds once taken over, however, execution of the second contract is not conditional on the fulfillment of first (Sh. St. 10).

A-5. Muajjal Financing

The literal meaning is deferred / credit sales. Islamic Financial Institutions (IFIs) are using this mode to finance the customers' needs by the supply of desired commodities. The difference between Murabaha and Bai Muajjal lies in the disclosure of cost. Under Bai Muajjal cost may or may not be disclosed. All other features are same as discussed in Murabaha.

A-6. Istisna'a Financing

This mode of financing is designed to transact business through an order to manufacture and/or supply. It is a sales contract with the exception of the existence of subject matter. This tool of financing is useful for infrastructure projects. Parallel Istis-

The second full-fledge Islamic Commercial Bank in Pakistan, was incorporated on October 18, 2004 in Pakistan. BankIslami Pakistan Limited made a public offering of Rs. 400 Million, at par, from 6th to 8th March & received overwhelming response from the general public as the applications received were 9 times higher than offered, fetching nearly Rs. 3.5 Billion, against the demand of Rs. 400 Million. As at June 2013, it has branch network of 142. BankIslami offers retail, corporate, investment banking as well as Takaful services. [*www.bankislami.com.pk*]

na'a contract is allowed however performance of second Istisna'a contract must not be conditional on the fulfillment of the first contract (Shari'a standard 11).

B-Shari'a Based Financing

Shari'a based transactions mean the financing modes adopted by IFIs on profit and loss sharing basis including Musharaka (partnership in capital) and Mudaraba (a partnership of capital and skill). Under Shari'a based modes of financing returns of a financier are not fixed in advance rather it depends upon the outcome of the project. However, loss is to be shared according to capital contribution.

B-1. Musharaka Financing

According to Hadith Qudsi (revelation reported by Prophet Muhammad PBUH) *"Indeed, Allah the Exalted says: I am the third of the two partners so long as the one does not cheat the other, and when he cheats, I withdraw myself"* (Khan, 1989). The literal meaning of Musharaka is sharing. Its root in the Arabic language "Shirka" means being a partner. Musharaka means a joint enterprise formed conducting some business in which all partners share the profit according to pre-agreed ratio while the loss is shared according to the ratio of contribution (Meezan Bank guide 2002). For a valid Musharaka fulfillment of certain conditions required. First is there must be an agreement written (verbal) among the partners stating clearly the terms and conditions including management, capital contributions, profit and loss sharing among the partners. Second capital can be contributed in cash as well as in assets. However once an asset is contributed as capital that belongs to firm and contributing partner is relieved from the bar of risks and returns attached to ownership. Third profit is distributed according to the agreement of partnership, however, sleeping partner cannot claim a share in profit more than his proportionate share of equity. None of the partners can guarantee the capital or profit share to any other partner (Shari'a standard 12). Under Musharaka IFIs are receiving deposits and finances business requirements for profit and loss sharing.

B-2. Mudaraba Financing

Mudaraba is a type of partnership whereby skill and money brought together to conduct business. Profit is shared according to an agreement while the loss is borne by capital provider only. Under this scheme of financing, IFIs provide capital to financially weak but skillful people to do the business and share the outcome with IFIs. This scheme is also used in deposit collection. Mudaraba contract can be restricted or unrestricted. No one can claim a lump sum amount of profit it must be based on actual outcome (Shari'a standard 13). Following the rule of substance over form, one can conclude that the major difference between conventional and Islamic financing is Shari'a based modes of financing. By looking at portfolios of IFIs working in Pakistan (figure-5), it is depicted that share of Shari'a compliant modes of financing is dominant with a negligible portion (less than 5%) invested in Shari'a based modes. This is an issue which demands serious attention of industry leaders as well as policy makers.

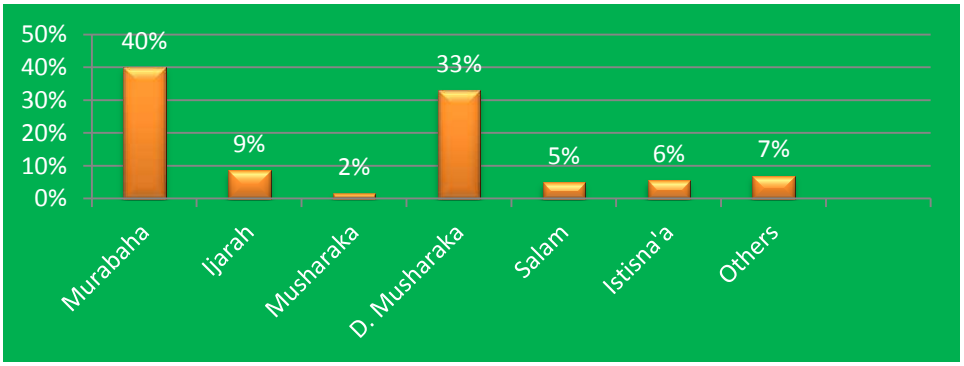
Practitioners of IFIs have focused so for on Murabaha, Ijarah, and diminishing Musharaka, all are very much similar to conventional banking. Of course, the difference lies in nature of contracts including bearing of ownership risk by IFIs, no extra charges for late payment, no interest charging, linkage of financial and real sector, etc. however returns of IFIs are certain and pre-calculated. One of the major reasons of lesser popularity of Profit and loss sharing (PLS) system is a lack of human resources equipped with updated knowledge of Islamic financial system. Most of the officers working in Islamic financial industry are trained in conventional banking and lacking the philosophy and knowledge of Islamic banking severely.

Hanif, & Iqbal, 2010, concluded that the major hurdle in the popularity of Musharaka financing is the dominance of conventional banking, and this hurdle can be removed only through the expansion and growth of IFIs. Other factors discouraging Shari'a based financing, identified in their study, include the higher risk level in Musharaka, profit manipulation behavior of businesses, lack of trust and confidence in the ability of Musharaka partner, manipulations of accounts by firms under conventional accounting framework, relatively

Murabaha is a cost-plus sale contract whereby disclosure of cost to the buyer is necessary.

higher taxes, weaker auditing and lack of awareness among masses about the philosophy and operations of IFIs. Through increased awareness, grants of tax incentives, capacity building of IFIs, strengthening audit institution, fostering by central bank and new products development with a focus on small and medium enterprises under Musharaka principles, Shari'a based financing can be promoted.

Figure-5. share of each mode of financing in portfolios of IFIs-Pakistan as at 30-06-2013.



Source: SBP-2013

1.6. Organization of Book

Rest of the book is organized as follows. Part two is about asset-backed financing provided by IFIs. It includes trading (selling) modes of financing including Murabaha, Salam, and Istisna'a; it also includes Ijarah financing. At the start of part two, a summary of Shari'a rulings about sales is reported. Chapter two is about Murabaha (cost plus profit) the most widely used financing tool by IFIs world over and Muajjal (deferred sale). The share of Murabaha is 40% in portfolios of IFIs working in Pakistan. Murabaha is a very useful tool to replace overdraft and short to medium term financing. Chapter two discusses the basic rules of Murabaha, necessary steps involved and comparative study with conventional short-term loans including bank overdraft facility. Chapter three is about Bai Salam; a form of sale contract whereby IFIs purchase goods for spot payment with deferred delivery. Practically it is used in the financing of agricultural needs of farmers. Chapter four is about Istisna'a. This mode of financing is designed to

Mudaraba is a type of partnership whereby skill and money brought together to conduct business.

transact business through an order to manufacture and/or supply. It is a sales contract with the exception of the existence of subject matter. This tool of financing is useful for infrastructure projects. Chapter five is about Ijarah; a rental contract whereby IFI leases an asset for a specific rent and period to the client. Ijarah is very useful in replacement of leasing. Share o f Ijarah is 18% in portfolios of IFIs working locally.

Part three of the book deals with profit and loss sharing modes of financing including Musharaka, diminishing Musharaka and Mudaraba. Chapter six is about Musharaka financing. The literal meaning of Musharaka is sharing. Its root in the Arabic language "Shirka" means being a partner. Musharaka means a joint enterprise formed for conducting some business in which all partners share the profit according to pre-agreed ratio while the loss is shared according to the ratio of contribution. A special section is devoted to discussing the lesser application of Musharaka in operations of IFIs in addition to Shari'a rulings and financial impact. Chapter seven is about Diminishing Musharaka; a form of gradually declining partnership between IFI and client generally used to finance real estates. Under diminishing Musharaka I have discussed the basic Shari'a rulings, Islamic house financing, comparative study, and installment calculation for house financing. Chapter eight is about Mudaraba. Mudaraba is a type of partnership whereby skill and money brought together to conduct business. Profit is shared according to an agreement while the loss is borne by capital provider only. Under this scheme of financing, IFIs provide capital to financially weak but skillful people to do the business and share the outcome with IFIs.

Part four is about deposits management. Chapter nine presents various types of deposits collected by IFIs and profit sharing mechanism. Concepts of daily product and weight age based profit system are elaborated.

Musharaka means a joint enterprise formed conducting some business in which all partners share the profit according to pre agreed ratio while loss is shared according to the ratio of contribution.

Part five of the book presents special topics in Islamic banking. In this part areas of liquidity management [including capital market], Cash financing options and summary of financial reports along with accounting prin-

ciples as adopted/developed by accounting & auditing organization of Islamic financial Institutions (AAOIFI), are discussed.

At the last section of the book procedures and rules, as issued by a central bank, relating to the creation of Islamic bank, independent Islamic banking branches by conventional banks and subsidiary of a conventional bank to transact business of Islamic banking are included as appendixes.

1.7. Questions

1. What is meant by Islamic Banking? Why there was a need to have a separate stream of banking? What are the differences in conventional and Islamic banking?
2. What are injunctions about the prohibition of interest in Bible and Qur'an? Explain briefly?
3. What is the volume of Islamic finance world over? Enlist country wise share.
4. What are the salient features of Islamic banking?
5. Address the objections raised by critics of Islamic banking.
6. What is meant by word "*Riba*" used in Holy Qur'an? Whether *Riba* covers usury or interest? Explain the juristic opinion of Muslim Clerics about the meaning of *Riba.*

Multiple Choice Questions

1. Which of the following best describes the difference in Conventional and Islamic Banking?
    a. Riba (Interest) is the only difference in conventional and Islamic banking.
    b. Shari'a compliance in all operations of banking by Islamic banks
    c. There is no difference between Islamic and conventional banking
    d. None of the above
2. Which of the following best describes term *Riba,* used in Holy Qur'an?
    a. Additional charge on consumption loans (usury) is Riba
    b. Additional charge on productive loans (commercial interest) is Riba

c. Any predetermined additional charge in a loan transaction irrespective of purpose is Riba
d. None of the above

3. Under Islamic law, sources of law are four. Which of the following, priority wise is a correct order?

a. Ijma, Sunnah, Qur'an, and Ijtihad
b. Qur'an, Sunnah, Ijma and Ijtihad
c. Ijtihad, Ijma, Qura'n, and Sunnah
d. Sunnah, Qura'n, Ijma and Ijtihad

4. The last set of revealed Ayahs (Verses) about the prohibition of Riba is reported in which of following Surah (Chapter) of Holy Qura'n?

a. Surah Al-Rum
b. Surah An-Nisaa
c. Surah Al-i-'Imran
d. Surah Al-Baqarah

5. According to IFSL-2013, by the end of 2010, which of the following countries is the largest contributor to global volume of Islamic finance?

a. Saudi Arabia
b. The Islamic Republic of Iran
c. United Arab Emirates
d. Malaysia

6. Which of the following regions is the largest contributor to global volume of assets under Islamic financial industry?

a. South Asia
b. Middle East
c. European Union
d. North America

7. Five Khiyars (options) in a trading contract are salient features of Islamic financial law. What is meant by Khiyar-e-Ghaban?

a. Option to terminate contract by purchaser if goods lacking required quality

b. Option to terminate contract by purchaser if seller charges significant higher than market price
c. Option to rescind contract within a specified period
d. Option to return defective goods

8. The financial penalty is charged by both conventional as well as Islamic banks in case of delay in payment by the debtor. Which of the following correctly displays the difference?

a. Both types of banks have to serve the depositors; hence, late payment charges are justified
b. Anybody who is a willful defaulter should be penalized in the form of financial penalty
c. Charging of financial penalty to defaulter is not against Islamic law. However, the amount of penalty must not be used to compensate the creditor, rather, it should be spent on charity.
d. When a debtor defaults, it put the financial institution in hardship; hence, time value of money should be recovered from defaulter.

9. To invest in the equity of a company by an Islamic bank, Shari'a compliance of investee is required. One of the Shari'a compliance tests is a debt to total assets ratio. Which of the following is the maximum limit?

a. Debt/Total Asset <40%
b. Debt/Total Asset <30%
c. Debt/Total Asset <20%
d. Debt/Total Asset <10%

10. During last nine and half years (01/04 to 06/13) Islamic banking has grown, approximately, at an average annual growth rate of

a. 63 percent
b. 77 percent
c. 79 percent
d. 86 percent

True/ False

Mark the following statements as True or False.

1. According to capitalism factors of production include land, labor, capital and organization. Rewards for three production factors (i.e. land, labor, and capital) are fixed while the reward of an entrepreneur is variable depending upon the out-come of the underlying project.

2. According to Shari'a reward for an entrepreneur is not fixed hence it is a similarity in capitalism and Islamic financial system however difference lies in fixation of reward for capital.

3. Sources of law in Islam have categorized (into four) keeping in view the changing needs of society. Two are the prime sources (Qura'n & Qiyas) while two are derivations/ inferences i.e. Ijma'a'a and Sunnah (consensus opinion of clerics; and individual opinion of a cleric).

4. Room of difference in opinion for an individual exists in two sources of law i.e. Sunnah and Ijma'a'a.

5. Prohibition of Riba (usury and interest) has proven in three sources of Islamic law (Qura'n, Sunnah & Ijma'a'a) repeatedly hence no question of having a difference of opinion according to Shari'a.

6. Keeping in view the prohibition of interest and importance of banking in the economy, Muslims (clerics & professionals) decided to search for an alternative and after due consideration, they came up with the idea of Islamic banking.

7. Islamic banking is not the dealing in money like conventional banking. It is dealing with goods and services.

8. During last quarter of 20th-century serious efforts were made for promotion of Islamic financial system in Muslim societies as well as throughout the world in general.

9. By the end of 2012, estimated the global volume of assets of Islamic finance has reached to US$ 1,460 Billion (IFSL, 2013) with operations in more than 50 countries consisting of above 300 institutions.

10. Persian Gulf area is the center of Islamic financial system with a share of 60% followed by Fareast & South Asia region 13% and balance from rest of the world is contributed in Shari'a compliant assets.

11. Islamic banks are not dealers of money hence, no provision of financing in hard currency is available while conventional banks provide hard cash as loans for charging of interest.

12. Islamic banks are traders of goods and services and not the loan houses as for financing is concerned while conventional banks are lenders of cash.

13. Islamic banks use financing tools being used in trade including Murabaha (cost plus profit), Ijarah (rental arrangement), Bai Salam (spot payment with the deferred delivery of goods), Bai Muajjal (deferred sale), and Istisna'a (order to manufacture).

14. Doing business according to principles of profit and loss sharing is easier given the dominance of interest based banking and non-conduciveness of existing business environment.

15. Certain quarters are of the view that Riba, which is prohibited by revelations is the banking interest (interest charged on productive loans), and the term does not cover usury (interest charged on consumption loans).

16. Charging of additional predetermined amount (usury, interest) on loans had always got support in ethics/religions. Interest charging is not forbidden by at least all known revealed religions including Judaism, Christianity and Islam.

17. What is prohibited through revelations is the predetermined charge on capital (risk-free return) and not the profit on capital (involving risk) invested

18. Under partnership business (Musharaka & Mudaraba) IFIs cannot limit their sharing in profit only, to safeguard the capital. IFIs are required by Islamic law to share loss as well.

19. Under Islamic financial system, loss in the partnership must be shared according to equity stake; however, profit can be shared in any ratio subject to the limit for a sleeping partner whose share cannot be more than a proportionate equity stake.

20. Islamic banks cannot claim additional amount from a customer in case of default because it falls in the circle of Riba. However to penalize the defaulters, Ulema (clerics) have allowed IFIs to charge a penalty; but same cannot form part of income of IFIs rather it goes to charity

21. If any IFI accepts deposits in current account as Amanah then principles of Amanah shall prevail including a guarantee of refund and right to invest.

22. For IFIs avenues are very limited to create required liquidity at the same time to earn some revenue by investing in the short term and liquid securities. IFIs cannot invest in government securities, short-term loans, bonds and money at call and short notices because of interest based transactions.

23. Recently IFIs have created an avenue to meet their liquidity requirement in the form of Sukuk (Islamic Bonds) whereby servicing is fixed like conventional bonds however such types of Sukuk can be issued against Ijarah rentals.

24. The underlying principle in the issue of Sukuk against a portfolio of assets is that liquid assets should dominate in the portfolio against which Sukuk are issued.

25. The most important issue is the devaluation of paper currency due to inflation. Certainly one loses his wealth due to inflation if kept in currency. Equally; wealth is lost if given as Qarz e Hasna (charity loan) giving zero return rather negative return if currency devalued due to inflation.

26. An investor who purchases the shares of a company becomes the unlimited partner of that company; hence, sharing modes of doing business are not totally foreign to the business world.

27. Certainly this is not appreciable that an institution claiming itself Shari'a compliant in its operations use the benchmark of interest for charging profit however using KIBOR as benchmark does not translate the transaction itself Haram

28. In early eighties council of Islamic ideology presented a blue print of interest-free banking in its report and country-wide efforts started to switch the economy towards interest-free system. However due to a number of reasons including dependence on foreign aids (concessional loans), the incapacity of trained human resources required to run the economy on interest-free basis, financial indiscipline, corruption, political instability, etc. system could not run in its true spirit.

29. Overall an average growth of 57% per annum in the last six years and nine months (12/03-06/13) was achieved by Islamic banking in Pakistan.

30. Shari'a compliant products mean the modes of financing where the return of financier is predetermined and fixed but within Shari'a constraints.

31. Murabaha is a cost-plus sale contract whereby disclosure of cost to the buyer is necessary.

32. Ijarah is a rental contract whereby IFI sells an asset for a specific rent and period to the client.

33. Diminishing Musharaka is a form of increasing partnership between IFI and client generally used to finance real estates.

34. Bai e Salam is a form of sale contract whereby IFIs purchase goods for spot payment with deferred delivery.

35. Bai e Muajjal is a mode of financing designed to transact business through an order to manufacture and/or supply. It is a sales contract with the exception of the existence of subject matter.

36. Shari'a based transactions mean the financing modes adopted by IFIs on profit and loss sharing basis including Musharaka (partnership in capital) and Mudaraba (a partnership of capital and skill).

37. Musharaka means a joint enterprise formed to conduct a business in which all partners share the profit according to pre-agreed ratio while the loss is shared according to the ratio of contribution.

38. Under Musharaka once an asset is contributed as capital that belongs to firm and contributing partner is relieved from the bar of risks and returns attached to ownership.

39. Mudaraba is a type of partnership whereby capital and money brought together to conduct business. Profit is shared according to an agreement while the loss is borne by capital provider only.

Assignment

Select ten companies of your choice and determine Shari'a compliance status by applying the Shari'a filtering criteria discussed under the heading of salient features of Islamic banking.

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Part-2
Asset Based Financing

A. Murabaha & Muajjal Sales
B. Salam Sale
C. Istisna'a Sale
D. Ijarah

Summary of Rules of Sales

As we are moving to study the asset-backed financing (sale & lease) it is pertinent to present the summary[8] of Shari'a rules about sales. These rules are the basis for regulation and design of financing products through sales of assets including Murabaha, Muajjal, salam, and Istisna'a.

Rule.1-A person cannot sell a commodity unless:-

a. It has come into existence physically
b. The seller owns it
c. It is in possession of the seller

Exceptions. Two types of sales (Salam and Istisna'a) are exempted from this rule. For example one can sell goods under Salam contract [usually agricultural products] without having goods in his possession in exchange for a price paid immediately and also a manufacturer can book an order with specifications for goods to be delivered after completion. Except these types of cases under the normal course of business, one has to meet the three criteria listed above to become a seller.

Rule.2- Unconditional sale contract is required. (e.g. it is not allowed to sell the car "if I would be able to purchase a new car" or I sell the car to Mr. X if Mr. Nawaz Sharif becomes prime minister once again etc.

Rule.3- Subject of sale (commodity) must be a thing of value. It is also important that what is being sold is a commodity/service which carries utility and not available to everyone without cost.

Rule.4-Normal usage is for Halal (not prohibited) purposes. Any sales of prohibited goods/services including liquor, pornography, prostitution and pork, etc. is not allowed by Islamic law.

Rule.5- Subject of sale must be identified. Mr. X had two cars and sold one to Y is not a valid sale unless it is identified as which of the car is being sold.

[8] For detailed Shari'a rules reader is requested to consult Usmani, 2002.

Rule.6- Delivery of goods sold should be certain. If Mr. A sells a ton of apples to be obtained from orchard Y is not a valid sale as delivery is uncertain, however without identifying the orchard one can sell apples with deferred delivery for price received in advance.

Rule.7- Price of the commodity sold must be certain. One should clearly know as how much is to be paid by him. It is not allowed to sell the house to Mr. X with deferred payment linked with inflation or KIBOR or any other benchmark. Price must be settled at the time of sales agreement irrespective whether cash sales or credit sales.

Rule.8-Deffered price can be more than the spot price. One can negotiate any price for any period, however linking deferred price with payment duration is not allowed. For example, one cannot say that I will charge 5% profit if it is paid within six months and charge 10% on cost if paid within one year and leave the payment schedule on the purchaser. One can negotiate a price with 5% and 10% margins respectively keeping in view the payment length. However it is necessary to settle one and only one price in a sale contract.

Rule.9-Once price fixed and contract executed it can neither be increased (on account of late payment) nor decreased (on account of early payment). For example, if Mr. Alam purchased a computer from BankIslami costing Rs; 50,000 for a profit of 10% above cost. It is not allowed to charge Rs; 55,000 if payment is made after a year or Rs; 60,000 if payment made after two years and Rs; 52,500 if payment is made within six months. Only one price is to be negotiated which can neither be increased on account of late payment, not decreased if payment is made earlier.

Rule.10-Penalty in the case of default can be included in the contract of sale, however, same cannot be used by the seller, and it must go to charity. A penalty clause is not the only cash penalty; it can be taken away if the proper justice system is being at work which can ensure speedy justice in the society. Defaulter can be punished some other ways, however at present keeping in view the prevailing justice system in Muslim majority countries, Clerics have allowed charging cash penalty to defaulter and the additional amount so recovered is not

the property of the bank, rather it goes into charity account maintained and supervised by Shari'a board of the bank.

Rule. 11- Buyer has been given certain options [Khiyars]. Islamic banks have to follow the principles of sales and purchase as given by Shari'a including five *khiyars* (stipulations). According to Usmani, 2002a, Five khiyars include, Khiyar e Shart (option to rescind contract within specific period), Khiyar e Roiyyat (option to inspect the article prior to purchase), Khiyar e Aib (option to return defective goods), Khiyar e Wasf (option to return low-quality goods if do not carry the required function), Khiyar e Ghaban (option to return goods when charged price higher than market by deceiving buyer).

Nokia company sold a mobile with a feature of 20 hrs battery talk time. If after purchase battery could not work up to required time, the buyer has the right to claim new battery, and if any of battery is not up to specified feature, then the buyer can return [Khiyar e Wasf].

Alam Khan purchased a laptop from Margalla Computers, however when computer delivered, it was found that keyboard is not working. Hence Alam has the option to claim a replacement or return the computer and receive price back [Khiyar e Aib].

Zahoor purchased goods on a condition of three days as sales and returned basis; he has the right to return goods within specified time without having any defect in goods [Khiyar e Shart].

Any of the buyers of anything has right to insist upon inspection of goods prior entering into a sale/purchase contract [however in case of Salam and Istisna'a (deferred sales), it is not possible, and one has to rely on specifications] [Khiyar e Roiyyat]

Anyone can rescind a contract concluded based upon cheating and/or fraud. It includes charging exceptionally higher profit by deceiving the other, by providing false information to motivate him to enter into sales agreement, etc.

12- In the case of deferred sale contract [Salam sales) Buyer needs to specify the quantity and quality of goods to be delivered and buyer must not insist upon the production of a specific piece of land.

Zahoor Khan entered into a contract of Salam sale with Roshan of Sargodha to deliver after harvesting the total production of Orchard-C [whatever it is] for a price of PKR 1,000,000 paid at the spot, is a void contract. The correct contract would be to specify the fruiter in count or Kgs to be delivered, however even then he cannot specify that required quantity must be delivered from Orchard-C. It would be ok to ask for preference to Orchard-C, however if required production could not be obtained, then accept produce of other lands.

Chapter 2

Murabaha Financing

Murabaha is a dominant source of retail banking under Islamic financial system

Murabaha is a sale agreement whereby seller charges a percentage profit on the cost of goods sold. Under this mode of financing disclosure of the cost of underlying commodity is necessary to the customer. Murabaha is a dominant mode of financing in portfolios of IFIs world over due to its easiness in operations of banking and relatively similarity with conventional loans.

Learning objectives

After going through this chapter reader should be able to understand and interpret the following:

What is Murabaha financing?

What are Shari'a rulings about operations of Murabaha financing?

What are differences and similarities in conventional loans and Murabaha financing?

What are steps in a transaction of Murabaha financing?

What is the financial impact of Murabaha financing and how it is accounted for?

2.1. Introduction

Murabaha is a cost-plus profit sale contract whereby disclosure of cost to the buyer is necessary. Under Murabaha arrangement customer requests to the Islamic Financial Institution (IFI) to purchase an asset for him (customer) and sell on deferred payment. An essential feature of Murabaha is that IFI must purchase the required commodity from supplier first and then sell to the customer. Bank charges a certain profit usually linked with Inter-Bank Offered Rate. Recovery could be agreed in installments or Balloon payment. The amount of installment or price of the asset cannot be (stipulated) increased or decreased in case of default or early payment (Shari'a standard 8). To create pressure on the client for prompt payment a penalty is imposed upon customer as agreed in Murabaha contract. The amount of penalty for default in prompt payment recovered, cannot be included in the income of IFI in any case and must be spent for charity (Usmani, 2002). Murabaha has successfully replaced the overdraft and short-term loans facility under conventional banking.

Urboun is earnest money received from customer against a contract which can be forfeited if contract is rescinded by customer.

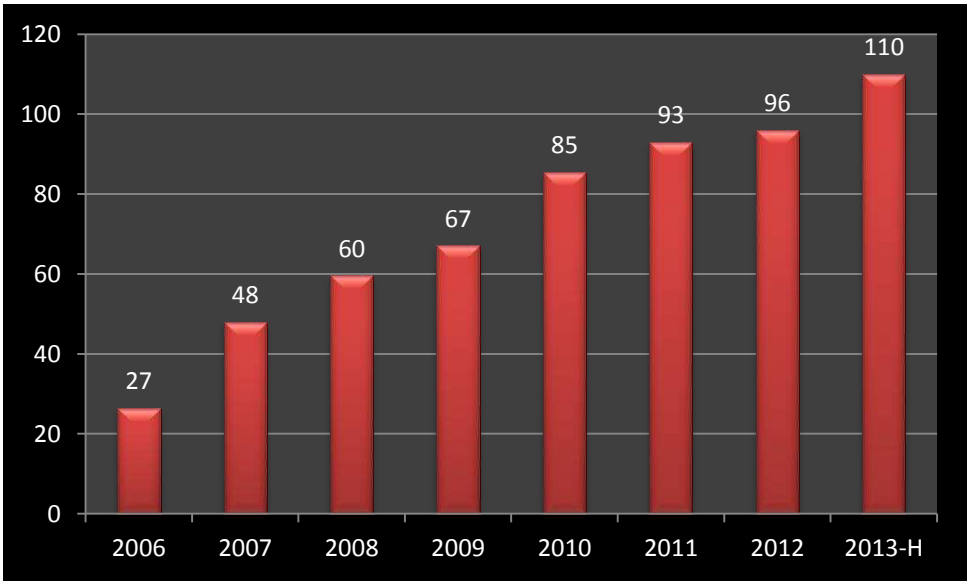
Murabaha is the dominant mode of financing in portfolios of IFIs since the inception of Islamic banking due to its easiness in practice and low risk as compared to profit and loss sharing modes of financing. Figure 2.1 depicts percentage share of Murabaha in portfolios of IFIs working in Pakistan, during 17 quarters 09/06 to 09/10 (SBP-2010). The average share of Murabaha in portfolios of IFIs working in Pakistan is 41%. Figure 2.2 presents closing amounts of Murabaha financing from 12/06 to 06/13.

Figure.2.1. Percentage share of Murabaha financing in portfolios of IFIs

Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
38.4%	40.3%	41.0%	45.0%	40.9%	44.5%	44.0%	38.1%
Dec-08	**Mar-09**	**Jun-09**	**Sep-09**	**Dec-09**	**Mar-10**	**Jun-10**	**Sep-10**
40.7%	37.5%	40.25%	36.6%	42.3%	37.5%	44.1%	43.3%

Source: SBP-Islamic Banking Bulletins

Figure.2.2. Closing Amounts (PKR Billion) of Murabaha financing in portfolios of IFIs from 12/06 to 06/13.



Source: SBP-Islamic Banking Bulletins

2.2. Summary of Shari'a Rulings

Rule.1. It is permitted to purchase a commodity on request of the customer after a unilateral promise by the customer to purchase the asset. A bilateral promise is allowed only with an option to cancel by any of the parties. Invoice (offer of sale) by supplier must be in the name of bank and price must be paid to the supplier by IFI. It is not permitted to transfer a contract of customer with supplier to IFI under Murabaha. It is permitted to purchase the asset from a specific supplier identified by customer except customer himself or his agent. It is not permitted to sell equity share in Musharaka to the other partner on Murabaha basis. Currency, gold and silver cannot form the subject matter of Murabaha. It is permitted to demand

Hamish Jiddiya is a security deposit received from a customer in case of binding promise which can be forfeited equal to the amount of actual loss suffered by bank.

security deposit (*Hamish Jiddiya*) from a customer in case of binding promise which can be forfeited equal to the amount of actual loss suffered by the bank (excluding time value of money) if customer breaches his promise.

Mr. A requested to an IFI to arrange a machine for him on deferred sale basis. As per agreement both agreed to charge profit of 10% per annum and payment would be due after one year. As goods are not available with the bank and has to arrange from the market, hence contract of sales cannot be executed, so Mr. A promised to purchase once the goods arranged by the bank and paid PKR 50,000 as a security deposit. After the goods arranged by bank Mr. A shown lack of interest in the execution of sales agreement. Bank disposed of goods for cash at a loss of PKR 20,000. Mr. A is obliged to reimburse the actual loss of bank. Hence bank is required to refund only 30,000 out of security deposit to Mr. A after deducting the actual loss. Suppose goods value was PKR 1,000,000, and it was agreed to sell to Mr. A at PKR 1,100,000, still loss accounted for under Islamic financial system is only PKR 20,000 and not 120,000 [100,000 loss of expected profit and 20,000 loss from actual spending]. Suppose further bank entered into another Murabaha with Mr. B for 1,080,000 and lost expected profit of PKR 20,000. In this case, nothing shall be deducted from security money deposited by Mr. A as bank lost nothing from cost [no actual lost]. Loss of expected profit of PKR 20,000 is not to be reimbursed by Mr. A under Islamic financial system.

Mr. B entered into Murabaha agreement with a local Islamic bank on ten percent profit on the cost to purchase cotton for his textile mill. Bank authorized the customer to purchase goods of his choice from his trusted supplier and paid cash of PKR 500,000Mr. B for the discharge of liability to be refunded PKR 550,000 after one year is a void contract, as under Murabaha it is necessary that goods should be purchased in the name of bank and payment should be made to the supplier.

Mr. X requested to purchase an asset for him by an IFI with a condition that asset should be purchased from Mr. X and then sold to Mr. X at a profit on deferred sale basis is a void contract.

Rule.2. An IFI cannot conclude a contract of Murabaha sale before purchase of the underlying asset because ownership of seller is required for sale. Ideally, IFI should purchase the asset from supplier through his staff, however, it is permitted to acquire the asset through an agent including customer (purchaser in Murabaha). The asset must be purchased in the name of bank[9] and payment must be made to the supplier (not to the customer). There must be a reasonable time between the purchase of the asset from the supplier and onward sale to the customer under Murabaha so that bank (being a seller) must bear the risk of ownership. The asset must come in possession (physical or constructive) of bank and insurance expenses incurred must be borne by the bank before sale.

Mr. Alam entered into Murabaha agreement with the bank. As per term, bank shall charge 10% per annum profit on Murabaha sale. Bank authorized the customer to select goods for purchase from his supplier of convenience. Customer purchased goods in his name and transferred from the supplier to his premises is a void agreement as the bank has not born the risk of ownership at any stage. Under Murabaha it is necessary that bank bear the risk of ownership. Hence it is suggested that bank should purchase goods in its name and then sell to the customer. However it is also allowed keeping in view the lack of capacity of the bank that customer himself select the goods to be purchased. However those goods should be purchased in the name of the bank and after passing a reasonable time these goods should be sold to customer and payment must be made to the supplier.

In order to ensure prompt payment and penalize defaulters IFIs can stipulate a penalty clause; however amount so recovered cannot form part of income of bank and must go into charity fund.

Mr. Jazz purchased goods from Khan and submitted invoices to the bank for making payment by signing a Murabaha contract is a void contract as payable cannot be transferred to another party for an incentive to gain some time in making payment. It is necessary that goods must be purchased from the bank under Murabaha sales.

[9] It is also allowed to purchase the goods in the name of agent on behalf of principal, however this should not be made a practice and used only in cases of dire needs e.g. when double taxation on sale/ purchase is imposed leading to increase in cost.

Murabaha stages must be completed in different phases, if all stages completed in one sitting, it will make contract invalid.

Rule.3. IFI cannot enforce the customer to take delivery of asset and enter into Murabaha sale; after the asset is acquired however damages[10] (equal to actual loss excluding time value of money) can be claimed in case of binding promise.

Mr. Khan requested to Margalla Islamic Bank to arrange raw material for his factory amounting to PKR 500,000 and promised to enter into Murabaha agreement once the goods arranged. After the acquisition of bank, Mr. Khan was not interested in sale agreement, and the bank had to dispose of goods at 10% loss to Mr. Alam. Mr. Khan is responsible for reimbursing loss of PKR 50,000 to the bank. Suppose bank and Khan were agreed to a profit of 20% through this Murabaha deal and non-performance of promise put the bank on the loss of expected profit. This expected profit cannot be charged to the customer under Islamic financial system, and the bank can claim damages equal to actual loss from a defaulter of promise.

Rule.4. The cost of Murabaha includes the payment due to supplier plus direct expenses (transportation, insurance, storage, the fee for a letter of credit) incurred. Operating expenses of the bank must not be included in the cost. Any discount received from supplier even after execution of Murabaha contract must be passed on to the customer. Cost and profit must be certain at the time of sale[11]. It is permitted to sell the asset on Bai al Bara'ah (sale on 'as is' basis) relieving the IFI from any manufacturing defect of the asset, however, in this case, right of recourse to the manufacturer should be assign to a customer. *Urboun* (earnest money) is allowed after execution of Murabaha contract. However, it is preferred to forfeit the amount equal to the actual loss suffered.

[10] Damages include the loss on sale of asset to third party at a price lower than cost and not the mark up agreed with Murabaha to purchase orderer.

[11] Profit charging must not be tied with any indicator including bank rate (KIBOR). Charging profit on the basis of KIBOR is allowed at the time of sale however amount of profit must be settled in Murabaha sale contract. It cannot be stipulated to change the receivable amount after conclusion of contract based on KIBOR or any other indicator.

Mr. Khan requested the bank to purchase a machine for him from Germany and supply to the customer under Murabaha sale at 10% profit. The machine was imported by Mr. Z and charged to bank PKR 1,000,000. The price of this contract would be PKR 1,100,000. Suppose after completion of deal importer gave 2% discount to the bank, it is necessary that bank reduce the selling price even after completion of the sales transaction. Suppose it was Bai al Bara'ah and machine got a defect covered by warranty, the customer can contact importer for making the default good. Suppose while Murabaha sales agreement was signed a security deposit of PKR 200,000 agreed by parties which can be forfeited by the bank in case of non-performance of sales contract by Mr. Khan. However it is preferred that bank sell the asset to another party and if could not recover the original price paid [PKR 1,000,000 in this case] the difference may be charged to Mr. Khan.

Rule.5. Customer and IFI can agree on any terms of payment including balloon payment, equal installments or variable installments, however, it is not allowed to stipulate a premium in case of delay or discount in case of earlier payment[12]. Lawful security including the subject matter of Murabaha and guarantee of the third party can be demanded. It is allowed to receive promissory note or post dated cheques from the customer. It is not permitted to stipulate that the transfer of ownership is linked with full payment of installments, however, registration in the name of the customer can be postponed. It is prohibited to extend payment period by increasing the price as it is practiced under conventional banking for rescheduling of debt. It is permitted to agree on the payment in a different currency on the basis of exchange rate prevailing at the date of payment. To ensure prompt payment, any of the followings can be stipulated in the contract of Murabaha.

1. All installments shall due at once in case of default in any installment for a specific period as agreed.

[12] However bank can give rebate to customer in case of earlier payment without having stipulated in contract of Murabaha.

2. Lump sum amount or percentage of the installment due as agreed shall be charged as penalty. This amount of penalty cannot form part of the income of IFI and must be spent for charitable purposes duly coordinated by Shari'a supervisory board of IFI.

Mr. Jaan entered into Murabaha agreement with an IFI and decided to charge profit of 10%. Payment schedule left with the purchaser. If paid in three months profit would be 2.5% and if paid in six months profit would be 5% and if paid after one year profit would be 10%, is a void contract as under sales agreement a single price negotiation is required. IFI has the right to charge these profit percentages based upon the length of the period. However a single price must be negotiated with the length of credit upon which Murabaha sales agreement would be signed.

2.3. Steps in Murabaha

Risk bearing by bank is essential part of Murabaha sale, otherwise contract is void.

Murabaha is used extensively by Islamic Financial Institutions (IFIs) due to its salient features including low risk and easy settlement. Murabaha financing is completed in certain steps, and those must be adhered to achieve Shari'a compliance. In fact, risk bearing is essential for the seller to earn profit hence underlying asset must come into ownership and possession of IFI. Steps involve in Murabaha are as under. Figure 2.1 depicts Murabaha sale process.

1. Customer requests to an IFI for the purchase of an asset. IFI gets written promise from customer to purchase the asset once IFI acquires it.[written promise]

2. IFI purchases asset as per specifications of the customer from the vendor. [Purchase order]

In certain exceptional cases where IFI is lacking in technical expertise relating to the purchase of an asset, she can appoint another person as a purchasing agent including the customer himself. Appointing customer as purchasing agent could be fruitful for both customer and IFI because the asset is purchased for the customer and his satisfaction can be ensured if he is the purchasing agent. How-

ever at this stage customer is the only agent to IFI and underlying asset belongs to IFI. All risks of ownership are borne by IFI. (e.g. asset suffers any damage without negligence of agent it is the loss of IFI and not of the customer). Once the asset is being purchased agent will inform to IFI. Asset at this stage is in ownership and possession of IFI [I & II].

3. The asset is purchased by IFI and possession taken over, physical or constructive [Invoice in the name of IFI].

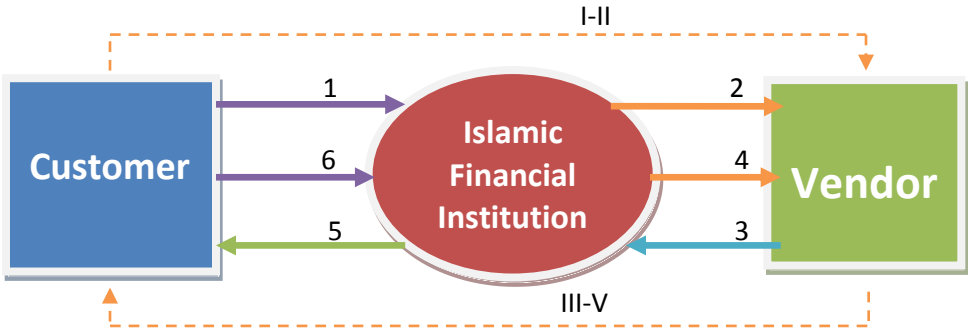
4. IFI makes payment to the vendor. In no case payment should be handed over to the customer, even if the asset is directly acquired by the customer as an agent of IFI from the vendor. [Cash or cheque in the name of vendor]

5. After the acquisition of asset offer to purchase by customer or offer to sell by IFI is made which becomes a sale contract on the acceptance by the other party. The asset is transferred to the ownership and possession of customer along with all risks and returns of ownership [Murabaha sale agreement].

Under certain exceptional circumstances asset is transferred directly to premises of customer by the vendor but in this case, still a risk of ownership is the responsibility of IFI until the asset is being sold to customer [III –V].

6. Customer makes payment to IFI either a lump sum or installments as the case may be [Cash or cheque(s) in the name of IFI].

Figure 2.1. Graphic presentation of Murabaha sales process



2.4. Financial Impact of Murabaha

Financial reporting and financial impact of Murabaha are discussed in following paragraphs. I shall illustrate with a hypothetical balance sheet and show the impact on balance sheet of an IFI of different transactions under Murabaha. Balance sheet of an IFI is different from balance sheet of a conventional bank in the sense that IFIs accept deposits either as loan which is in line with practices of commercial banks and does not create any difference in balance sheet; or on profit and loss sharing basis under Musharaka and Mudaraba which changes the nature of relationship between customer and IFI. Deposits under profit and loss sharing (PLS) models including Musharaka & Mudaraba are not shown as liabilities in the balance sheet of an IFI rather reported as equity. On the other hand, conventional banks lend money and shows advances to customers as an asset while IFIs are not lending cash rather sell the goods on credit hence resulting in receivables under Murabaha, Muajjal, etc.

Furthermore, IFIs are investing in businesses who need cash financing under schemes of Musharaka & Mudaraba hence investment under Musharaka & Mudaraba is shown as an asset and not the receivables or advances. Let us look at a simple balance sheet of an IFI as at December 31, 2009.

MURABAHA IN ACTION

Bolan Fertilizer Company requested to Margalla Islamic Bank to finance purchase of Gas from Ravi Gas Co; by using existing infrastructure a pipeline between premises of two companies. Under Murabaha financing how to execute the transaction? Answer at end.

Cash and balances include cash in branches, balances with other banks and reserve with the central bank. Accounts receivables include receivables under Murabaha, Ijarah, Bai Muajjal, Bai Salam and Istisna'a. Short-term investments are investments made in stocks and Sukuk while PLS investments include investments made under Musharaka, Diminishing Musharaka, and Mudaraba. Property plant and equipment are the physical assets of the bank used in the business process and not held for sale (e.g. furniture, building, motor vehicles, etc.). On liabilities side, payable include payments to the vendors and balances payable to other banks. Accrued expenses are day to day expenses due but not paid. Equities consist of two types including deposits

under profit and loss sharing and owners equity. Law requires statutory reserve for banks to maintain equal to their paid up capital and retained earnings are undistributed profits.

ABC Islamic Bank Ltd

Balance sheet, as at December 31, 2009.

Assets	**Rs (000)**	**Liabilities & Equities**	**Rs (000)**
Current Assets		**Liabilities**	
Cash and balances	1,000	Payables and balances	400
Accounts R/A	1,000	Current deposits	300
Inventory (assets for sale)	500	Accrued expenses	50
Accrued revenue	200	**Total liabilities**	**750**
Short term investments	150	**Equities**	
Total current assets	**2,850**	PLS deposits balances	1,500
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
		Statutory reserves	400
		Retained earnings	200
		Total Equities	**5,100**
Total assets	**5,850**	**Total liabilities & Equities**	**5,850**

Now we are ready to understand the impact of any Murabaha transaction. To illustrate a customer walked in the bank on January 1st, 2010, with a request to supply 100 computers of specified brand on one year credit and signed the promise to purchase as and when supplied by the bank within a period of one month. What is effect of this agreement on bank's balance sheet? The answer is nothing as it is simply a promise not an agreement of sale and purchase which carries rights and liabilities. Suppose the bank is demanding earnest money of Rs; 200,000 to guarantee the seriousness of customer in the form of current account deposit to be maintained till the deal is finalized and customer provide the deposits. The affect of this transaction is shown in following condensed balance sheet.

ABC Islamic Bank Ltd

Balance sheet, as at January 1, 2010.

Assets	**Rs (000)**	**Liabilities & Equities**	**Rs (000)**
Cash and balances	1,200	Current deposits	500
Others from earlier B/S	4,850	Others from earlier B/S	5,550
Total assets	**6,050**	**Total liabilities & Equities**	**6,050**

Suppose to ensure quality and desired specification bank appoint the customer as an agent to visit another city and purchase computer on behalf of the bank. Expenses incurred amounting to Rs; 50,000 during purchases process and deal is finalized between bank and supplier of computers @ Rs; 60,000 per computer on 10th of January 2010. Bank reimburses expenses incurred by customer as expenses of the agent are always borne by the principal. Suppose instead of agreeing to make payment to the vendor in cash customer relations department of bank succeeded in getting a current deposit from the vendor for its branch in the city of vendor and opened a current account of the vendor. The impact of the transaction is displayed in following balance sheet. Both sides of balance sheet current deposits (liability) and inventory (asset) increased by 6 million and both sides decreased by 50,000 cash and balances (asset) and equities (R/E) for payment of expenses.



ABC Islamic Bank Ltd

Balance sheet, as at January 10, 2010.

Assets	**Rs (000)**	**Liabilities & Equities**	**Rs (000)**
Cash and balances	1,150	Current deposits	6,500
Inventory-Computers	6,000	Others from earlier B/S	5,500
Others from earlier B/S	4,850		
Total assets	**12,000**	**Total liabilities & Equities**	**12,000**

On January 15, 2010, customer and bank exchanged offer and acceptance documents, hence sale executed. Selling price agreed on Rs; 6,996,000 consist of cost plus 10% profit payable at the end of December 2010. It is irrelevant, as for validity of Murabaha agreement is concerned, whether goods are delivered first to the bank and then transported to the customer or directly delivered to the customer by the shipping company. What is required is to borne the risk of ownership by bank being a seller to the customer. The risk of loss or damage is borne by bank till the delivery of goods to the customer at a place which is agreed between parties. If that place is ex-factory of vendor, then the bank is responsible for loss between periods of 10th to 15th January 2010, and if delivery point is customer premises then the bank is responsible till the time goods delivered to the customer. By 17th January 2010, goods delivered to the customer without any damage to his premises by the shipping company. The price of Murabaha sales calculated as under table 2.1.

Table 2.1 Price Calculation of Murabaha Sales

Description	**Amount Rs.**
Payable to vendor	Rs. 6,000,000
Transportation expenses	300,000
Insurance/Takaful expenses	60, 000
Total cost	Rs.6, 360,000
Add 10% profit on cost	636,000
Selling price	**6,996,000**

The impact of this transaction is shown in following balance sheet.

ABC Islamic Bank Ltd

Balance sheet, as at January 17, 2010.

Assets	**Rs (000)**	**Liabilities & Equities**	**Rs (000)**
Cash and balances	790	Current deposits	6,500
Murabaha Receivables	6,996	Deferred profit	636
Others from earlier B/S	4,850	Others from earlier B/S	5,500
Total assets	**12,636**	**Total liabilities & Equities**	**12,636**

Note the change on both sides. Cash and balances decreased due to the payment of Rs; 360,000 as expenses of insurance and transportation. Inventory of computers finished and Murabaha receivable generated with a profit of Rs; 636,000 which is disclosed as deferred profit to be realized by December 31, 2010, irrespective whether the amount received at due date or not. Suppose amount received on December 31, 2010, and in the mean time vendor, who is a depositor of the bank as well, has withdrawn 50% of the balance. Following balance sheet has shown the impact of all transactions relating to this particular Murabaha sale.

ABC Islamic Bank Ltd, Balance sheet, as at December 31, 2010.

Assets	**Rs (000)**	**Liabilities & Equities**	**Rs (000)**
Current Assets		**Liabilities**	
Cash and balances	4,586	Payables and balances	400
Accounts R/A	1,000	Current deposits	3,300
Inventory (assets for sale)	500	Accrued expenses	50
Accrued revenue	200	**Total liabilities**	**3,750**
Short term investments	150	**Equities**	
Total current assets	**6,436**	PLS deposits balances	1,500
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
Total long-term assets	**3,000**	Statutory reserves	400
		R. earnings/ Un appropriated	786
		Total Equities	**5,686**
Total assets	**9,436**	**Total liabilities & Equities**	**9,436**

2.5. Comparative Study

Comparative study of conventional and Islamic financial system reveals following important points as for rights, liabilities, risks and rewards of the parties concerned. If a client goes for conventional financé he will get simply Rs; 6,000,000 loan in cash form for a charge of 10% interest assuming same return as for Islamic bank. By the time loan approved and available to the customer an asset of 6 million is created as loans receivables by the conventional bank and another asset of current deposit is created of the equal amount while cash and balances decrease as and when the amount is withdrawn. The conventional bank has no risk in this transaction except default on behalf of the customer. After expiry of one-month interest revenue of Rs; 50,000 is due hence form the income of conventional bank. Asset (loan receivables) increased by Rs; 50,000 while the liability of customer is also increased by Rs; 50,000.

Under normal circumstances, the conventional bank has not much concern whether computers are purchased or not. His interest is in return of principal as well as interest hence linkage of the financial sector with the real sector is not guaranteed. What could be the impact of this transaction if loaned money has not gone into production process? On one hand income is increasing while on the other hand, goods and services are not increasing; more income and less goods and services consequently, hence leading to higher prices for goods and services (inflation) in the economy. In the case of default by the customer on due date loan can generally be rescheduled by charging a little higher rate of interest e.g., 11% in this transaction.

On the other hand rights, liabilities, risks, and reward are much different under Islamic financial system. When customer contacted for the purchase of computers although IFI consented to the provision of financing but no rights and liabilities affected. When computers purchased in the name of IFI, it increased the risk exposure of the bank being owner of goods carrying a number of risks including destruction, damage, obsolescence, theft, fire, transportation, etc. and finally refusal by customer to accept, as he has not signed an

Under Murabaha frame work role of Islamic bank is more of trader than financial institution.

Payment of goods purchased by IFI to pass on to customer must be made to supplier of goods in order to ensure Shari'a compliance of transaction.

agreement to purchase, with bank, rather a promise to purchase. On the next stage goods sold to the customer and now IFI is at par in risk of default with a conventional bank. Profit of Islamic bank is due by the date Murabaha sales took place however as customary and keeping in view the nature of baking (where deposits are changing hands frequently) it is spread over a period of Murabaha transaction. No profit can be assumed by IFI until sales of goods to the customer has taken place.

As per principle of Murabaha IFI will not pay amount of Rs; 6 million to customer rather payment is made to (or current account is opened in the name of) vendor hence ensuring the use of funds for the purpose these are requested and guaranteed linkage of financial sector to the real sector hence zero contribution of this transaction in inflation. Finally, rescheduling of Murabaha receivables is not allowed, and IFI cannot extend the period by charging at the higher interest rate or same rate. IFI can take legal action for recovery or auction the security held in extreme cases. Generally, IFI does not want to lose the customer for a minor default and Ulema (clerics) has allowed incorporating a penalty clause in the contract of Murabaha in the case of default by Customer, subject to use of the penalty amount is only for charity and must not be included in the income of IFI.

IFIs enter into additional risk of ownership in comparison of conventional banks under asset based financing framework.

One must understand & appreciate nature of the penalty imposed by IFI on the customer. It is not extra charge like conventional banking which is rent of money paid late by the customer. It is to penalize the defaulter and encourage prompt payment. Even then if the default is committed and the penalty is charged, the amount recovered under penalty head is not the income of IFI. The difference lies here in the use of penalty amount by IFI and extra interest earned by a conventional bank. Former is using recovered amount for charity and not increasing his income while later is treating late payment charges as his income. It is further pertinent to state that late payment penalty is not the only solution to encourage prompt

Although late payment charges are recovered under Islamic financial system, however it cannot form part of income of bank rather goes in charity account.

payment. If a speedy with an easy access judicial system is in order; or a commission to settle default cases is established, financial penalty may not be required in case of default.

2.6. Concept Building-Murabaha

Illustration.1. Mr. Abdullah requested to Meezan Bank Islamabad on January 1st 2010, to issue cash for the purchase of cotton amounting to Rs; 2 million payable in four equal six monthly installments. Meezan bank agreed to the deal by charging 10% profit. Meezan Bank appointed Mr. Abdullah as an agent to visit the cotton belt and finalize the purchase of cotton as per required quality. Mr. Abdullah spent amounting to Rs; 50,000 in searching and purchasing the required commodity of cotton. On January 10th 2010, Mr. Abdullah made the deal with a broker (Mr. Omer) in Veharri in the name of Meezan Bank. On January 15, 2010, offer and acceptance completed between Mr. Abdullah and Meezan Bank at Islamabad office of Meezan Bank. As per desire of Mr. Abdullah cotton is to be supplied by Meezan Bank at factory premises located in industrial estate Hattar. Punjab Sarhad goods transport company hired by Mr. Abdullah on behalf of Meezan Bank to transport cotton bales from Melsee (Godown of Mr. Omer) to Hattar (Factory of Mr. Abdullah) for shipping charges of Rs; 200,000. Transportation insurance/takaful is amounting to Rs; 20,000 paid to Pak-Qatar Takaful Company.

Cotton: A cash crop in Pakistan

Required:-

1. Will Meezan bank pay the required cash of Rs; 2 million to Mr. Abdullah?
2. Who will bear the transportation and cost of living amounting to Rs; 50,000 spent by Mr. Abdullah?
3. Who will pay the cost of transportation and insurance/takaful of cotton bales shifted from Melsee to Hattar?
4. What is the cost of this transaction to be used to calculate profit?
5. What is selling price and amount of profit?
6. What is the amount of profit realized annually? Quarterly? Monthly?

Solution

1. No as per Murabaha principles bank is a trader who purchases the goods from the vendor and sells to customer hence receive cash from a customer and pay to the vendor. Meezan bank should not make payment to Mr. Abdullah rather pay directly to the vendor.
2. Mr. Abdullah is working in the capacity of agent for bank. Hence all expenses incurred relating to the purchase of asset are required to be borne by Meezan Bank.
3. As per agreement, Meezan bank is required to supply the goods at factory premises of customer hence transportation cost is to be paid by the bank. During this period, any damage to the inventory is charged to bank, and/or insurance company as the case may be however the whole risk is of the bank and not the customer.
4. Direct costs incurred relating to inventory are used in the calculation of cost including payment or payable to vendor and transportation including insurance. The cost of goods for charging profit is calculated as under table 2.2.

It is preferred that an IFI purchase the goods through his own sources under Murabaha, however anyone else including customer himself can be appointed as purchasing agent subject to bearing of risk of ownership by bank

Table 2.2. Calculation of cost of goods sold

Description	Amount Rs.
Vendor charges	Rs.2, 000,000
Transportation cost	200,000
Insurances cost	20,000
Total cost	**2,220,000**

5. Selling price calculated by adding 10% margin on cost of goods sold as under (Table 2.3).

Table 2.3 Calculation of selling price

Description	Amount Rs.
Total cost as calculated in Table 2.2	2,220,000
10% markup/profit on cost	222,000
Selling price of Murabaha	**2,442,000**

6. Because it is two years deal hence pro rata share of profit is Rs; 111,000 for each year. Quarterly profit is Rs; 27,750 and monthly profit is Rs; 9,250. As In banking sector depositors are free to deposit and withdraw except fixed PLS deposits hence de-annualization of profit is necessary to quarter or to month for servicing depositors.

Illustration.2. In Continuity of illustration 1, to ensure the prompt payment Meezan Bank inserted a clause in Murabaha agreement that a penalty of 10% of the amount due shall be imposed if default continued for 30 days from due date.

Required:-

1. What is the amount of penalty if the first installment is paid on 10^{th} of August 2010? 30^{th} of August 2010?

2. What is the impact of penalty recovered on revenue, assets, liabilities and equity of Meezan Bank?

Solution

1. The due date for the first installment is six month July 15th 2010, from the date of sale January 15th 2010. As per agreement, grace period is 30 days hence penalty shall be imposed after 15th of August 2010. If the amount is paid on 10th of August 2010, no penalty is imposed. However in case payment is made on 30th August 2010, a penalty equal to 10% of the amount due is charged. Amount due on the first installment is calculated as under.Following are given two methods of calculation first based on time value and second ignoring time value. Selection of method is very vital in the transaction as it determines the rights and liabilities of parties concerned. Time value of money concept has not been accepted in Islamic financial literature hence the use of the first method in the practice of Islamic banking is not recommendable. First is traditional method of installment calculation by applying following formula:

$$P = R[1 - \frac{1/(1+i/m)^{nm}}{i/m}]$$

Where *P* is the amount spent on inventory, *R* is the installment, *I* is the interest rate, and *n* is the number of years and *m* is number of compounding in a year. This formula is based on the concept of time value of money hence not recommended for use in Islamic modes of financing. As per this formula if we calculate four equal six monthly installments amount of each installment becomes approximately Rs; 626,000 rounded to 100.

The second method is based on a simple calculation by ignoring the time value of money. While ignoring the time value of money, it is simply division of selling price calculated in part 5 of illustration one hence, the amount of each installment is Rs; 610,500. The second method of calculation is recommended. Consequently amount of penalty is Rs; 61,050.

2. The amount of penalty cannot form part of the income of Meezan Bank and role of the bank is only to act as trustee for collection and distribution of charity. It will not affect the financial position of the bank at all. However as a matter of

disclosure in financial statements, it is shown as an increase in cash on the asset side and an increase in charity fund on the liabilities side of balance sheet.

Illustration.3. Continuing through illustration 1& 2. To mitigate the risk of default by Mr. Abdullah, Meezan Bank demanded security and customer offered the ownership paper of a plot in Defense with estimated market value of Rs; 3 million, to be auctioned in the case of default for the amount due for more than one year. Mr. Abdullah made the first payment on 10th of August 2010, second installment by February 10th of 2011, but could not make the last two installments till 15th January 2013 and not sure when to be able to make payment in foreseeable future. He informed the Meezan Bank accordingly. The plot was auctioned by Meezan Bank on April 25, 2013, for amounting to Rs; 3,500,000. For the auction of plot Meezan bank had to incur expenditures amounting to Rs; 100,000.

Required:-

1. What is the impact on financial reporting of Meezan Bank, if any, of receiving and retaining ownership paper of plot from the customer as security?
2. What is the amount of penalty received with the first installment? And second installment?
3. What is the amount of penalty due with the third installment? And fourth installment?
4. How much amount is to be refunded to Mr. Abdullah, if any, on the sale of the plot?

Time value based formula of IRR for charging to customer is not recommended as total claim varies in monthly and quarterly installments which is violation of the rule of fixed price (irrespective of early and /or delayed payments price should remain unchanged).

Solution

1. Holding ownership paper of plot as security does not affect financial position or revenues of Meezan Bank. However, this fact must be disclosed in notes that Murabaha receivables are secured hence the risk of default is mitigated.

2. Because both installments are within grace period so no question of charging penalty.
3. The amount of penalty is equal in both installments amounting to Rs; 61,050. One must appreciate the fact that penalty is different from late payment charges as charged under conventional banking. Late payment charges of installment three and four are not equal under conventional banking because the time period of default is larger for the third installment as compared to fourth.
4. The selling price of the plot is Rs; 3,500,000. Meezan bank can claim only actual receivables and amount spent on disposal of plot and not the time value of money for the delay in recovery of approximately one and half years in the first installment and one year in the second installment. Hence, the amount refunded to Mr. Abdullah is calculated as under.

Table 2.4 calculation of refundable amount

Description	**Amount in Rs.**
Selling price of plot	Rs. 3,500,000
Disposal cost	100,000
Amount receivable	610,500 X 2 = 1,221,000
Amount of penalty	61,050 X 2 = 122,100
Total deductions	1,443,100
Refundable amount	**2,056,900**

Illustration.4. In the continuity of earlier illustrations suppose instead of default Mr. Abdullah paid third and fourth installments at once on 30th June 2011. What is the amount of installments after deducting rebate, if any, from the balance due?

Solution

In the case of early payment, no rebate can be demanded from Meezan Bank as for legal position is concerned however it is the discretion of Meezan Bank to give some rebate to establish a better relationship with the client. Unlike penalty section the rebate cannot be stipulated in the original contract.

Illustration.5. In the continuity of earlier on January 30, 2012, Mr. Abdullah requested to Meezan Bank to reschedule the balance due (3^{rd} and 4^{th} installments) for one year by entering into new Murabaha contract for a charge of 11%. If general rate of profit on Murabaha is 10% in 2012, Should Meezan bank accept the offer?

Solution

Murabaha is not overdraft or short term loan. It is the sale of a commodity hence receivables under Murabaha cannot be rescheduled for a charge. However, keeping in view the financial position of the customer, it is persuaded in Shari'a to extend recovery period for misers and even to waive off. It is again a matter of discretion for Meezan bank whether to extend recovery period, but any such extension must be without charge.

Illustration.6. MR. Khan contacted to Albaraka Islamic Bank Rawalpindi on June 01, 2010, to finance the generators required to be used in his factory for an amount of Rs;1,000,000 payable after one year. Albaraka bank is charging 10% profit on Murabaha sales for credit period of one year. Albaraka appointed Mr. Khan as an agent to purchase the generator from international market according to his desire and specification in the name of Albaraka. As per agreement generators are required to be supplied at premises of Mr. Khan by Albaraka bank. Next day Mr. Khan submitted details of expenses incurred in the purchase of generators in Germany on May 15, 2010, amounting to Rs; 50,000 and shipping cost of Rs; 100,000. He informed that he has already purchased the generator in his name and payment of expenses and price to the vendor has already been made.

He gave the proposal to Albaraka bank to prepare Murabaha contract and reimburse him for expenses already paid.
How shall Albaraka bank execute the transaction?

Solution

As a matter of fact, Murabaha sales contract cannot be executed for goods already purchased by the customer. Murabaha is a sales contract which requires certain conditions to be fulfilled including (but not limited to) existence of goods, possession, and ownership by the seller, the risk of ownership is borne by seller, etc. As these conditions of valid sale are missing so Murabaha sales contract cannot be executed.

Farm Mechanization offers a great opportunity for IFIs working in Pakistan

2.7. Questions

1. Define Murabaha? What is the difference between Murabaha sales contract and overdraft account?
2. Late payment charges are charged by conventional as well as Islamic banks. What is the difference?

3. Why Murabaha contract cannot be executed on goods already purchased?
4. Murabaha has been used very successfully by Islamic banks to replace the overdraft facility by conventional banks. Why Murabaha receivables cannot be rescheduled?
5. Explain the steps in Murabaha. Why all steps cannot be completed in one session?
6. Explain conventional calculation method of equal installments and simple calculation method of equal installments. What is the difference in both? and what implications of a calculation method have for rights and liabilities of parties concerned?
7. Can Murabaha sales be executed for currency and shares trading?

Multiple Choice Questions

1. Ownership, possession and existence of a commodity are essential for a valid sale of a commodity under Islamic law. Which of the following selling contract is exempted from these conditions?

a. Murabaha sale
b. Muajjal sale
c. Muswama sale
d. Salam sale

2. Under Murabaha sale, late payment charges cannot be claimed by seller as compensation, because under Islamic law

a. The price of the commodity sold must be certain.
b. Deferred price can be more than the spot price.
c. Once price fixed and contract executed it can neither be increased (on account of late payment) nor decreased (on account of early payment).
d. Penalty in case of default can be included in contract of sale, however, same can be used by seller, and it must not go in charity

3. Under which of the following selling agreements, the disclosure of the cost of goods sold as well as profit is necessary under Islamic law?

a. Murabaha sale
b. Muajjal sale

c. Salam sale
d. Istisna'a sale

4. During the period of last seventeen quarters (09/06 to 09/10), the average share of Murabaha financing in portfolios of Islamic banks working in Pakistan is dominating. Average share of Murabaha sale is

a. 39 percent
b. 41 percent
c. 43 percent
d. None of the above

5. To ensure seriousness of customer, Islamic banks demand a sum of money from a customer who request supply of an asset under Murabaha sale. Which of the following correctly describes the nature of this amount?

a. It is Urboun which can be forfeited if the customer fails to execute the contract.
b. It is Hamish Jiddiya whereby Islamic bank can deduct actual amount of loss in case customer is not willing to execute contract after purchasing of an asset by an Islamic bank.
c. It is guaranteed to execute contract by customer
d. It is advanced payment of price by customer

6. Once the Murabaha sale agreement is executed, Islamic bank can ask for a security deposit by a customer. Which of the following correctly describes the nature of this amount?

a. It is Urboun which can be forfeited if the customer fails to execute the contract.
b. It is Hamish Jiddiya whereby Islamic bank can deduct actual amount of loss in case customer is not willing to execute contract after purchasing of an asset by an Islamic bank.
c. It is guaranteed to execute contract by customer
d. It is advanced payment of price by customer

7. Under Murabaha sale agreement, Islamic banks are allowed to receive a sum of deposit as Hamish Jiddiya and/or Urboun. Which of the following is correct differentiation of both?

a. There is no difference in Hamish Jiddiya and Urboun except the names
b. Hamish Jiddiya is demanded against binding promise while Urboun against selling agreement
c. Hamish Jiddiya can be forfeited in full while amount more than actual loss under Urboun must be refunded
d. None of the above

8. Under Murabaha sale agreement disclosure of the cost of goods sold is essential along with profit charged by an Islamic bank. Which of the following depicts correct cost calculation under Murabaha?

a. Payment to supplier plus transportation expenses
b. Payment to supplier plus transportation expenses minus any discount received from supplier
c. Payment to supplier plus transportation expenses and operating expenses of bank
d. Payment to supplier only

9. Late payment charges (whether fixed amount or variable) is allowed under Islamic law in Murabaha sale as is the case in conventional banking. Which of the following depicts correctly the nature of penalty?

a. It is time value of money to compensate debtor
b. It is penalty on defaulter and should not form income of Islamic bank, rather must go in charity
c. It is penalty on defaulter to meet the operating expenses of Islamic bank
d. None of the above

10. As a practice in banking industry, if a customer is unable to meet his obligations, the amount of debts is rescheduled at a higher rate. Which of the following is the correct course of action under Islamic financial system?

a. To enter into a new Murabaha by increasing the price and reschedule installments
b. To grant some additional time keeping in view the hardship
c. To sell the security and recover the amount
d. B & C above

True/False

Mark the following as True or False.

1. Murabaha is not a cost-plus profit sale contract whereby disclosure of cost to the buyer is necessary.

2. An essential feature of Murabaha is that IFI must purchase the required commodity from supplier first and then sell to the customer.

3. Under Murabaha, the amount of installment or price of the asset cannot be (stipulated) increased or decreased in case of default or early payment.

4. The amount of penalty for default in prompt payment recovered could be included in the income of IFI in any case and must be spent for charity.

5. Murabaha is the dominant mode of financing in portfolios of IFIs since the inception of Islamic banking due to its easiness in practice and low risk as compared to profit and loss sharing modes of financing.

6. During 09/06 to 09/10, the Average share of Murabaha in portfolios of IFIs working in Pakistan is 51%.

7. Under Murabaha financing, it is not permitted to purchase a commodity on request of the customer after a unilateral promise by the customer to purchase the asset.

8. It is not permitted to transfer a contract of customer with supplier to IFI under Murabaha financing.

9. Under Murabaha financing, it is permitted to purchase the asset from a specific supplier identified by customer except customer himself or his agent.

10. It is not permitted to sell equity share in Musharaka to the other partner on Murabaha basis.

11.Under Murabaha financing, It is not permitted to demand security deposit (Hamish Jiddiya) from a customer in case of binding promise which can be forfeited equal to the amount of actual loss suffered by the bank (excluding time value of money) if customer breaches his promise.

12. An IFI can conclude a contract of Murabaha sale before purchase of the underlying asset because ownership of seller is required for sale.

13. There must be a reasonable time between the purchase of asset from supplier and onward sale to customer under Murabaha so that bank (being seller) must bear risk of ownership.

14. IFI cannot enforce the customer to take delivery of asset and enter into Murabaha sale; after asset is acquired however damages (equal to actual loss excluding time value of money) can be claimed in case of binding promise.

15. Cost of Murabaha includes payment due to supplier plus direct expenses (transportation, insurance, storage, fee for letter of credit) incurred. Operating expenses of bank must not be included in cost.

16. Any discount received from supplier even after execution of Murabaha contract must not be passed on to customer.

17. Under Murabaha, it is not permitted to sell the asset on Bai al Bara'ah (sale on 'as is' basis) relieving the IFI from any manufacturing defect of asset, however, in this case right of recourse to manufacturer should be assign to customer.

18. Urboun (earnest money) is allowed after execution of Murabaha contract, however it is preferred to forfeit the amount equal to actual loss suffered.

19. Under Murabaha financing, Customer and IFI can agree on any terms of payment including balloon payment, equal installments or variable installments however it is not allowed to stipulate a premium in case of delay or discount in case of earlier payment.

20. Lawful security including subject matter of Murabaha and guarantee of third party can be demanded.

21. Under Murabaha, it is permitted to stipulate that the transfer of ownership is linked with full payment of installments, however, registration in the name of the customer cannot be postponed.

22. Under Murabaha, It is permitted to extend payment period by increasing the price as it is practiced under conventional banking for rescheduling of debt.

23. Late payment charges cannot form part of the income of IFI and must be spent for charitable purposes duly coordinated by Shari'a supervisory board of IFI.

24. Under Islamic financial system, Deposits under profit and loss sharing (PLS) modes including Musharaka & Mudaraba are not shown as liabilities in the balance sheet of an IFI rather reported as equity.

25. The difference lies in the use of penalty amount by IFI and extra interest earned by a conventional bank. Former is using recovered amount for charity and not increasing his income while later is treating late payment charges as his income.

2.8. Exercises

Ex.1. Pak Suzuki is providing 800 cc Car for Rs; 500,000 in Islamabad city. Mr. Mammon contacted BankIslami, Islamabad branch for the provision of the car on installments payable quarterly within one year period. BankIslami is charging 12% profit per annum on Murabaha of cars.

Required:-

a. Calculate cost of car to BankIslami
b. Calculate selling price
c. Calculate the amount of four equal installments payable quarterly (i) using conventional calculation method (ii) using simple calculation method.

Ex.2. Mr. Ali is a manufacturer of cement and requires funding to replace one of its machines being vital for the production process. The machine is manufactured internationally and requires import from Dubai. Estimated purchase price in Dubai is AED 50,000. Mr. Khan having an office in Islamabad is doing the business of import of such machinery for 2% commission of import price paid to vendors. Transportation and insurance etc. are paid by the local purchaser. Mr. Ali is a very trusted customer of Albaraka bank who agreed to supply the machine to Mr. Ali. Machine imported by Mr. Khan on request and claimed following expenses from Albaraka bank.

Description		
Payment to vendor	AED	48,000
Commission	AED	960
Transportation	AED	500
Insurance	AED	480
Total	AED	49,940

Required:-

a. If the exchange rate is 25:1 what is the amount to be paid to import agent?

b. If exchange rate on the day of contract with Mr. Ali is 26:1 what is the cost of Murabaha to be used for charging profit?
c. What is selling price if 12% markup is charged by bank?
d. If the amount is agreed to be paid in two equal annual installments what is the amount of each installment?

Ex.3. XYZ Company is a manufacturer of soft drinks requests financing facility to Dubai Islamic Bank for purchase of fruits amounting to Rs; 500,000 on July 1st 2010. Bank agreed to the proposal on following terms.
Fruit shall be provided in Multan and transportation is the responsibility of XYZ. 8% profit shall be charged for six months. Bank has the authority to sell the inventory of XYZ in the case of default for more than two months and penalty of 5% on the amount due shall be charged if payment is not made within 15 days of due date. Miscellaneous expenses incurred by Bank in Multan (being the cost of living and daily allowance to procurement officer) for executing purchase amounting to Rs; 30,000. Transportation cost is Rs; 40,000 paid to Multan Karachi goods forwarding agency and transit insurance is Rs; 20,000 paid to Adamjee insurance company.

Agriculture and Agro-based industry looking for investment by IFIs

Purchase contract signed between bank and supplier on July 7th 2010 while offer and acceptance between customer and bank completed on July 10th 2010. Payment amounting to Rs; 450,000 made to the supplier on July 20th 2010.

Required:-

a. Calculate selling price and profit on Murabaha.
b. Calculate the amount of penalty if payment made by XYZ on (i) January 1st 2011 (ii) January 26th 2011 (iii) February 25th 2011.
c. Why amount of penalty is different in above three options if any?
d. What is the effect of this transaction on financial reporting of Dubai Islamic Bank on (i) July 1st 2010 (ii) July 7th 2010 (iii) July 10th 2010 (iv) January 1st 2011 if payment made (v) January 26th 2011 if payment made on this date.

Ex.4. ABC Company is a manufacturer of furniture contacted to First Islamic Bank for the financing of a machine costing Rs; 100,000. Bank provided a used machine for Rs; 85,000 which accepted by ABC and signed the document of Murabaha for payment to be made in six months.

Required:-

Is it a valid sale? If not, why? Enlist the conditions of valid Murabaha sale.

Ex.5. Mr.ABC requested to Margalla bank to purchase a car for him from Capital motors. The cost of the car is Rs; 500,000. Bank demanded Hamish Jiddiya of Rs; 100,000 which was deposited by the customer to be accounted for against price after execution of the contract. Bank purchased the car and constructive possession taken over.

Required:-

1. What is the amount of refund/claim if ABC failed in the execution of the transaction and the car was disposed of by bank at 2% discount?
2. Suppose contract was executed with 10% profit per annum. The amount is payable within one year in four equal installments. What is the amount of in-

stallment under simple formula? What is the amount of installment under time value formula? Explain the reason for difference.
3. What is IRR if the calculation of installments is made through simple formula?

2.9. Bai Muajjal

The literal meaning of Bai Muajjal is deferred / credit sales. Islamic Financial Institutions (IFIs) are using this mode to finance the customers' needs by the supply of desired commodities. The difference between Murabaha and Bai Muajjal lies in the disclosure of cost to the purchaser. Under Bai Muajjal cost may or may not be disclosed. All other features are same as discussed in Murabaha. To practice this mode of financing, Islamic banks have to establish warehouses which are not in practice so for. Only Meezan Bank has started the sale of computers by applying this mode of financing in Pakistan.

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Chapter 3

Salam Financing

Agriculture in Pakistan is an underserved sector as for financial services are concerned

Salam is a sale agreement whereby seller receives the price in advance while goods are delivered at a future date. Salam is a valuable tool with IFIs to provide agricultural finance to a large community of unserved/underserved farmers' world over especially in less developed countries including Pakistan.

Learning objectives

After going through this chapter reader should be able to understand and interpret the following:

What is Salam financing?

What are Shari'a rulings about operations of Salam financing?

What are differences and similarities in derivatives and Salam Transactions?

What are steps in a transaction of Salam financing?

What is the financial impact of Salam financing and how it is accounted for?

3.1. Introduction

Bai Salam is a form of sale contract whereby IFIs purchase goods for spot payment with deferred delivery. Practically it is used in the financing of agricultural needs of farmers. Farmers sell their crops before harvesting to IFIs to get money to purchase seeds and fertilizers. Generally, spot price agreed is lesser than future prices on the actual date of delivery. Hence, IFIs are making a profit. As a matter of practice, IFIs are entering into a parallel Salam contract with the third party to sell the proceeds once taken over, however, execution of the second contract is not conditional on the fulfillment of the first contract of Salam (Shari'a standard 10).

Application of Salam as a tool of financing could not get momentum in the operations of IFIs working in Pakistan despite having an agrarian economy. The share of agriculture in GDP is about 20% while providing jobs to 65% of the country's population living in rural areas; however, less than 20% of seven million farm households have access to bank financing. The agricultural sector is vastly underserved as for banking services are concerned and is a potential market for Salam financing. Figure 3.1 depicts share of Salam financing as a percentage share in portfolios of IFIs working in Pakistan, for 17 quarters from 09/06 to 09/10 (SBP-2010). The average share of Salam financing in investment portfolios of IFIs working in Pakistan during the period under review was only 1.7%. Figure 3.2 presents closing amounts of investments by IFIs under Salam financing.

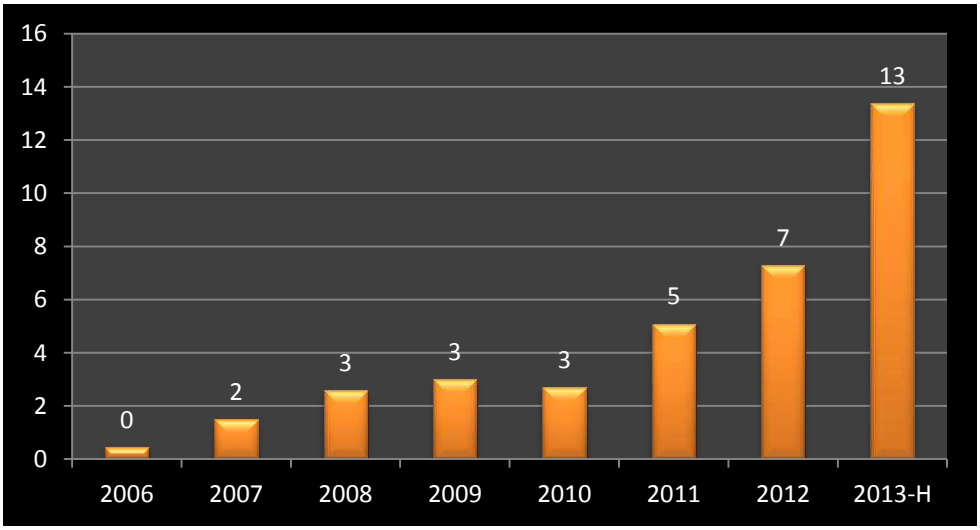
> Commodities in Salam contract are fungible goods, (sharing common features e.g. wheat, rice, fruits etc.) and also include standardized products of companies.

Figure.3.2. Percentage Share of Salam Financing in Portfolios of IFIs.

Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Jun 08	Sep 08
4.3%	0.7%	0.8%	1.2%	1.3%	1.4%	1.4%	1.5%
Dec 08	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10
1.8%	2.2%	2.0%	1.2%	1.2%	4.0%	2.0%	0.8%

Source: SBP-Islamic Banking Bulletins

Figure.3.1. Closing Amount (PKR Billion) of Salam Financing by IFIs during 12/06 to 06/13



3.2. Summary of Shari'a Rulings

Rule.1- Capital in Salam should be known to both of the parties involved in Salam sale agreement. Ideally, it should be in cash however it is allowed to supply the capital in kind subject to (1) specifications and (2) quantity of goods to be delivered as capital in Salam contract. The capital of Salam should be paid immediately by the time contract is concluded or within two, three days, however payment period of capital must not be equal to or greater than the delivery time of goods purchased under Salam. A debt receivable from the customer cannot be converted into Salam capital. In this rule capital means the price paid at spot to receive the goods in future under Salam sale.

ABC Bank entered into a Salam contract by making payment of PKR 100,000 to Bhola farmer for delivery of 10,000 kgs of wheat at the completion of harvesting season. Salam contract duration is six months. After passing three months, the bank sold the goods to a whole seller under parallel Salam contract for PKR 12/-

PER Kg. On delivery date, bank handed over goods to the whole seller after taking possession from Bhola and contract completed.

Mr. Bhola contacted a local bank to provide cash of PKR 100,000, enabling him to purchase the seeds, to be paid to the bank after six months in the form of rice PKR 50/- per Kg. Bank handed over the required seeds without disclosing the cost of purchases [capital of Salam] and signed Salam contract for 2,000 Kgs of rice. It is a void contract as Salam capital is not known to one of the parties. It can lead to dispute later on if Bhola could not supply rice due to any known or unknown reason, hence, it is necessary that he should know the amount spent by the bank on seeds, he acquired, so that he can make payment of required amount if could not provide rice.

Akbar farming and HM bank entered into a Salam contract of 5,000 tons of rice @ the price of 70/- per Kg. Payment is to be made at the time of delivery [four months from now], is a void Salam sale as payment of price at the spot is required under Salam sales agreement.

Aakash and Margalla bank entered into a Salam sales contract to purchase 5,000 tons of wheat for a price 10% less than prevailing at the time of delivery. Margalla bank made the payment of PKR 500,000 to be adjusted later on is a void contract as price certainty, and settlement is an important ingredient of a sales contract.

Aslam a debtor of Margalla bank entered into a contract of Salam to provide 6,000 tons of rice after six months at a price PKR 50/- per Kg. The amount of capital adjusted against the debts receivables from Aslam is a void contract as receivables cannot form part of Salam capital.

Rule.2- Commodities in Salam contract are fungible goods, (sharing common features e.g. wheat, rice, fruits, etc.) and also include standardized products of companies. It is not permitted to stipulate the products of a specific piece of land in Salam contract. The subject matter of a Salam contract must be different from the mode of payment of the price. (e.g., if capital provided in currency or gold then commodity in Salam contract must not be currency or gold). Commodities involved in Salam contract must be clearly known to both of the parties involved,

and no ambiguity and uncertainty should be left unaddressed at the time of contract relating to quality and quantity. It is required that commodities involved in Salam contract should be generally available in the market at the time of delivery (so that seller should be able to discharge his liability). Date or dates of delivery and place of delivery should be certain and unambiguous.

Mr. Alam entered into a salam contract to supply 1,000 tons of apple to a local IFI for a price of PKR 70/- per Kg. IFI made the payment to the seller immediately. It is stipulated that fruit shall be provided from archard # 6, is a void contract as delivery is not certain. It is permitted to deal in 1,000 tons of apple with spot payment and deferred delivery, but it is not permitted to specify the field. However, a preference of a field is acceptable subject to if that field could not provide required produce then the seller has the option to arrange otherwise.

SALAM IN ACTION

ABC entered into a Salam contract to sell rice of superior quality @ Rs; 50 per K.g. After cultivation it is disclosed that inferior quality rice were produced. How contract was settled? Answer at end.

Mr. X entered into a Salam contract with ABC bank to provide 50 laptops with complete specifications after two months @ PKR 50,000/- each for spot payment is a valid contract.

Mr. A sold the total produce of Orchard # 11 to a local juice manufacturer for PKR 2,000,000 to be delivered after harvesting is a void sale as the quantity of goods to be delivered is not certain.

Rule.3- Security in Salam contract can be obtained through guarantee, pledge or any other permissible mode of security.

Rule.4- Disposal of commodities involved in Salam contract is not allowed prior to maturity of the contract, however, replacement with other commodities, except with cash, is allowed. It is permissible to cancel the contract of Salam by mutual agreement subject to no reduction and increase in original capital refunded.

Alam Khan entered into a salam contract with an IFI to supply 2 tons of super Basmati rice after six months @ PKR 80/- per Kg. At the time of delivery, seller could not arrange Super Basmati rice and offered 2nd grade Basmati rice for a price of PKR 70/- per Kg. the bank accepted the deal and contract completed.
Agha Khan purchased 3 tons of rice from Khan Farms under Salam sale for spot payment and deferred delivery for six months. Before delivery of goods, he entered into resale of goods to Malik corporation for deferred payment is a void transaction.

Rule.5- Delivery of goods at the due date is the responsibility of seller and acceptance of goods by the buyer is required if goods are meeting the required specification in quantity and quality. It is permitted:-

a. To settle the contract at a discount if the seller provides inferior goods.
b. To settle the Salam contract earlier than due date if required commodities are supplied by seller.
c. To replace the commodities (except with currency) and settle the contract as the case may be.
d. To settle contract by supplying superior commodities.

However, it is not permitted to stipulate penalty clause for delay in delivery.
Raja of Gujar Khan entered into a Salam contract with the local bank to provide 100 tons of wheat grade-II @ PKR 10/- per kg after six months for the amount received at the spot. At the time of supply Raja offered wheat grade-I @ PKR 12/- per Kg. Keeping in view the demand of grade-I wheat bank accepted the deal and contract settled.

Rule.6- Parallel Salam by the purchaser as well as a seller of goods is allowed subject to the condition that performance of any one of the Salam contracts is not conditional on the performance of any other Salam contract. All rulings listed above for slam contract are applied to parallel Salam agreement.
Bank of Bolan entered into Salam contract with Ch. of Khanewal for 10,000 bales of cotton @ PKR 1,000 per bale for spot payment with six months deferred delivery. After passing four months, bank sold under the Salam sales contract the

expected 10,000 bales of cotton to Khanpur Textile Ltd. for PKR 1,200 per bale for spot payment is a valid contract, subject to that supply of cotton by the bank to Khanpur Textile Ltd. is not linked with the supply by Ch. of Khanewal.

Suppose after passing four months bank entered into Murabaha sales with Khanpur textile limited is a void contract as under Murabaha contract existence of commodity is required.

Salam transaction contains risk for IFIs because in case of default only original amount can be claimed from seller.

Suppose bank entered into a deferred sales contract with Khanpur textile whereby both payment and delivery of goods shall take place after receipt of goods from Ch of Khanewal is a void contract, as for selling on credit existence of goods is required and both counter values cannot be deferred.

3.3. Steps in Salam & Parallel Salam

Salam is used by IFIs to provide agricultural finance. As in modern economy role of banks is not trader hence they are not interested in creating trading wings. Furthermore national laws are also not allowing banks to act as traders hence Salam sale contract is another device used to avoid interest in commercial transactions. Generally, banks after signing the first transaction of Salam, search for a buyer of the goods and enter into parallel Salam contract. In a complete transaction of modern Salam contract normally following steps are involved. Figure 3.1 depicts the process of Salam and parallel Salam sales.

1-2. Customer requests to an IFI for finance and sells the commodity with deferred delivery hence Salam sales contract is executed while bank makes payment at the spot.

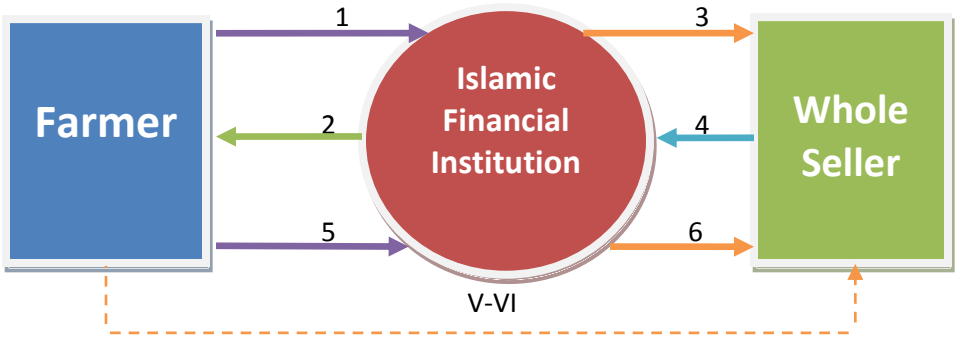
3-4. IFI enters into a contract of parallel Salam with another party [usually a whole seller]; receives the payment at spot and signs contract of Salam with a promise to deliver the goods at a point in time in future [usually delivery date from farmer].

5. At the date of delivery farmer [Seller in first Salam contract] delivers the goods to IFI to discharge his liability.

6. IFI delivers the goods to the whole seller [buyer in Parallel Salam contract] hence transaction closed.

Under some exceptional circumstances goods are directly transferred to the whole seller by the farmer; however even in this case IFI needs to bear the risk of ownership till the discharge of liability [V-VI].

Figure -3.1. Graphic presentation of Salam sales process



3.4. Difference between Salam & Forwards

Future and Forward contracts are very much dominating the business world. Futures and forwards are sold and purchased for currencies, stocks, gold, oil and other commodities. How Salam contract is different from futures and forwards is discussed in following paragraphs. Salam sale can be affected for only Halal fungible goods which are generally available in the market at the time of delivery. Physical delivery of goods forming the subject matter of Salam contract is required by Islamic law while in the case of futures and forwards physical delivery is not required. In most of the cases contract is settled on margins by the parties involved under futures and forwards. This practice of settling contracts on margins has led to short selling which creates an imbalance in the market by affecting demand and supply of the underlying commodity. Under futures and forwards, goods are not sold and purchased rather claims are sold and purchased which create no utility for the society as a whole. It is zero sum game where certain individuals gain at the expense of others. Furthermore, future and forward

contracts create an imbalance in the prices of consumable commodities (generally moving upward) by creating an artificial demand (e.g. prices of oil in 2007-08) which affects ordinary users. Two basic features of Salam sale (immediate payment of the price and definite delivery of goods) differentiate it from futures and forwards.

3.5. Financial Impact of Salam

Financial reporting and financial impact of Salam are discussed in the following paragraph. I shall illustrate with a hypothetical balance sheet and show the impact of different transactions on the balance sheet of an IFI. Balance sheet of an IFI is little different from balance sheet of a conventional bank in the sense that IFIs accept deposits either as loan which is in line with practices of commercial banks and does not create any difference in balance sheet; or on profit and loss sharing basis under Musharaka and Mudaraba which changes the nature of relationship between customers and IFIs. Deposits under profit and loss sharing (PLS) models including Musharaka & Mudaraba are not shown as liabilities in the balance sheet rather form part of equity.

On the other hand, conventional banks lend money and show advances to customers as assets while IFIs do not lend cash rather sell the goods on credit hence resulting in receivables under Murabaha, Muajjal, etc. Furthermore, IFIs invest in businesses that need cash financing under the scheme of Musharaka & Mudaraba; hence, investment under Musharaka & Mudaraba is shown as an investment and not the receivables or advances. Let us look at a simple balance sheet of an IFI.

Under futures and forwards goods are not sold and purchased rather claims are sold and purchased which create no utility for the society as a whole.

First Islamic Bank

Balance Sheet, as at December 31, 2009

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	4,586	Payables and balances	400
Accounts R/A	1,000	Current deposits	3,300
Inventory (assets for sale)	500	Accrued expenses	50
Accrued revenue	200	**Total liabilities**	**3,750**
Short term investments	150	**Equities**	
Total current assets	**6,436**	PLS deposits balances	1,500
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
		Statutory reserves	400
Total long-term assets	**3,000**	R. earnings/ Un appropriated	786
		Total Equities	**5,686**
Total assets	**9,436**	**Total liabilities & Equities**	**9,436**

Suppose on January 01, 2010, Mr. Shah contacted the Lahore branch of First Islamic Bank (FIB) to advance Rs; one million for the purchase of seeds and fertilizers for six months to be paid by delivery of 50 tons of wheat by July 30th 2010. FIB agreed to provide required financing in cash by opening current account of Mr. Shah and prepared Salam sale contract duly signed by both parties on 5th January 2010. At the same day, account opening form was signed by Mr. Shah. This transaction has an effect on both sides of the balance sheet. A current deposit is generated on liabilities side (consequently current deposits increased by one million) and investment under Salam Financing, of the equal amount, has been created on the assets side.

First Islamic Bank

Balance Sheet, as at January 05, 2010

Assets	Rs. (000)	Liabilities & Equities	Rs. (000)
Salam financing	1,000	Current deposits	4,300
Other assets	9,436	Other Liabs. & Equities	6,136
Total assets	**10,436**	**Total liabilities & Equities**	**10,436**

Suppose on 1st May 2010, FIB searched another party Mr. Chaudhary as a potential buyer of 50 tons of wheat @ Rs; 21,000 per ton, and enter into parallel Salam of wheat to be delivered on July 31, 2010. The impact of this transaction is shown as follow. Following balance sheet shows the impact of cash withdrawn by Mr. Shah the seller of wheat to FIB and a cash payment of Mr. Chaudhary, the ultimate purchaser from FIB. Withdrawl of cash by Mr. Shah reduced the current deposit while payment of the amount by Mr. Chaudhary showed under the heading of parallel Salam. On the other hand, cash reduced by Rs; 1,000,000 withdrawn by Shah and increased by Rs; 1,050,000 paid by Mr. Chaudhary.

First Islamic Bank

Balance Sheet, as at May 31, 2010

Assets	Rs. (000)	Liabilities & Equities	Rs. (000)
Salam financing	1,000	Current deposits	3,300
Other assets	9,486	Parallel Salam	1,050
		Other Liabs. & Equities	6,136
Total assets	**10,486**	**Total liabilities & Equities**	**10,486**

Now suppose on June 1, 2010, Islamic bank come to know that prices of wheat have fallen to Rs; 19,000 per ton hence the commodity to be received has lost a portion of its book value. Current market price is 50,000 X 19 = Rs; 950,000. An immediate write-off of loss is required as per accounting standard on Salam. The impact of this write-off is shown as under. This event affected equities as well as

Salam financing by equal amount because loss in value is charged to equities of Islamic bank

First Islamic Bank

Balance Sheet, as at Jun 01, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Salam financing	950	Current deposits	3,300
Other assets	9,486	Parallel Salam	1,050
		Other Liabs. & Equities	6,086
Total assets	**10,436**	**Total liabilities & Equities**	**10,436**

On July 30, 2010, Mr. Shah provided 50 tons of wheat which handed over to Mr. Chaudhary and shifting expenses (from fields of Shah to storage of Chaudhary) incurred amounting to Rs; 10,000. The financial impact is shown below.

First Islamic Bank

Balance Sheet, as at July 31, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	4,626	Payables and balances	400
Accounts R/A	1,000	Current deposits	3,300
Inventory (assets for sale)	500	Accrued expenses	50
Accrued revenue	200	**Total liabilities**	**3,750**
Short term investments	150	**Equities**	
Total current assets	**6,526**	PLS deposits balances	1,500
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
		Statutory reserves	400
Total long-term assets	**3,000**	R. earnings/ Un appropriated	826
		Total Equities	**5,776**
Total assets	**9,526**	**Total liabilities & Equities**	**9,526**

This transaction has affected parallel Salam account, Salam account, cash account (other assets) and retained earnings account (Equities). In fact, bank earned a profit of Rs; 100,000 and incurred expenses of Rs; 10,000. Cash decreased by Rs; 10,000 while Salam financing account comes to an end as well as parallel Salam account also finished. Let us see the balance sheet as at July 31st 2010.

Suppose Mr. Shah was unable to deliver the goods on the due date and FIB had to acquire the goods from market @ Rs.21, 500 per ton to deliver to Mr. Chaudhary because under Salam framework performance of parallel Salam is independent of Salam contract. FIB has to suffer the loss of Rs; 25,000 plus transportation cost of Rs; 10,000. At this point Salam financing would become receivables from Mr. Shah hence a profit of Rs; 50,000 realized because FIB reduced the amount of Salam earlier by Rs; 50,000. Now the original amount becomes receivables due to the recovery of Rs; 50,000 earlier written off. The net result is a loss of Rs; 35,000 on this transaction. **First Islamic Bank**

Balance Sheet, as at July 31, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	3,551	Payables and balances	400
Accounts R/A	2,000	Current deposits	3,300
Inventory (assets for sale)	500	Accrued expenses	50
Accrued revenue	200	**Total liabilities**	**3,750**
Short term investments	150	**Equities**	
Total current assets	**6,401**	PLS deposits balances	1,500
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
		Statutory reserves	400
Total long-term assets	**3,000**	R. earnings/ Un appropriated	751
		Total Equities	**5,651**
Total assets	**9,401**	**Total liab & Equities**	**9,401**

3.6. Concept building

Illustration.1. Mr. Abdullah a farmer requested to Meezan Bank Islamabad on March 1st 2010, to issue cash for purchase of seeds and fertilizers amounting to Rs; 2 million for supply of 500 bags of rice (net weight 50 Kgs. Per bag), at his fields locating at Ghaziabad, to be delivered on September 30, 2010. Meezan bank agreed to the deal and Salam sales contract executed and signed by both parties on March 5th 2010. On 1st May 2010, Meezan Bank entered into Parallel Salam contract with Mr. Ghazi a local (Islamabad-based) wholesaler of rice to sell 500 bags for Rs; 4,500 per bag to be delivered in Islamabad, with delivery on October 15, 2010, for 100% spot payment.

Wheat is the food staple in many countries including Pakistan

Required:-

1. Are both deals valid?
2. If both contracts executed smoothly at due date and transportation cost incurred Rs; 50,000 what is a profit of Meezan Bank and % return per annum on investment.
3. If Mr. Abdullah failed in the provision of goods by October 15, and Meezan bank has to purchase the rice from local market @ Rs 4,600 per bag to deliver Mr. Ghazi and discharge his liability under Parallel Salam. What is profit/loss of Meezan Bank and % return per annum on investment?

Solution

1. Under Salam sale a supplier can sell the products without being come into existence for spot payment of the price, hence both deals are valid with the condi-

tion that performance of both contracts is independent of each other. If Mr. Abdullah fails in delivering the goods Meezan bank is not allowed to default in delivery under parallel Salam on this excuse. Meezan bank is obliged to deliver the goods of same quality and specification to Mr. Ghazi as included in the contract of Salam. If Meezan bank could not arrange the goods of the same quality customer has the option to accept the inferior quality goods on discount or rescind the contract and get his money back.

2. Following is the profit of Meezan bank if both contracts executed smoothly.

Selling price in Parallel Salam contract		Rs. 2,250,000
Cost price in Salam Contract	Rs. (2,000,000)	
Transportation cost	Rs. (50,000)	
Total cost		Rs. (2,050,000)
Profit		Rs. 200,000
Percentage return on investment is 17% per annum.		

3. Following is the profit of Meezan Bank if Mr. Abdullah could not provide the goods at the due date.

Selling price in Parallel Salam contract	Rs. 2,250,000
Cost price in purchase	Rs. (2,300,000)
Profit (loss)	Rs. (50,000)
Percentage return on investment is -4% per annum.	

Illustration.2. Following is balance sheet of Margalla Islamic Bank as on December 31, 2009. Selected transactions occurred during first six months of 2010 are reported below.

Margalla Islamic Bank

Balance Sheet, as at December 2009

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	3,551	Payables and balances	400
Accounts R/A	2,000	Current deposits	3,300
Inventory (assets for sale)	500	Accrued expenses	50
Accrued revenue	200	**Total liabilities**	**3,750**
Short term investments	150	**Equities**	
Total current assets	**6,401**	PLS deposits balances	1,500
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
Total long-term assets	**3,000**	Statutory reserves	400
		R. earnings/ Un appropriated	751
		Total Equities	**5,651**
Total assets	**9,401**	**Total liabilities & Equities**	**9,401**

1. January 15th Murabaha sales contract signed for the provision of machine to Salaam Khan costing Rs; 1,000,000 payable within five months for Rs; 1,100,000. Transaction completed smoothly.
2. January 20th entered into Salam contract with ABC for 10 tons of wheat for Rs; 18,000 per ton to be delivered on 20/04 – 30/04. On receipt of wheat sold to AAA Mills @ Rs; 20,000 per ton on Murabaha sale for one month with a penalty of 2% on the amount due if default continued for 15 days. ABC made payment within two months.
3. February 5th supplied raw material to Zahoor Mills costing Rs; 500,000 at a sale price Rs; 550,000 on Murabaha payable within three months with a penalty of 3% if default continued for 25 days. Zahoor Mills made prompt payment without penalty.
4. February 20th paid accrued expenses in full and realized accrued revenue in full.
5. February 25th entered into Salam contract for the purchase of one-ton fruits for Rs; 500,000 to be delivered on 25th June 2010. March 31st en-

tered into parallel Salam contract of one-ton fruits for Rs; 600,000 to be delivered between 25/06 and 30/06, 2010. Both transactions executed smoothly.

Work Sheet

	DEC																	JUNE
Description	2009																	2010
Cash	3551	-1000	1100	-180	204	-500	550	200	-50	-500	600	-500	-400	500	-1200	400	600	3375
Account R/A	2000	1100	-1100	200	-200	550	-550						500	-500				2000
Inventory	500																	500
Acc revenue	200							-200										0
Salam Financing				180	-180					500		-500	500					500
Short term inv	150																	150
Investment PLS	1000																	1000
ty, Plant & Equipment	2000																	2000
TOTAL	**9401**																	**9525**
Payables	400																	400
Current deposits	3300															500	-200	3600
Acc expenses	50								-50									0
Parallel Salam											600	-600						0
Charity fund					4													4
PLS Deposits	1500															1000	-700	1800
Paid up capital	3000																	3000
Statutory reserve	400																	400
Retained earnings	751	100			20	50						100	100		-1200	400		321
TOTAL	**9401**																	**9525**

6. March 20th entered into Salam contract for the purchase of 10 tons of rice from XYZ for Rs; 50,000 per ton to be delivered between 10/10 and 30/10, 2010.
7. April 15th supplied two generators to Shaheen manufacturers costing Rs; 400,000 at a price of Rs; 500,000 on Murabaha sale for two months with a penalty of Rs; 30,000 if default continued for more than 15 days and acquired paper of plot to be sold for recovery if defaulted for more than one month. Shaheen paid the amount on 25th of June, 2010.
8. Operating cost for six months is Rs; 1,200,000 and miscellaneous earnings are Rs; 400,000 all paid and received respectively.
9. Change in deposits occurred as follow.

Current deposits

Inflow Rs; 500 millions & outflow Rs; 200 millions

PLS deposits

Inflow Rs; 1000 millions & outflow Rs; 700 millions

Prepare Balance sheet of Margalla Islamic Bank as at June 30th 2010. Show the impact of transactions through worksheet.

Worksheet shows the changes in the respective account during the period Jan-June, 2010.

Margalla Islamic Bank, Balance Sheet, as at June 30, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	3,375	Payables and balances	400
Accounts R/A	2,000	Current deposits	3,600
Inventory (assets for sale)	500	Charity fund	4
Salam financing	500	**Total liabilities**	**4,004**
Short term investments	150	**Equities**	
Total current assets	**6,525**	PLS deposits balances	1,800
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
		Statutory reserves	400
Total long term assets	**3,000**	R. earnings/ Un appropriated	321
		Total Equities	**4,521**
Total assets	**9,525**	**Total liab & Equities**	**9,525**

3.7. Questions

1. Define Salam & Parallel Salam? What is the difference between Salam sales, Murabaha sales, and Muajjal sales?
3. Can a Salam sale contract be executed for goods already produced and production of a specific field (Piece of land)?
4. Enlist at least five applications of Salam contract of sale.
5. Explain the steps in Salam and Parallel Salam?

6. Salam and parallel Salam are jointly used by IFIs without going into the production process. Do not you think it is like lending on interest?
7. Can Salam sales be executed for currency and shares trading?

Multiple choice questions

1. A sale with two essential features of deferred delivery of subject matter and immediate payment of price is called:
    a. Murabaha sale
    b. Muajjal sale
    c. Salam sale
    d. Istisna'a sale
2. Agricultural finance is severely needed in Pakistan, having a share of agriculture more than 20% of GDP, and is a ready market for financing by Islamic banks. To meet the agricultural needs of farmers prime financing mode available to IFIs is:
    a. Murabaha financing
    b. Salam financing
    c. Ijarah financing
    d. Istisna'a financing
3. Which of the following is not true about the capital of Salam financing?
    a. Capital of Salam financing should be known to both parties whether paid in cash or kind
    b. Capital of Salam may be paid at any time before delivery of goods
    c. A debt receivable from customer cannot be converted into Salam capital
    d. None of the above
4. Salam sale is a contract with two essential features of immediate payment and deferred delivery. Which of the following is not true about the subject matter of Salam sale?
    a. Subject matter of Salam must be different from mode of capital payment
    b. Specifications of subject matter must be cleared to both parties
    c. Availability of subject matter in the market at the time of delivery is not required

d. Salam financing contract can be concluded for fungible goods only

5. Delivery of goods at the due date is required from the seller under Salam financing. Which of the following is untrue, about Salam financing contract?

a. To settle the contract at discount if seller provides low-quality goods
b. To settle the contract earlier if seller supplies goods
c. To delay the settlement by reducing the price if seller is unable to deliver at due date
d. To replace the commodities except with currency

6. Banking is a business of financial intermediation and not trade, hence, parallel Salam by IFIs is a technique to mitigate risk and ensure liquidity. Which of the following is untrue in a contract of parallel Salam?

a. Entering into parallel Salam with the quantity, quality and delivery date of original Salam contract
b. Transferring goods of original Salam contract at the time of delivery in parallel Salam agreement
c. Making performance of parallel Salam conditional on performance of original Salam contract
d. Charging price higher in parallel Salam than the price of original Salam contract

7. Salam is a contract of forward sale. Which of the following makes it different from conventional forward trading?

a. Delivery of goods is postponed
b. Payment is made in advance and delivery is taken at due date
c. Both counter values are postponed in conventional forwards
d. There is no difference in Salam and conventional forward trading

8. Which of the following is correct procedure to record the transaction of Salam financing in financial reports?

a. Amount of capital under Salam financing is recorded as investment
b. Amount of capital under Salam financing is recorded as receivables
c. Amount of capital under Salam financing is recorded as inventory
d. Amount of capital under Salam financing is recorded as sales

9. When the value of the commodities under Salam financing is decreased, which of the following is the correct financial reporting treatment?

a. An adjustment in Salam financing showing the decrease should be recorded
b. No adjustment should be made till the delivery of goods
c. Adjustment in cost should be made at the time of selling
d. All of the above

10. Salam is a forward sale contract of specified goods. Which of the following can't be traded through Salam financing?

a. Wheat
b. Rice
c. Equity shares
d. Television

True/False

Mark the following statements as True or False.

1. Bai Salam is a form of sale contract whereby IFIs purchase goods for spot payment with deferred delivery.

2. Generally in Salam transaction, spot price agreed is lesser than future prices on the actual date of delivery. Hence IFIs are making a profit.

3. The share of agriculture in GDP is about 40% while providing jobs to 65% of the country's population living in rural areas; however, less than 20% of seven million farm households have access to bank financing.
4. The average share of Salam financing in investment portfolios of IFIs working in Pakistan during the period under review was only 3.7%.

5. Capital in Salam should be known to both of the parties involved in Salam sale agreement. Ideally, it should be in cash however it is allowed to supply the capital in kind subject to (1) specifications and (2) quantity of goods to be delivered as capital in Salam contract.

6. The capital of Salam should be paid immediately by the time contract is concluded or within two, three days, however payment period of capital must not be equal to or greater than the delivery time of goods purchased under Salam.

7. A debt receivable from the customer can be converted into Salam capital.

8. Commodities in Salam contract are not necessarily fungible goods, (sharing common features e.g. wheat, rice, fruits, etc.) and also include standardized products of companies.

9. The subject matter of a Salam contract must be different from the mode of payment of the price. (e.g., if capital provided in currency or gold then commodity in Salam contract must not be currency or gold).

10. Commodities involved in Salam contract must be clearly known to both of the parties involved, and no ambiguity and uncertainty should be left unaddressed at the time of contract relating to quality and quantity.

11. It is not required that commodities involved in Salam contract should be generally available in the market at the time of delivery (so that seller should be able to discharge his liability).

12. Security in Salam contract can be obtained through guarantee, pledge or any other permissible mode of security.

13. Disposal of commodities involved in Salam contract is allowed before maturity of the contract, however, replacement with other commodities, except with cash, is allowed.

14. Under Salam sale, it is not permitted to settle the contract at a discount if the seller provides inferior goods.
15. Under Salam sale, it is not permitted to replace the commodities and settle the contract as the case may be.

16. Under Salam sale, it is not permitted to settle contract by supplying superior commodities.

17. Under Salam financing, it is not permitted to stipulate penalty clause for delay in delivery.

18. Under conventional futures and forwards, goods are not sold and purchased rather claims are sold and purchased which create no utility for the society as a whole. It is zero sum game where certain individuals gain at the expense of others.

19. Spot payment and actual delivery of goods at due date in Salam financing make it different from conventional futures and forwards.

20. Conventional future and forward contracts create an imbalance in the prices of consumable commodities (generally moving upward) by creating an artificial demand which affects ordinary users.

3.8. Exercises

Ex.1. Mr. Rabnawaz-- a landlord of Sargodha-- is owner of fields of citrus locating near newly constructed motorway (M-2) Lahore-Islamabad section with an estimated production as follow:-

Description	Production
Field.1.	200 tons
Field.2.	400 tons
Field.3.	50 tons

On October 1st 2010, Mr. Rabnawaz contacted Bank Islami Ltd; to sell expected production of 400 tons for Rs; 15,000 per ton. Bank Islami keeping in view the export potential of fruit to the Middle East accepted the offer and Salam sale contract signed on 10th October 2010 with a delivery date January 15-30, 2011. Mr. Rabnawaz offered the whole production of designated field (2) to the bank which was not accepted and deal finalized on the supply of required quantity of fruits irrespective of fields.

Required:-

If climatic conditions are suitable and estimated production of field (2) is above 400 tons, should the bank not accept the offer?

a. Bank Islami entered into parallel Salam contract with a wholesaler in UAE on 10th December 2010, @ 800 AED (Ex. Rate 22:1), for spot payment with delivery dates15/1 to 15/2, 2011. What is the profit earned by the bank on this deal if both contracts executed smoothly and the bank has to pay Rs; 200,000 carriages from Sargodha to Karachi as per agreement.
b. Bank Islami entered into parallel Salam contract with a wholesaler in UAE on 10th December 2010, @ 800 AED (Ex. Rate 22:1), for spot payment with delivery dates15/1 to 15/2, 2011. What is the profit earned by the bank on this deal if due to natural calamity Mr. Rabnawaz was unable to deliver the goods and the bank had to purchase from Mr. Mughal @ Rs; 17,000 per ton to discharge his liability. Bank has to pay Rs; 200,000 carriages from Sargodha to Karachi as per agreement.

Ex.2. Mr. Arshad is a farmer requires funding for seeds and fertilizer amounting to Rs; 500,000 contacted local Islamic bank to finance against the production of 30 tons of wheat to be delivered at Khanewal after cultivation @ Rs; 16,667 per ton. Salam sale contract executed on 1st September 2009, with delivery dates between 01/04 -15/04, 2010. Bank entered into parallel Salam with Mr. Alum owner AAA flour mills, Rawalpindi on 1st December 2009, @ Rs; 19,000 per ton with delivery dates 10th to 30th April 2010 to be delivered at Mill godown. Mr.

Arshad handed over 30 tons of wheat according to agreed quality to bank on 10th of April 2010 at Khanewal in a rented godown. Bank informed the AAA Mills of expected delivery by 20th April 2010. On 15th April fire broken out in godown and four tons of wheat destroyed.

Required:-

a. What is the amount of loss? Is it the same amount for all parties? Which of the three parties should be charged for the loss?
b. What is a profit of bank if transportation charges amounting to Rs;10,000 and AAA Mills agreed to accept four tons lesser than 30 tons, as agreed in the original contract, for a refund of the balance.
c. What is a profit of bank if transportation charges amounting to Rs;10,000 and AAA Mills did not agree to accept four tons lesser than 30 tons and bank had to acquire four tons from local market @ Rs; 20,000 per ton to fulfill his liability.
d. What is a profit of bank if AAA Mills refused to accept the wheat on the excuse of quality suffering due to smoke and demands refund of money while the bank had to dispose of the wheat in the open market at Rawalpindi @ Rs; 18,000 per ton (after incurring transportation charges listed above).
e. What advice you can offer to bank to mitigate such risks inherent in Salam transactions.
f. How this Salam transaction is different from the same amount of loan from Agricultural Development Bank @ 12% per annum.

Ex.3. Dubai Islamic Bank entered into a Salam contract with Amir Khan of Multan for a Ton of Mangoes to be delivered between 15th June to 30th June 2010 for Rs;500,000 at his orchard, locating 24 Kilometers away from New Multan city towards Bahawalpur. After taking the possession on 30th June 2010, bank stored mangoes in cold storage for Dailey charge of Rs; 500 and informed selling department to search for a buyer.

XYZ Company is a manufacturer of soft drinks requested financing facility to Dubai Islamic Bank for purchase of a ton of mangoes estimated cost is amounting to Rs; 600,000 on July 1st 2010. Bank agreed to supply the required quantity of mangoes and took the customer to visit in cold storage Multan. After examining fruits, the customer agreed to the deal and Murabaha sales agreement executed on 10th of July 2010, including following terms.

1. Fruits shall be provided at factory premises of customer at Islamabad.
2. 20% profit on cost shall be charged for six months.
3. Bank has the authority to sell inventory (finished juices) of XYZ in the case of default for more than two months.
4. The penalty of 5% on the amount due shall be charged if payment is not made within 15 days of due date.

Miscellaneous expenses incurred by the bank in Multan (being the cost of living, transportation and daily allowance to procurement officer) for executing purchase amounting to Rs; 10,000. Transportation cost is Rs; 40,000 paid to Multan Karachi goods forwarding agency and transit insurance is Rs; 20,000 paid to Adamjee insurance company.

Required:-

a. As per Murabaha sales, the disclosure of cost to the purchaser of goods is necessary, what is the amount of cost in this transaction to be used for calculation of profit?
b. Calculate selling price and profit on Murabaha.
c. Calculate the amount of penalty if payment made by XYZ on (i) January 1st 2011 (ii) January 26th 2011 (iii) February 25th 2011.
d. Why amount of penalty is different (if any) in above three options?
e. What is the effect of this transaction on financial reporting of Dubai Islamic Bank on (i) July 1st 2010 (ii) July 7th 2010 (iii) July 10th 2010 (iv) January 1st 2011 if payment made on this date (v) January 25th 2011 if payment made on this date.

Ex.4. Mr. Alam Khan requested financing of amounting to Rs; 100,000 from First Islamic Bank for the purchase of seeds to be paid through the production of wheat. Bank supplied the required seeds costing to bank Rs; 80,000 without disclosing to the customer and demanded 5 tons of wheat keeping in view the required profit for five months. Alam Khan agreed and signed the deal on November 1st 2009 with a delivery date between 1st -10th March 2010. On January 1st 2010 Bank entered into parallel Salam contract with ABC Company for a price of Rs; 20,000 per ton with delivery dates 01/03 to 20/03, 2010. Both transactions executed smoothly.

Required:-

a. What is a profit of bank in this deal? Calculate % return per annum.
b. Being auditor do you think it is a valid transaction? If not how to spend earnings of the bank through this deal?

Flower industry offers opportunities for small businesses

Suggested readings

- AAOIFI. 2004. *Shari'a Standards.* P.O. Box 1176, Bahrain.
- AAOIFI.2003. *Accounting and Auditing Standards for Islamic Financial Institutions,* International Institute of Islamic Economics, Islamabad, Pakistan.
- C.I.I. (1980). Council of Islamic Ideology: Report on Elimination of Interest from Economy.

- Khan, M.A., (1989). Economic Teachings of Prophet Muhammad: A Select Anthology of Hadith Literature on Economics, chapter 6:2, page 72. *International Institute of Islamic Economics,* P.O. Box 1647, Islamabad, Pakistan.
- SBP 2010. [State Bank of Pakistan] *Islamic Banking Bulletins 2007-2010.*
- Usmani, T.S., 2002.An Introduction to Islamic Finance. Maktaba Ma'arif Al Quran, Karachi, Pakistan.

SALAM IN ACTION

Contract was settled by reducing the price to Rs; 40/- per kg. It is permitted to accept exchanged goods (except currency or goods in capital of Salam), inferior goods and superior goods in contract of Salam.

Chapter 4

Istisna'a Financing

Istisna'a has the potential to finance manufacturing, civil as well as infrastructure projects including roads, bridges, railways and water reservoirs

Istisna'a is a sale agreement whereby buyer places an order with manufacturer to produce specified commodities for a price agreed within specified period. Istisna'a is a valuable tool with IFIs to provide required funding for civil works projects including roads, bridged and dams, etc. Istisna'a is also a very useful tool to finance working capital of manufacturing sector.

Learning objectives

After going through this chapter reader should be able to understand and interpret the following:

What is Istisna'a financing?

What are Shari'a rulings about operations of Istisna'a financing?

What are steps in a transaction of Istisna'a financing?

What is the financial impact of Istisna'a financing and how it is accounted for?

4.1. Introduction

Istisna'a applies to both manufacturing and construction. This mode of financing is designed to transact business through an order to manufacture and/or supply. It is a sales contract except the existence of subject matter. This tool of financing is useful for infrastructure projects. Parallel Istisna'a contract is allowed however performance of second Istisna'a contract must not be conditional on the fulfillment of the first contract (Shari'a standard 11). Istisna'a could not get its due share in portfolios of IFIs, and its potential has not been exploited by IFIs due to lack of experience. Istisna'a can play its due role in the development process of the country by investing in infrastructure projects. This will help in reducing the dependence on foreign sources for development projects. Istisna'a could be used in the development of civil works projects including buildings, roads, bridges and water reservoirs, etc. Figure 4.1 depicts the share of Istisna'a in portfolios of IFIs working in Pakistan during 17 quarters. The average share of Istisna'a in portfolios of IFIs working in Pakistan is 3% only, however, increasing trend is found. Figure 4.2 presents closing amounts of investments under Istisna'a financing (SBP-2010).

Istisna'a can play its due role in development process of country by investing in infrastructure projects including Dams, roads, bridges, buildings.

Figure.4.1. Depicts % of Istisna'a financing in portfolios of IFIs.

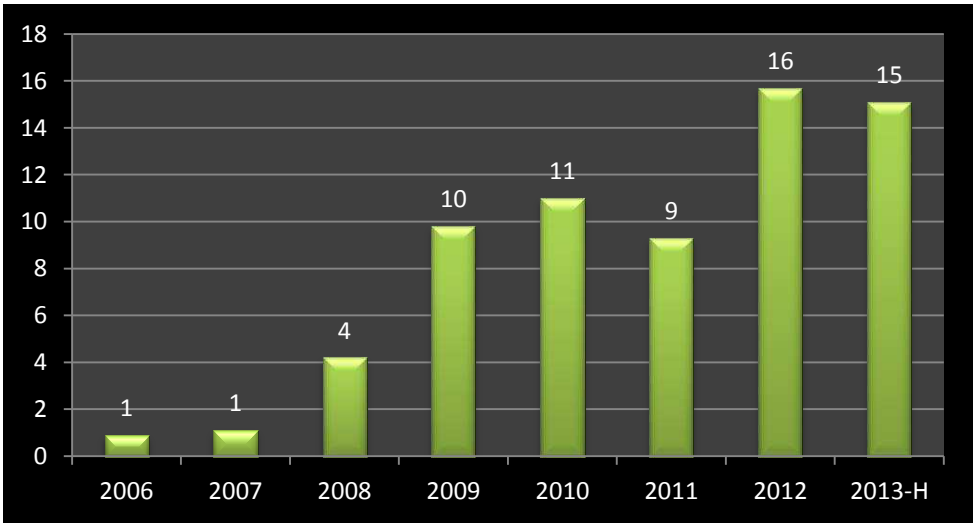
Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Jun 08	Sep 08
1.19%	1.36%	0.57%	0.94%	0.04%	1.2%	2.56%	2.43%
Dec 08	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10
2.86%	3.24%	3.33%	4.41%	6.18%	6.54%	3.90%	5.37%

4.2. Summary of Shari'a Rulings

Rule.1- Contract of Istisna'a is binding upon parties involved provided certain conditions fulfilled including specifications of underlying subject matter (commodity), price and delivery date (if required).

Mr. X entered into a contract of Istisna'a with a local bank to construct sewerage system of newly build Lolab town in Islamabad. Completion period is six months and price is to be settled on completion of the project is a void contract as without price certainty a sales contract cannot be executed.

Figure.4.1. Closing Amounts PKR Billion of Investments under Istisna'a Financing 12/06 to 06/13



Source: SBP- Islamic banking bulletins

Rule.2- Contract of Istisna'a is a sale contract with deferred delivery of subject matter to buyer hence all rules of a valid sale are applied except the existence of subject matter, ownership of seller and possession of the seller.

Mr. Y entered into a contract to manufacture a water reservoir for a local Islamic bank under Istisna'a sales contract. Price agreed was PKR 100 million with indefinite time to complete is a void contract as the certainty of the delivery date is required.

Rule.3- Contract of Istisna'a cannot be executed with a customer who is the purchaser of underlying commodity/subject matter from IFI and in the same Istisna'a transaction acts as manufacturer or contractor for the production and supply of subject matter.

HR got a contract from NHA to manufacture a bridge for 5 million and need funding. Expected cost to complete is 4 million. Local Islamic bank entered into the deal to construct the bridge for 4.5 million under Istisna'a. After finalizing the deal bank called for tenders and HR offered the lowest price of 4 million to construct the bridge. Deal finalized with following structure. HR to construct a bridge for NHA for 5 million. Bank to construct for HR for 4.5 million and HR for the bank for 4 million. It is a void contract as a purchaser of goods [HR in this case] and manufacturer [HR in this case] cannot be same in a contract of Istisna'a and Parallel Istisna'a.

ISTISNA'A IN ACTION
In a contract of Istisna'a penalty and Urboun to compensate the purchaser is allowed. How penalty is different from Urboun. Answer at end.

Rule.4- Istisna'a sale is allowed only for those commodities/projects where the raw material is transformed from its natural shape to a finished product by involving a manufacturing or construction process. Mr. Alam entered into a contract of Istisna'a with Margalla Islamic bank to supply ten tons of rice @ PKR 100/- per Kg is a void contract as Istisna'a contract can be executed for manufactured goods only.

Rule.5- Istisna'a sale is applicable to both unique commodities with the specification or generally available commodities, and consumable goods or capital goods, however, the transformation from Raw material to finished goods through manufacturing or construction process is required. Mr. H entered into a contract of sale with Margalla Islamic bank to sell a unique set of furniture to be gifted to a prime customer of bank for PKR 500,000 with a delivery date of two months after signing the deal subject to make 50% advance payment, is a valid

Istisna'a sale is allowed only for those commodities/ projects where raw material is transformed from its natural shape to a finished product by involving a manufacturing or construction pro-

Istisna'a sale but same cannot be a valid Salam sale due to uniqueness of underlying goods. This is a condition in Salam sale that only fungible goods can be the subject matter of sale which is not required under Istisna'a sale contract. Also, under Salam sale, total price must be paid in advance which is not required under Istisna'a. Furthermore, under Istisna'a manufacturing process is necessary for the subject matter of sale.

Rule.6- Istisna'a sale cannot be executed for a product already manufactured and or constructed.

Pakistan cement entered into a contract with local Islamic bank to sell the cement already manufactured under Istisna'a for spot payment @ PKR 350/- per bag with the deferred delivery of three months. Expected price at the time of delivery in the market is PKR 380/- hence make economic sense, but it is a void contract as Istisna'a contract cannot be executed for already manufactured goods.

Rule.7- Under Istisna'a sale, it is not required that manufacturer produces the subject matter by himself using his production facilities. Production and construction can be outsourced subject to meeting the specifications. However if purchaser stipulate that production must be carried on by the seller himself, then outsourcing is not allowed.

A local Islamic bank participated in bidding for construction of KALABAGH dam for PKR 100 billion within ten years. After successful bidding bank hires a local construction company to do the job in 80 billion within ten years as per the specification of purchaser. At the completion of project bank handed over the project to government and received money. It is a valid deal because one can outsource manufacturing except contract bound the manufacturer/seller to manufacture by using his facilities.

Rule.8- Price in Istisna'a sale can be made at the spot, deferred, subject to completion, stages of completion and in cash or kind as the parties agreed. However, determination of price on cost plus margin (Murabaha pricing) is not allowed.

Hence, any un-estimated profit or loss is not required to be shared with purchaser.

A local Islamic bank entered into an Istisna'a contract with margalla constructions to build a bridge on M-2 to be handed over to NHA. Keeping in view the uncertainty in cost, it was agreed to pay the manufacturer cost plus ten percent margin is a void contract.

Rule.9- Urboun (guaranteed consideration) can be demanded and forfeited if the contract is rescinded. However, it is preferred to forfeit an amount equal to actual damages suffered. It is also allowed to demand guarantee and security to secure the rights.

Margalla Islamic bank entered into a contract of Istisna'a with Taxila builders to build 100 low-cost housing units to be sold under diminishing Musharaka basis for amounting to PKR one million each. Earnest money settled PKR 500,000. Texila builders could not complete the project, which was completed by Wah builders and the bank had to pay PKR 300,000 above the original cost. Bank has the right to forfeit whole PKR 500,000 Urboun money. However it is preferred to refund the PKR 200,000 to Taxila builders as the actual loss is only PKR 300,000.

Rule.10- It is permitted (by way of agreement, arbitrage, and judicial process), to change the price of contract due to intervening contingencies (force majeure).

Kashmir Bank entered into the bidding process for construction and expansion of Kashmir Highway and declared successful by CDA for an amount of PKR 5 Billion within two years. Kashmir bank outsourced the construction to Gulmarg enterprises for PKR 4 Billion within scheduled time. After passing one year, some of the land owners went into court and obtained stay order resulting in delay of one year. As A matter of fact, 10% inflation in the construction industry increased the cost of construction. Gulmarg enterprises as well as Kashmir bank has the right to claim excess cost from CDA.

Rule.11- It is permitted to appoint the ultimate purchaser as an agent of IFI to ensure the construction as per the specification of Istisna'a sale agreement by a separate contract of agency.

In addition to the previous example under Rule 10, Kashmir bank can appoint CDA engineers to supervise the construction through a separate contract.

[M-2 First Motorway of Pakistan]

Rule.12- Penalty clause can be stipulated for the delay in completion to compensate the purchaser, however, penalty on default in payment by the purchaser is not allowed.

Mr. Alam entered into an Istisna'a contract to manufacture a house for a customer of Modoodi bank for a consideration of PKR 4 million within 24 months. It was stipulated in the contract that payment shall be released based upon work in progress after every quarter. It was also part of the contract to impose a penalty of PKR 500,000 if the house could not be completed within three months grace period. It was a condition that if prices of materials are increased beyond 10% of prevailing within two years, the excess shall be charged to the bank. It was also included in the contract that Mr. Alam will construct the house by using his facilities. Prices remained under 10% inflation during the period, however, within a

period of 27 months Mr. Alam could not finish the work. Hence he had to pay a penalty of PKR 500,000.

Rule.13- Manufacturer or builder can be appointed as agent of IFI to dispose of a commodity once the possession of subject matter is taken over.

Wah cement limited needs funding to pay operating cost and contacted to a local Islamic bank. After due consideration deal was finalized by using Istisna'a sale. According to agreement, bank will pay immediately PKR one million to Wah company for 3,333 bags of cement to be delivered within 90 days. After 90 days cement was handed over to the bank. Given the incapacity bank appointed Wah company as selling agent at 5% commission on the sale to sell the cement to his customers for a price of PKR 350 per bag. Within one month cement was disposed of and an amount of PKR 1,108, 222/- was handed over to the bank after deducting selling commission. Hence, bank earned an amount of PKR 108, 222/- on an investment of 1 million which is 32% per annum.

Rule.14- Selling of subject matter in Istisna'a contract before taking the possession is not allowed however IFI can enter into a Parallel Istisna'a contract having the same specifications. The performance of Parallel Istisna'a contract must not be conditional on the completion of first Istisna'a contract.

Margalla computers needed cash for making payment to the supplier and contacted to local Islamic bank for cash of PKR 2 million. Bank agreed to provide immediate cash under Istisna'a sale. According to agreement, bank will receive 50 computers after four months. After passing two months bank negotiated a contract of Parallel Istisna'a with a local computer college to supply 50 computers within 6o days for a price of PKR 45,000/- per computer. Half payment is made to the bank by Computer College and balances on delivery. At due date bank obtained computers from Margalla Company and handed over to a local college. Parallel Istisna'a contract becomes void if delivery of goods linked to the performance of original Istisna'a contract.

4.3. Steps in Istisna'a & Parallel Istisna'a

Istisna'a is used by IFIs to provide project financing. As in modern economy role of banks is not manufacturers and builders hence they do not establish such departments which can carry out construction etc. Furthermore national laws are also not allowing banks to act as manufacturers and builders hence Istisna'a sale is a device created to avoid interest in project financing. Generally, following are the products (financing options) used in Istisna'a sale.

1. Banks enter into a contract for completing a project (e.g. a bridge), after signing the first transaction of Istisna'a sale as manufacturer or builder, search for a contractor or builder to perform the job and enter into Parallel Istisna'a contract.
2. Banks provide finance to a manufacturer and purchase the production under Istisna'a sale then enter into a Parallel Istisna'a contract to sell the goods so produced before completion.
3. Banks enter into a contract of Istisna'a sale to acquire the production, after taking the possession appoint the same manufacturer as an agent of the bank to sell the production to customers.

In a complete transaction of modern Istisna'a contract normally following steps are involved. Figure 4.1 depicts the Istisna'a and Parallel Istisna'a sales.

1-2. Customer requests to an IFI for finance and sell the commodity with deferred delivery normally at a lower price hence Istisna'a sales contract is executed while payment is made by bank immediately or deferred or Installments as per requirement.

3-4. IFI enters into a contract of Parallel Istisna'a with another party at a price higher than original contract of Istisna'a, receives the payment at spot or deferred and sign contract of Istisna'a sale with promise to deliver the goods at a point in time in future [usually date of delivery closer to maturity of earlier Istisna'a contract].

5. Producer of goods [seller in first Istisna'a contract] delivers the goods to IFI on the due date to discharge his liability.

6. IFI delivers the goods to the buyer in Parallel Istisna'a contract [whole seller] hence transaction closed.

Under some exceptional circumstances goods are directly transferred from manufacturer to the whole seller; however risk of ownership is the liability of Islamic Financial Institution till the completion of the transaction [V-VI].

Figure -4.1. Graphic presentation of Istisna'a sales process

4.4. Financial Impact of Istisna'a

Financial reporting and financial impact of Istisna'a are discussed in the following paragraph. I shall illustrate with a hypothetical balance sheet and show the impact of different transactions under Istisna'a sale on the balance sheet of an IFI. Balance sheet of an IFI is little different from balance sheet of a conventional bank in the sense that IFIs accept deposits either as loan which is in line with practices of conventional banks and does not create any difference in balance sheet; or on profit and loss sharing basis under Musharaka and Mudaraba which changes the nature of relationship between customer and IFI. Deposits under profit and loss sharing (PLS) modes including Musharaka & Mudaraba are not shown as liabilities rather form part of equity.

On the other hand, conventional banks lend money for interest and show advances to customers as asset while IFIs do not lend cash rather sell the goods on credit hence resulting in receivables under Murabaha, Muajjal etc. Furthermore IFIs invest in businesses who need cash financing under scheme of Musharaka & Mudaraba hence investment under Musharaka & Mudaraba is shown as invest-

ment and not the receivables or advances. Let us look at a simple balance sheet of an IFI.

Balance Sheet, as at December 31, 2009

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	4,586	Payables and balances	400
Accounts R/A	1,000	Current deposits	3,300
Inventory (assets for sale)	500	Accrued expenses	50
Accrued revenue	200	**Total liabilities**	**3,750**
Short term investments	150	**Equities**	
Total current assets	**6,436**	PLS deposits balances	1,500
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
		Statutory reserves	400
Total long-term assets	**3,000**	R. earnings/ Un appropriated	786
		Total Equities	**5,686**
Total assets	**9,436**	**Total liab & Equities**	**9,436**

Suppose on January 01, 2010, ABC Company contacted the Faisalabad branch of Margalla Islamic Bank (MIB) to advance Rs; one million for payment of day to day expenses (working capital) for six months to be paid by delivery of 40,000 yards of cotton fabric by July 30th 2010. FIB agreed to provide required financing in cash by opening current account of ABC Company and prepared Istisna'a sale contract, containing a penalty clause of lump sum Rs;50,000 [deducted] if goods delivered after 15 days of due date, duly signed by both parties on 5th January 2010. At the same day, account opening form was signed by ABC Company. This transaction has an effect on both sides of the balance sheet. A current deposit is generated on liabilities side (consequently current deposits increased by 950,000; security deposit by 50,000) and investment under Istisna'a Financing, of one million, has been created on the assets side.

Balance Sheet, as at January 05, 2010

Assets	Rs. (000)	Liabilities & Equities	Rs. (000)
Istisna'a financing	1,000	Current deposits	4,250
Other assets	9,436	Security deposit (Istisna'a)	50
		Other Liabs. & Equities	6,136
Total assets	**10,436**	**Total liabilities & Equities**	**10,436**

Suppose on 1st May 2010, MIB searched another party Mr. Nasir as a potential buyer of 40,000 yards of fabric @ Rs; 26.25 per yard, and enter into Parallel Istisna'a of fabric with 50% payment at spot and balance at delivery on August 30, 2010. Delivery of goods is to be made by MIB on showroom of Mr. Nasir at Raja Bazar, Rawalpindi. The impact of this transaction is shown as follow. Following balance sheet shows the impact of cash withdrawn by ABC Company the seller of fabric to MIB and a cash payment of Mr. Nasir, the ultimate purchaser from MIB. Withdraw of cash by ABC Company reduced the current deposit while price agreed with Mr. Nasir showed under the heading of Parallel Istisna'a. On the other hand, cash reduced by Rs; 950,000 withdrawn by ABC Company and increased by Rs; 525,000 paid by Mr. Nasir. 50% payment due on delivery is included in receivables under Istisna'a.

Urboun is earnest money which can be forfeited in full if contract is rescind-

Balance Sheet, as at May 31, 2010

Assets	Rs. (000)	Liabilities & Equities	Rs. (000)
Istisna'a financing	1,000	Current deposits	3,300
Istisna'a R/A	525	Parallel Istisna'a	1,050
Other assets	9,011	Security deposit (Istisna'a)	50
		Other Liabs. & Equities	6,136
Total assets	**10,536**	**Total liabilities & Equities**	**10,536**

On July 30, 2010, ABC Company could not provide required goods and default continue till 20th of August, 2010. On 20th August 40,000 yards of fabric handed over to FIB, which transferred to Mr. Nasir on August 30, 2010. Transportation and transit insurance/takaful expenses (from the factory of ABC Company, Fai-

salabad to showroom of Mr. Nasir, Rawalpindi) incurred amounting to Rs; 10,000. The financial impact is shown below. This transaction has affected Parallel Istisna'a account, Istisna'a account, Security deposit-Istisna'a account, Istisna'a R/A account, cash account (other assets) and retained earnings account (Equities). In fact, bank earned a margin of Rs; 100,000 (50,000 on price differential and 50,000 security forfeited) and incurred expenses of Rs; 10,000. Cash decreased by Rs; 10,000 for expenses, increased by Rs; 525,000 received from Mr. Nasir, while Istisna'a financing account, Parallel Istisna'a account, Istisna'a security and Istisna'a receivables come to an end. Let us see the balance sheet as at Aug 31st 2010.

Margalla Islamic Bank

Balance Sheet, as at August 31, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	4,676	Payables and balances	400
Accounts R/A	1,000	Current deposits	3,300
Inventory (assets for sale)	500	Accrued expenses	50
Accrued revenue	200	**Total liabilities**	**3,750**
Short term investments	150	**Equities**	
Total current assets	**6,526**	PLS deposits balances	1,500
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
		Statutory reserves	400
Total long-term assets	**3,000**	R. earnings/ Un appropriated	876
		Total Equities	**5,776**
Total assets	**9,526**	**Total liab & Equities**	**9,526**

Suppose ABC Company was unable to deliver the goods till August 31, 2010, and MIB had to acquire the goods from market @ Rs.27 per yard, to deliver to Mr. Nasir because under Istisna'a framework performance of Parallel Istisna'a is independent of any other Istisna'a contract. MIB shall forfeit security deposit of

Rs; 50,000 and pay transportation cost of Rs; 10,000. Position of MIB closed at 10,000 profit [50-10-(40*0.75)]. At this point Istisna'a financing (Rs; 1,000,000) would become receivables from ABC Company although earlier paid Rs; 950,000 and added security forfeiture.

Margalla Islamic Bank

Balance Sheet, as at August 31, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	3,596	Payables and balances	400
Accounts R/A	2,000	Current deposits	3,300
Inventory (assets for sale)	500	Accrued expenses	50
Accrued revenue	200	**Total liabilities**	**3,750**
Short term investments	150	**Equities**	
Total current assets	**6,446**	PLS deposits balances	1,500
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equip-ment	2,000	Paid up capital	3,000
		Statutory reserves	400
Total long-term assets	**3,000**	R. earnings/ Un appropri-ated	796
		Total Equities	**5,696**
Total assets	**9,446**	**Total liab & Equities**	**9,446**

4.5. Concept Building

Illustration.1. Mr. Abdullah manufacturer of cement requested to Meezan Bank Islamabad on January 1st 2010, to issue cash for the purchase of raw material amounting to Rs; 2 million for the supply of 8,000 bags of manufactured cement, at factory premises Hattar, on March 31st 2010. Meezan bank agreed to the deal and received Urboun of Rs; 100,000 to be forfeited if supply delayed by 15 days or manufacturer failed in delivery. Istisna'a sales contract executed and signed by both parties on January 1st 2010. On 1st February 2010, Meezan Bank entered

into Parallel Istisna'a contract with Mr. Ghazi a local distributor of cement to sell 8,000 bags for Rs; 260 per bag to be delivered in Islamabad, with delivery on April 30, 2010, for 50% spot payment and balance on delivery.

Required:-

1. Are both deals valid?
2. If both contracts executed smoothly at due date and transportation cost incurred Rs; 40,000 what is a profit of Meezan Bank and % return per annum on investment.
3. If Mr. Abdullah provided the cement on 20th April 2010 and Parallel Istisna'a Contract executed in time with transportation cost incurred Rs; 40,000 what is a profit of Meezan Bank and % return per annum on investment.
4. If Mr. Abdullah failed in the provision of Cement by April 30th and Meezan bank has to purchase the cement from local market @ Rs 258 per bag to deliver Mr. Ghazi. What is profit of Meezan Bank and % return per annum on investment?

Solution

1. Under Istisna'a sale a manufacturer/supplier can sell the products without being came into existence . Hence both deals are valid with the condition that performance of both contracts is independent of each other. If Mr. Abdullah fails in delivering the goods Meezan bank is not allowed to default in delivery under Parallel Istisna'a on this excuse. Meezan bank is obliged to deliver the goods of same quality and specification to Mr. Ghazi. If Meezan bank could not arrange the goods of the same quality customer has the option to accept the inferior quality goods on discount or rescind the contract and claim damages.

2. Following is the profit of Meezan bank if both contracts executed smoothly.

Selling price in Parallel Istisna'a contract		Rs. 2,080,000
Cost price in Istisna'a Contract	Rs. (2,000,000)	
Transportation cost	Rs. (40,000)	
Total cost		Rs. (2,040,000)
Profit		Rs. 40,000
Percentage return on investment is 6% per annum.		

3. Following is the profit of Bank if Mr. Abdullah provided the goods after the due date.

Selling price in Parallel Istisna'a contract		Rs. 2,080,000
Cost price in Istisna'a Contract	Rs. (2,000,000)	
Transportation cost	Rs. (40,000)	
Total cost		Rs. (2,040,000)
Profit in trading		Rs. 40,000
Forfeiture of Urboun		Rs. 100,000
Total profit		Rs. 140,000
Percentage return on investment is 21% per annum.		

4. Following is the profit of Bank if Mr. Abdullah could not deliver at the due date.

Selling price in Parallel Istisna'a contract	Rs. 2,080,000
Cost price in purchase	Rs. (2,064,000)
Profit in trading	Rs. 16,000
Forfeiture of Urboun	Rs. 100,000
Total profit	Rs. 116,000
Percentage return on investment is 18% per annum.	

Illustration.2. MR. Khan Manufacturer of generators, contacted to Albaraka Islamic Bank Rawalpindi on June 01, 2010, to finance the working Capital requirements amounting to Rs; 1,000,000 payable after one year in the form of 10 generators of the standard specification at a price of Rs; 100,000 each. Albaraka agreed with the deal and included following two conditions.

1. The penalty of Rs; 50,000 shall be charged in case of delay above 15 days.
2. Urboun of Rs; 100,000 if default crossed 45 days and contract shall be rescinded.
Istisna'a contract was signed by both parties on June 5th 2010.

Required:-

1. Albaraka appointed Mr. Khan as an agent to sell the generator (at completion) to customers in the market at a price of Rs; 110,000 for a commission of 8% on gross profit. If the transaction is executed smoothly, what is profit to Albaraka bank on this deal assuming transportation on the sale of generators is Rs; 12,000?
2. Albaraka appointed Mr. Khan as an agent to sell the generator (at completion) to customers in the market at a price of Rs; 110,000 for a commission of 8% on gross profit. If one of the generators damaged in selling process and demands major repair of Rs; 25,000 what is profit to Albaraka bank and percentage return on this deal assuming transportation on the sale of generators is Rs; 12,000?
3. Mr. Khan delivered goods after 20 days of due date which sold for Rs; 105,000 each with transportation of Rs; 15,000 what is profit of Bank on this transaction. State % per annum returns on investment.

Solution

Penalty is charged under Istisna'a frame-work if delivery is delayed.

1. Appointment of the manufacturer to sell the products in the open market is allowed. If generators sold in the market for Rs; 110,000, transportation cost is the responsibility of bank. Following is profit calculation.

Sale price	10 X 110,000	1,100,000
Cost of goods sold	10 X 100,000	(1,000,000)
Transportation cost		(12,000)
Gross profit		88,000
Commission	8% of 100,000	(7,040)
Net profit		80,960
Percentage return p.a.		0.08

2. Damage during the transportation is to be charged to the seller who is a bank in this case.

Sale price	10 X 110,000	1,100,000
Cost of goods sold	10 X 100,000	(1,025,000)
Transportation cost		(12,000)
Gross profit		63,000
Commission	8% of 63,000	(5,040)
Net profit		57,960
Percentage return p.a.		0.06

3. For delay more than 15 days penalty is due on the manufacturer to compensate the purchaser, hence, a penalty of Rs; 50,000 shall form part of the income of bank.

Sale price	10 X 105,000	1,050,000
Cost of goods sold	10 X 100,000	(1,000,000)
Transportation cost		(15,000)
Gross profit		35,000
Profit on trading		35,000
Penalty received		50,000.00
Net income		85,000
Percentage return p.a.		0.09

4.6. Questions

1. Define Istisna'a and Parallel Istisna'a? What is the difference between Salam sales contract and Istisna'a?
2. What is Urboun? What is the difference in Penalty in Murabaha and Istisna'a?
3. Why Istisna'a contract cannot be executed for agricultural production and goods already manufactured?
4. Enlist at least five applications of Istisna'a contract of sale
5. Explain the steps in Istisna'a and Parallel Istisna'a?
6. Istisna'a and Parallel Istisna'a are jointly used by IFIs without going into the production process. Do not you think it is like lending on interest?
7. Can Istisna'a sales be executed for currency and shares trading?

Multiple Choice Questions

1. According to SBP-2010, what is an average share of Istisna'a in portfolios of IFIs working in Pakistan for last seventeen quarters (09/06-09/10)?

a. 03%
b. 04%
c. 06%
d. 08%

2. The prime condition of Istisna'a contract which makes it different from other types of sales is:

a. Nonexistence of goods at the time of contract
b. Payment of price in advance
c. Supply of specified products
d. Manufacturing process involved

3. Earnest money is received from customers to safeguard the interest of Islamic bank (almost) in every transaction. Where Islamic bank is entitled to forfeit the whole amount irrespective of amount of loss, it is known as:

a. Penalty
b. Hamish Jiddiya
c. Urboun
d. All of the above

4. Urboun and Hamish Jiddiya both are a type of security deposit. Which of the following is the correct interpretation?

a. Urboun is charged against contract while Hamish Jiddiya against a promise.
b. Urboun is charged against promise while Hamish Jiddiya against a contract.
c. Urboun is charged in Istisna'a while Hamish Jiddiya in Murabaha.
d. Urboun is charged in Murabaha while Hamish Jiddiya in Istisna'a.

5. At the time of entering into contract of Istisna'a price paid by bank to manufacturer is reported in the balance sheet as:

a. Investment

b. Receivables
c. Inventory
d. Fixed asset

6. Facto Cement is in need of financing to pay the overheads for coming six months and contacted to you (branch manager of Islamic bank) for the provision of cash subject to sale of cement to be manufactured. Which of the following is the most appropriate mode of financing to service the customer need?

a. Diminishing Musharaka
b. Salam financing
c. Istisna'a financing
d. Murabaha financing

7. The chief difference between a transaction of Salam sale and Istisna'a financing is:

a. Deferred delivery
b. Payment of price in advance
c. Delivery of physical goods
d. Manufacturing process

8. Istisna'a transaction is exempted from certain rules of sale as laid down by Islamic financial system. Which of the following is the correct interpretation?

a. Delivery is not required
b. Ownership of goods by seller is not required
c. Price certainty is not required
d. All of the above

9. To ensure prompt completion of the project under Istisna'a, it is allowed to stipulate a penalty clause. Which of the following penalty is imposed for delay in completion of the project?

a. Urboun
b. Hamish Jiddiya
c. Late payment charges
d. Late completion charges

10. The difference between a transaction of Salam sale and Istisna'a financing is:

a. Penalty imposed on late delivery under Salam

b. Penalty imposed on late delivery under Istisna'a
c. Payment of price in advance under Istisna'a
d. Delivery of physical goods under Salam

True/False

Mark the Following statements as True or False.

1- Contract of Istisna'a is binding upon parties involved provided certain conditions fulfilled including specifications of underlying subject matter (commodity), price and delivery date (if required).

2- Contract of Istisna'a is not a sale contract with deferred delivery of subject matter to buyer hence all rules of a valid sale are not applied except the existence of subject matter, ownership of seller and possession of the seller.

3- Contract of Istisna'a can be executed with a customer who is the purchaser of underlying commodity/subject matter from IFI and in the same Istisna'a transaction acts as manufacturer or contractor for the production and supply of subject matter.

4- Istisna'a sale is not limited to only for those commodities/projects where the raw material is transformed from its natural shape to a finished product by involving a manufacturing or construction process.

5- Istisna'a sale applies to both unique commodities with the specification or generally available commodities, and consumable goods or capital goods, however, the transformation from Raw material to finished goods through manufacturing or construction process is required.

6- Istisna'a sale can be executed for a product already manufactured and or constructed.

7- Under Istisna'a sale it is required that manufacturer produces the subject matter by himself using his production facilities. Production and construction can be outsourced subject to meeting the specifications. However if purchaser stipulate that production must be carried on by the seller himself, then outsourcing is not allowed.

8- Price in Istisna'a sale cannot be made at the spot. It must be deferred, subject to completion, stages of completion and in cash or kind as the parties agreed. However, determination of price on cost plus margin (Murabaha pricing) is not allowed. Hence, any un-estimated profit or loss is not required to be shared with purchaser.

9- Urboun (guaranteed consideration) cannot be demanded and forfeited if the contract is rescinded. However, it is preferred to forfeit an amount equal to actual damages suffered. It is also allowed to demand guarantee and security to secure the rights.

10- It is not permitted (by way of agreement, arbitrage, and judicial process), to change the price of contract due to intervening contingencies (force majeure).

11- It is permitted to appoint the ultimate purchaser as an agent of IFI to ensure the construction as per the specification of Istisna'a sale agreement by a separate contract of agency.

12- Penalty clause cannot be stipulated for the delay in completion to compensate the purchaser, however, penalty on default in payment by the purchaser is not allowed.

13- Manufacturer or builder can be appointed as agent of IFI to dispose of a commodity once the possession of subject matter is taken over.

14- Selling of subject matter in Istisna'a contract before taking the possession is not allowed however IFI can enter into a Parallel Istisna'a contract having the same specifications. The performance of Parallel Istisna'a contract must not be conditional on the completion of first Istisna'a contract.

4.7. Exercises

Ex.1. Bank Islami entered into an Istisna'a contract with CDA for fixing of chair-lift from Shakarparian to Daman-e- Koh for a price of Rs; 5,000,000 to be completed in one year. Contract of Istisna'a signed on 1st January 2009 and price shall be paid in four equal installments within one year of completion and hand-ing over. Bank Islami hired a local contractor K.K. Enterprises for completion of the project as per the desired specification on following terms for a price of Rs; 4,500,000. Parallel Istisna'a contract signed on 10th of January 2009. Bank ap-pointed Mr. Dada as a project engineer for amounting to Rs; 300,000.

1. Project completion date set as 15th December 2009, with a penalty of Rs; 2, 00,000 for delay of one month and incentive of Rs; 200,000 for completion of project one month earlier.

2. Payment shall be released in four equal installments subject to progress on the project as follow.

1st installment March 31, 2009	2nd installment June 30, 2009
3rd installment September 30, 2009,	Final installment at completion

Required:-

1. Is it a valid transaction?
2. If both contracts executed smoothly in time what is profit of bank? What is percentage return p.a. on investment?
3. If K.K. Enterprises completed contract one month earlier than due date what is profit of bank?
4. If K.K. Enterprises completed contract one month late than due date what is profit of bank?

5. If K.K. Enterprises delivered in time however after examination by CDA engineer it is found that certain specifications were not fulfilled and projected accepted for a 10% reduction in price, what is profit of bank? What is % return per annum on investment?

Ex.2. Mr. Ali is the manufacturer of cement and requires funding to replace one of its machines being vital for the production process. Mr. Ali is a very trusted customer of Albaraka bank who agreed to supply the machine to Mr. Ali on following terms. Contract of Istisna'a signed on 1st of March 2010.

1. Payment shall be made in the form of finished cement of 5,500 bags after 6 Months of delivery of Machine.
2. The penalty of Rs; 5,000 shall be levied per day for the period of default to compensate the bank.
3. Urboun of Rs; 100,000 received to be forfeited if default continued for 20 days and contract shall be rescinded. It is further agreed either penalty or Urboun shall be exercised.

The machine is manufactured internationally and requires import from Dubai. Estimated purchase price in Dubai is AED 50,000. Mr. Khan having an office in Islamabad is doing the business of import of such machinery for 2% commission of import price paid to vendors. Transportation and insurance etc. are paid by the local purchaser. Machine imported by Mr. Khan on request of Bank and claimed following expenses from Albaraka bank.

Description		
Payment to vendor	AED	48,000
Commission	AED	960
Transportation	AED	500
Insurance	AED	480
Total	AED	49,940

Machine delivered to Mr. Ali on 20th March 2010. Bank entered into a Parallel Istisna'a contract with Zolfo a local distributor of cement @ Rs; 260/- per bag on June 20th, 2010, price to be paid on delivery (before 15th October 2010).

Required:-

1. If the exchange rate is 25:1 what is the price of the machine to be used in Istisna'a contract? What is the purchase price of per bag cement in Istisna'a contract?
2. If Mr. Ali delivered goods in time, what is profit of bank?
3. If Mr. Ali delivered goods 15 days late, what is profit of bank?
4. If Mr. Ali could not deliver goods within 20 days of the due date and the bank had to purchase from open market @ Rs;240/- per bag to supply to Mr. Zolfo, what is profit of bank? What is amount receivable from Mr. Ali?

Suggested readings

- AAOIFI. 2004. *Shari'a Standards.* P.O. Box 1176, Bahrain.
- AAOIFI.2003. *Accounting and Auditing Standards for Islamic Financial Institutions,* International Institute of Islamic Economics, Islamabad, Pakistan.
- SBP 2010. [State Bank of Pakistan] *Islamic Banking Bulletin 2007-2010.*
- Usmani, T.S., 2002.An Introduction to Islamic Finance. Maktaba Ma'arif Al Quran, Karachi, Pakistan.

ISTISNA'A IN ACTION

Penalty is charged in case of delay in delivery and contract is executed however Urboun is charged when contract is rescinded. Normally a single source of compensation is used in a contract of Istisna'a.

Chapter 5

Ijarah Financing

Airline industry has a great potential for Ijarah Financing

Ijarah is an agreement of extending the facility of usufruct of an asset for agreed rentals for a specific period. Ijarah is a substitute of conventional leasing within constraints of Shari'a (Islamic law). Ijarah is one of the dominants modes of financing in portfolios of IFIs working in Pakistan with an average share of 22% during last 17 quarters 09/06-09/10. Normally Ijarah ends into sales contract hence very much similar to finance lease.

Learning objectives

After going through this chapter reader should be able to understand and interpret the following:

What is Ijarah financing?

What are Shari'a rulings about operations of Ijarah financing?

What are steps in a transaction of Ijarah financing?

What are similarities & differences in the conventional lease and Ijarah financing?

What is the financial impact of Ijarah financing and how it is accounted for?

5.1. Introduction

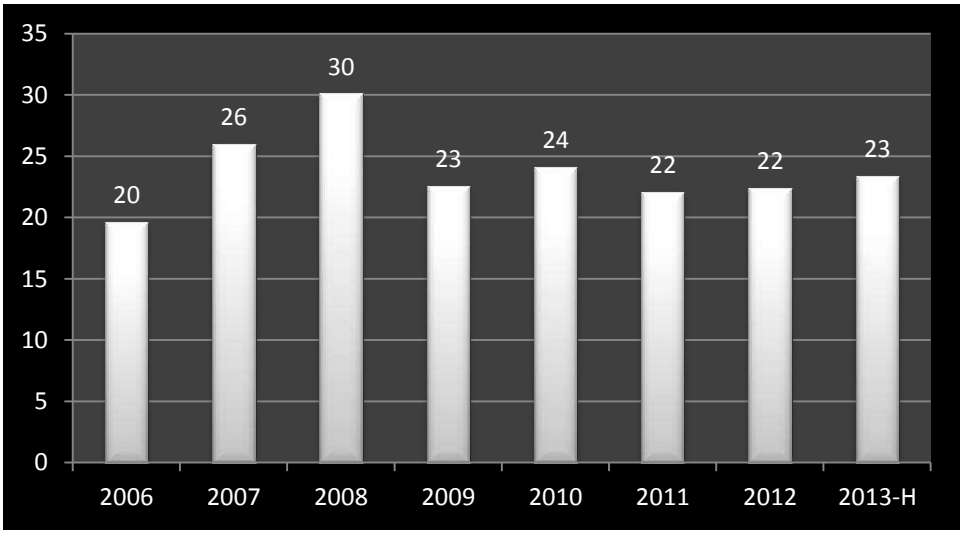
Consensus by jurisprudence: Since all the people are not in a position to own the assets, it is convenient for them to acquire the use of assets that they do not own. Ijarah (Leasing) is a rental contract whereby an IFI leases an asset for a specific rent and period to the client. Ownership risks of the asset are borne by IFI while expenses relating to use the asset are the responsibility of the client. The difference between Ijarah and sale is that ownership in Ijarah remains with lesser while in the case of sales it is transferred to the purchaser. Ending Ijarah in the sale of the asset is allowed by IFA through a separate contract at the completion of the term of the lease. The contract can be executed before purchase and possession of the asset. Consumables cannot be leased out. Right of lessee to use the asset is restricted to lease agreement or/and as per normal course of business. Lessee is liable for any harm to the asset caused by any misuse or negligence on his part. Rentals of joint property are shared according to equity. A joint owner can rent his share only to the copartner. Inter Bank Rate can be used as a benchmark for the amount of rentals. At the completion of Ijarah term either asset is returned to IFI or purchased by the client (Shari'a standard 9).

Ijarah has replaced successfully the facility of leasing under the conventional financial system. Ijarah is also dominating along with Murabaha and diminishing Musharaka in portfolios of IFIs working in Pakistan. Figure 5.1 depicts the progress made by IFIs under Ijarah financing during 17 quarters (09/06 – 09/10). The average share of Ijarah in portfolios of IFIs working in Pakistan is 22% which is appreciable, however with the decreasing trend which is due to overall low economic activity in recent years. Figure 5.2 presents closing amounts of investments under Ijarah mode of financing.

Figure 5-1. Percentage share of Ijarah in portfolios of IFIs

Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Jun 08	Sep 08
32.84%	29.84%	29.66%	30.23%	28.87%	24.10%	21.52%	21.26%
Dec 08	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10
20.53%	21.41%	18.18%	21.56%	14.24%	14.00%	14.51%	13.62%

Figure 5-2. Closing Amounts PKR Billion of investment under Ijarah 12/06-06/13



Source: SBP-Islamic Banking Bulletins

5.2. Summary of Shari'a Rulings

Rule.1- Ijarah Wa Iqtana. Ending Ijarah contract in the transfer of ownership of asset at the completion of the term of the lease is allowed, however through a separate contract, for consideration or without it. If an asset is under sale and leaseback then a reasonable period between lease and resale must have expired. Both contracts of lease and sale cannot be executed at the same time. In the case of transfer of ownership lease rentals can be accelerated to cover the price of asset however in such case if asset destroys during lease period without negligence of lessee or transfer becomes impossible, the excess amount is required to be refunded to Lessee.

Average share of Ijara in portfolios of IFIs working in Pakistan is 22% which is appreciable, however with decreasing trend which is due to overall low economic activity in recent years.

Mr. A entered into a contract of Ijarah with local Islamic bank to acquire a motor vehicle costing PKR 1,000,000. Lease term is five years. The contract ended in the transfer of ownership to lessee for a token price of Rs; 50,000.

Mr. X entered into a contract of Ijarah with local Islamic bank to acquire a car amounting to PKR 1,500,000. Lease term is seven years. It was agreed that if lessee makes prompt payments, then asset shall be gifted to him after seven years.

In both of these above examples, inflated rent was charged by the bank to cover principal as well as profit. If asset destroyed without negligence of lessee, excess rent so recovered by the bank must be returned to the lessee.

Rule.2- Contract of Ijarah (lease) can be executed before purchase & possession of asset by Mujeer (lesser).

Mr. B entered into a contract of Ijarah with an embassy to provide ten cars [as per agreed specification] on lease and contract finalized. It is a valid contract even if Mr. B is not the owner of cars at the time of contract. Likewise, an Islamic bank can enter into a contract of Ijarah with the customer before purchasing of the asset.

Rule.3. Commitment fee (Hamish Jiddiya) can be received in advance to compensate the IFI in the case of breach of promise by the customer to acquire asset on rent. The security for commitment is kept by the bank as Amanah (safe keeping but not using) except with the permission of client to invest on Mudaraba basis. It can also be used as an advance rental by mutual agreement. Bank can claim from customer only actual loss suffered and not the time value of money. For breach of promise customer is charged either:-

1. The difference between the cost of the asset and the total rentals agreed with the third party to whom the asset would be leased.
2. However, If the asset is sold in the open market, the difference between the total cost of the asset and the selling price.

Mr. Umel contacted local Islamic bank to supply a textile machine to him under Ijarah contract. Mr. Umel made a promise to obtain asset under five years Ijarah after purchase by local Islamic bank and deposited PKR 100,000 as a security deposit. After the

Mustager (Lessee) is permitted to sublease whole or any part of asset to a third party (except owner of asset) for any agreed amount of rent.

purchase of machine by local Islamic bank, Mr. Umel showed a lack of interest in the machine. Machine costing PKR 1,000,000 was disposed of PKR 950,000. Loss of PKR 50,000 is to be reimbursed by Mr. Umel. IFI is required to return PKR 50,000 to Mr. Umel out of 100,000 deposited earlier as security. Suppose instead of selling asset bank succeeded in negotiating Ijarah with Mr. Latif for five years period. As per agreement lessee will pay PKR 250,000 per year for a term of the lease (5 years) and Bank shall gift the asset at completion to lessee. In this case, the bank is required to refund the whole amount of PKR 100,000 to Mr. Umel as there is not an actual loss to Bank on this transaction.

Rule.4. Sale and lease back is allowed provided that lease is not stipulated in the sales contract, and both contracts are independent.
Mr. A needs cash and contact local banker for the sale of his house. Through a separate contract the same house can be taken back by Mr. A on lease and after passing a reasonable amount of time, the same house can be resold to Mr. A for an agreed price by Bank.

Leased asset is the responsibility of the lesser throughout the duration of Ijarah.

Rule.5. Mustager (Lessee) is permitted to sublease whole or any part of the asset to a third party (except the owner of the asset) for any agreed amount of rent, unless the owner stipulates in Ijarah contract, binding lessee from subletting. Sharing of usufruct by more than one person is permitted.
A car acquired on Ijarah from an Islamic bank can be used for hire, can be subleased by the lessee to anyone else. Mr. X acquired a house on Ijarah from an IFI for PKR 30,000 per month and given on rent to a local business house for PKR 40,000 per month.

Rule.6. Mustager (Lessee) can be appointed as agent of IFI to acquire the asset as per his desire and specification although it is preferred that IFI acquires the asset by its arrangements without involving the customer in the purchase process. However, the price should be paid to the vendor by IFI.

A farmer wants to acquire a rice husking machine and contacted local Islamic bank to finance. Bank agreed to provide asset under Ijarah with a clause to gift asset at the end of the lease term to lessee if all lease rentals made in time. As the bank has no expertise about rice husking machine, hence authorized the lessee to search and select asset of his choice. After selection, the machine is purchased in the name of IFI and payment made directly to the seller. Lessee made payment in time and at the end of lease tenure machine gifted to the farmer.

Rule.7. Ijarah (lease) contract is binding contract which neither party may terminate or alter without the consent of other except following:-

1. Mujeer (lesser) sell the asset to a third party (lessee's consent is not required on the sale of an asset, however, it must be known to the purchaser that asset is under lease).
2. In the case of destruction of leased asset.
3. If the asset is partially damaged leading to an impairment of expected benefits to the lessee, he can terminate the lease contract.
4. Any of the parties holds an option to terminate the contract as per lease agreement.
5. Force majeure (intervening contingencies)
6. Lesser stipulates in the contract of lease that lease shall come to an end if lessee defaults in payment of rent.
7. In the case of death of lessee if heirs can prove that the contract of the lease has become, after the death of legator, too onerous for their resources and in excess of their needs.

Commitment fee (Hamish Jiddiya) can be received in advance to compensate the IFI in case of breach of promise by customer to acquire

Mr. Mir, an owner of a house in G-10/1, entered into five years operating Ijarah with Mr. Khan for a lease rental of PKR 600,000 per year. A clause was inserted into Ijarah agreement that any of the parties can terminate the contract with one month notice. After passing two years, Mr. Mir sold the house to Mr. Chaudhary, who agreed to continue the Ijarah agreement with Mr. Khan on the same terms and conditions. The earlier contract

between Mr. Mir and Mr. Khan ended, and a new contract is required between new owner and Mr. Khan.

Mr. Abdul obtained a car under Ijarah from Margalla Islamic bank for five years term. As per the agreement, the lessee is required to pay a monthly installment of PKR 10,000. After two years car was stolen without negligence of Mr. Abdul and local Islamic bank could not provide replacement of car. Hence, Mr. Abdul is no more required to pay lease rentals and Ijarah contract stood terminated. Also, if it was an Ijarah ending in the transfer of ownership [Ijarah wa Iqtana] with or without consideration, any rent charged above the market rent should be returned to the lessee.

Mr. Agha entered into a contract of lease with local Islamic bank for the hiring of a truck to be used as a delivery van. The lease term was five years, and annual rentals were PKR 500,000. As per the agreement, the asset would be transferred to lessee at the completion of the lease term. It was further agreed that lease shall stand to cancel if lessee defaults for more than a month after due date, however, the lessee would have the option to acquire an asset by making payment of the whole amount due [remaining lease rentals]. After making three installments lessee could not arrange the fourth. Hence Ijarah stood canceled, however, as it was Ijarah wa Iqtana [ending lease in the transfer of ownership], hence, the difference of actual rentals paid and market rent of asset must be refunded to Lessee.

Rule.8. Urboun (earnest money) is permitted. If Ijarah contract is executed, Urboun may be adjusted against lease rentals. If the lessee does not execute Ijarah contract, IFI can forfeit the Urboun. However, it is preferable to charge up to the actual loss suffered (excluding time value of money).

Mr. Umel contacted local Islamic bank to supply a textile machine to him under Ijarah contract. Ijarah contract was signed before the purchase of the asset. According to contract, Mr. Umel will pay PKR 275,000 per year for five years. After five years asset shall be transferred in the name of the lessee as a gift from the lessor. Lessee deposited PKR 100,000 as a security deposit. After the purchase of machine by a local Islamic bank, Mr. Umel showed a lack of interest in the machine. Machine costing PKR 1,000,000 was disposed of PKR 950,000. IFI has

the right to forfeit whole security deposit however it is preferred to charge only Loss of PKR 50,000 and refund the balance. Suppose instead of selling asset bank succeeded in negotiating Ijarah with Mr. Latif for five years period. As per agreement lessee will pay PKR 250,000 per year for a term of the lease (5 years) and Bank shall gift the asset at completion to lessee. Even, in this case, bank is not required to refund the whole amount of PKR 100,000 to Mr. Umel, although there is no actual loss to Bank on this transaction. However, it is preferred to refund the whole amount to Mr. Umel. Under Islamic financial law, the loss is the actual amount suffered and not the difference of rent between two Ijarahs [125,000].

Rule.9. Subject matter (asset) of the lease must be capable of being used while preserving the asset (consumables cannot be leased), and benefits from Ijarah must be lawful in Shari'a. Ijarah contract can be executed with a non-Muslim subject to; the use of asset must not be for Haram (unlawful) purposes. In the case of damage to asset during lease tenure following rule applies.

a. Damage is caused due to the negligence of lessee, he is responsible for repairing and also pay the rentals for a period asset is not used and remained under repair.

b. Damage caused without negligence of lessee, the lessor is responsible for repair, and no rent shall be charged for the period during which asset was not useable.

During repair and overhauling phase, IFI cannot charge the rentals while conventional banks continuously receive the installments consisting of interest as well as principal irrespective of usage of asset by lessee.

Mr. Bala G [a Hindu] entered into an Ijarah agreement with Margalla Islamic Bank to supply a machine to be used in manufacturing of soft drinks with halal ingredients is a valid Ijarah, however if the same machine is acquired to be used in manufacture of liquor, it would be a void agreement for Margalla Islamic Bank.

Mr. Hassan [a Muslim] entered into a contract of Ijarah with local Islamic bank to hire a machine to be used in the manufacture of liquor to be exported to non-Muslim customers only, is a void contract eb initio.

Mr. Rahul entered into a contract with local Islamic bank to hire a car for five years Ijarah term. Accordingly lessee pays rental of PKR 12,000 per month. After two years a major accident occurred, and repair took three months and charge of PKR 100,000. If the accident was the result of negligence attributed to the lessee, then lessee is required to pay repair charges as well as rentals of three months[although asset was not available for use] period when asset went through the repair. However if the accident was not the result of lessee's negligence, then the bank will pay repair charges as well as shall not claim rent of three months from Mr. Rahul, because rent can be demanded only if the asset is available for use by the lessee.

Rule.10. Lessee is required to use the asset in a suitable manner or conformity with common practices and comply with conditions acceptable in Shari'a. Operating maintenance (ordinary) is the responsibility of the lessee.

IJARA IN ACTION
MB leased a car without transfer of ownership to DC for 5 years. After two years car was snatched by a group of Dacoits and police failed in recovery. Should DC be charged for rentals of remaining period? Answer at end.

Rule.11. Leased asset is the responsibility of the lesser throughout the duration of Ijarah. He is responsible for major repairs and maintenance. Permissible insurance is the responsibility of lesser. (However, he can delegate the tasks of insurance and maintenance to lessee on lesser's expenses).

Mr. A hired a house from Taxila property for PKR 100,000 per month with an agreement that total repair is the responsibility of lessee is a void contract as lessee agrees to pay rent in the form of major repair which is not known. Knowing of rental is essential in a contract of Ijarah, hence, contract with total repair done by the lessee is a void contract. However if the lessor is willing to reimburse for major repairs, the job can be done by the lessee.

Rule.12. Lease rentals may be in cash or kind (goods) or benefit (service) and must be specified as a lump sum or installments, fixed or variable based on a des-

Urboun (earnest money) is permitted. If Ijarah contract is executed Urboun may be adjusted against lease rentals. If Ijarah contract is not executed by the lessee, IFI can forfeit the Urboun.

ignated method by agreement of parties. Lease rentals are due from the period lessee starts using asset or asset made available for use to him. If rentals are variable, it is necessary to fix the rent for the first period and then tie up with a benchmark (e.g. inflation index, interbank offered rate, etc.). Such a benchmark must be based on a clear formula subject to floor and ceiling. Rentals of any future period can be fixed (changed) with agreement, however, unpaid rentals for the past cannot be increased being receivables from the lessee. If the lessee stops using the asset or returns it to the owner without owner's consent, the rent will continue to be due for remaining period of Ijarah subject to the condition that lesser keeps the asset available to the current lessee.

Mr. Alam entered into an Ijarah agreement with an IFI to hire a car for five years lease term. At the completion of the term, the asset shall be transferred to Mr. Alam for zero consideration. It was decided to charge the rent based upon KIBOR plus 2% of the investment. Accordingly first-period rent calculated and agreed by both parties and, later on, rent amount is not known, however, a well thought out and understood formula agreed by the parties. Knowing of rent is essential, and it cannot be left unknown. However, it is allowed to benchmark the rent with a reliable index subject to floor and ceiling as this will tell the lessee a range of expected rentals to be paid.

Rule.13. All permissible securities including guarantees to secure the rights of lesser against the negligence of lessee, default in payments, etc. are allowed. Penalty on default by Lessee can be stipulated in the contract of Ijarah, however, it cannot form part of the income of lesser and must be used for charitable purposes under the co-ordination of IFI's Shari'a supervisory board.

Mr. Y entered into five years Ijarah with local IFI. Lease term is five years after that asset shall be handed over to Mr. Y for zero consideration. Mr. Y agrees in the contract to pay an amount equal to KIBOR plus 1 percent of the installment due as a penalty for the period of default calculated on 360 days basis. This

amount is the same as being charged by conventional banks to their customers; however this amount goes to charity and does not form part of the income of IFI.

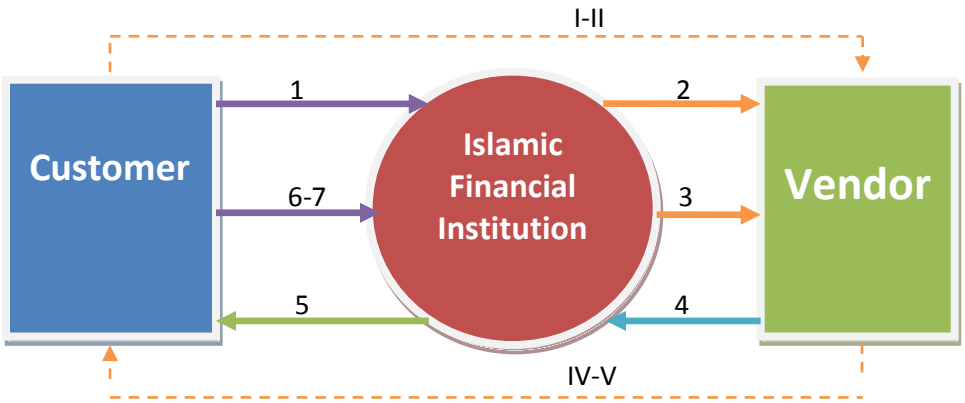
5.3. Steps in Ijarah

Under normal circumstances following steps are involved in an Ijarah contract without transfer of ownership. However if ownership is transferred that is also accommodated in step four. Figure 5.3 depicts the Ijarah process.

1. Customer contacts to an IFI for the provision of the desired asset and provides specifications. The customer signs a written promise or contract of Ijarah. It is pertinent to note that Ijarah contract can be signed with a customer without having ownership of the asset. However such contract would be effective at a date when asset made available for use. It is also customary to identify the supplier of asset [Written promise or Ijarah contract].

2. IFI either Purchases/arranges the asset from the vendor by entering into a purchase agreement [Purchase order]. Under some exceptional cases, IFI appoints the customer as an agent to purchase the required asset on behalf of IFI. In this case, the asset is purchased in the name of IFI and IFI is responsible for all risks and rewards of ownership [I-II].

Figure 5.3. Graphic presentation of Ijarah process



3. After receiving the invoice [asset is purchased], IFI makes payment to the vendor [Cash or cheque in the name of Vendor].

4. The asset is transferred to the ownership and possession of IFI [Transfer of Title in the name of IFI]. Under some exceptional circumstances, the asset may be transferred directly from vendor to customer; however risk of ownership is to be borne by IFI [IV-V].
5. The asset is handed over to the customer by signing Ijarah contract [Ijarah contract].
6-7. The customer takes the benefit of usufruct customer makes periodic lease rentals to IFI and finally purchase price [token amount] is paid if required to take possession of the asset. [Cash or cheques in the name of IFI and finally sales contract, if required]

5.4. Comparative Study of Ijarah and Lease

In this section, I have listed the points of difference between lease and Ijarah.

1. Under Ijarah rent is charged when the asset is made available to the lessee for use while under conventional leasing interest is charged once the contract is signed irrespective whether the asset is actually available for use or not. Any rent received before delivery of asset is not forming income of an IFI and treated as a liability which is not the case under interest-based banking.

Under Ijarah rent is charged when the asset is made available to the lessee for use while under conventional leasing interest is charged once the contract is signed irrespective whether asset is actually available for use or not.

2. During repair and overhauling phase, IFI cannot charge the rentals while conventional banks continuously receive the installments consisting of interest as well as principal irrespective of usage of the asset by the lessee.
3. Under Ijarah sale of asset and lease of an asset takes place through two separate contracts. Contract of Ijarah is signed by the time of asset handed over for use and contract of sale is signed by the time ownership is transferred while under conventional leasing a single contract includes sale and lease.

4. Under Ijarah risk of asset is mitigated through Takaful only (permitted mode of risk sharing) while under conventional lease risk is minimized through insurance (prohibited mode of risk sharing)
5. Under Ijarah, all rights and liabilities of ownership lies with the IFI being the owner of the asset while usage related rights and liabilities lies with customer being user. Under conventional leasing, all such rights and liabilities are placed on the user without distinguishing.
6. Under Ijarah rentals stopped once the asset has become unusable due to any reason (e.g. theft, destruction, etc.) without negligence of customer which is not the case under conventional leasing.
7. The penalty for default in prompt payment is levied in both cases however usage of penalty is different. Under conventional leasing it is the late payment charges and covers time value of money lost by leasing company hence, it is compensation for leasing company while under Ijarah it is not the income of lesser rather it goes to charity being coordinated by Shari'a supervisory board of IFI.

5.5. Financial Impact of Ijarah

Financial reporting and financial impact of Ijarah are discussed in the following paragraph. I shall illustrate with a hypothetical balance sheet and show the impact of different transactions under Ijarah on the balance sheet of an IFI. Balance sheet of an IFI is little different from balance sheet of a conventional bank in the sense that IFIs accept deposits either as loan which is in line with practices of conventional banks and does not create any difference in balance sheet; or on profit and loss sharing basis under Musharaka and Mudaraba which changes the nature of relationship between customer and IFI. Deposits under profit and loss sharing (PLS) models including Musharaka & Mudaraba are not shown as liabilities rather form part of equity.

Penalty for default in prompt payment is levied in both cases however usage of penalty is different.

IFIs should promote this philosophy among their customers that investor deserves higher return keeping in view the bearing of more risk as compared to conventional leasing.

On the other hand, conventional banks lend money for interest and show advances to customers as an asset while IFIs do not lend cash rather sell the goods on credit, hence, resulting in receivables under Murabaha, Muajjal etc. Furthermore IFIs invest in businesses who need cash financing under schemes of Musharaka & Mudaraba, hence, investment under Musharaka & Mudaraba is shown as an investment and not the receivables or advances. Let us look at a simple balance sheet of an IFI as follows.

Suppose, on January 01, 2006, ABC Company contacted the Gujranwala branch of the bank to provide a car costing Rs; 1,500,000, on lease for five years, payable in five equal annual installments at the beginning of the year. Bank promised to gift the asset after five years subject to prompt payment of lease rentals. Bank wants to earn 10% per annum on this deal.

Margalla Islamic Bank

Balance Sheet, as at December 31, 2005

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	3,375	Payables and balances	400
Accounts R/A	2,000	Current deposits	3,600
Inventory (assets for sale)	500	Charity fund	4
Salam financing	500	**Total liabilities**	**4,004**
Short term investments	150	**Equities**	
Total current assets	**6,525**	PLS deposits balances	1,800
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
	3,000	Statutory reserves	400
Total long-term assets		R. earnings/ Unapprop	321
		Total Equities	**4,521**
Total assets	**9,525**	**Total liab & Equities**	**9,525**

IRR formula is based on concept of time value of money hence not recommended for charging customers under Islamic modes of financing.

Two of the calculation methods are explained here. First is traditional method of installment calculation by applying following formula:

$$P = R[1 - \frac{(1+i/m)^{-nm}}{i/m}](1 + \mathrm{i})$$

Where *P* is the amount spent on the purchase of an asset, *R* is the installment, *I* is the rate of return, *n* is the number of years and *m* is number of compounding in a year. This formula is based on the concept of time value of money hence not recommended for use in Islamic modes of financing. As per this formula if we calculate five equal annual installments compounded annually amount of each installment becomes approximately Rs; 359,700 rounded to 100.

Second is to calculate rent on the basis of rentals of underlying asset prevailing in the market. Suppose rental of this type of car is Rs; 216,000 [18,000 per month] in the market but without transfer of ownership. It is assumed that impact of any inflation on rentals shall be equally offset by the depreciation in value of the car, hence, no increase in rentals. Suppose further after five years, estimated residual value of the car is Rs; 875,000. As the bank has promised to gift the car at the end without any consideration so the capital and return must be recovered through installments. To accelerate the payments, the residual value is included in the amount of installments hence amount of each installment becomes 391,000 [175,000+216,000]. Bank shall receive Rs; 391,000 of investment immediately hence no return for this amount. So actually investment is Rs; 1,109,000 and bank receives extra for four years amounting to Rs; 455,000 [(391,000 X 4) – 1,109,000] which is 41% of original investment and average annual return is 10.3%.

Certainly amount is higher from conventional banking; actually customer is required to pay an additional amount of Rs; 156,500 (in present value terms 130,500) rounded to 100 during the lease term. Is it a cost of being Muslim as some quarters claim; and following Islamic financial system? The answer is no! a strong No! Look at the nature of contract under both systems. First is the bearing of risk level by the investor and demanding a higher return for higher risk is

well established and accepted principle of finance. IFI is bearing the total risk of ownership during the lease term and mitigates through the permissible mode of insurance on its expenses while under the conventional leasing system risks are transferred to the customer. Second if asset demands certain overhauling IFI do not receive the rentals while under conventional system installments are required irrespective whether the asset is in repair or usage phase. IFIs should promote this philosophy among their customers that investor deserves higher return keeping in view the bearing of more risk as compared to conventional leasing. I recommend the second method to be used in the calculation of rentals, under Ijarah, by IFIs.

By following the second method let us look at financial impact of these transactions on the balance sheet of Margalla Islamic Bank, presented below. When an asset is acquired cash reduced by 1,500,000 and equal value of asset inserted in the balance sheet under the name of the asset under Ijarah. After handing over the asset to lessee first installment is received which increased cash balance and unearned revenue because the asset is yet to be utilized. **Work Sheet** (Rs in '000')

	DEC	JAN	DEC	JAN	DEC	JAN	DEC	JAN	DEC	JAN	DEC	Balances
Description	2005	2006	2006	2007	2007	2008	2008	2009	2009	2010	2010	Dec, 2010
Cash	3375	-1109		391		391		391		391		3830
Account R/A	2000											2000
Inventory	500											500
Asset under Ijara	0	1500	-300		-300		-300		-300		-300	0
Salam Financing	500											500
Short term inv	150											150
Investment PLS	1000											1000
Property, Plant &	2000											2000
TOTAL	**9525**	**391**	**-300**	**391**	**-300**	**391**	**-300**	**391**	**-300**	**391**	**-300**	**9980**
Payables	400											400
Current deposits	3600											3600
Unearned revenue	0	391	-391	391	-391	391	-391	391	-391	391	-391	0
Charity fund	4											4
PLS Deposits	1800											1800
Paid up capital	3000											3000
Statutory reserve	400											400
Retained earnings	321		91		91		91		91		91	776
TOTAL	**9525**	**391**	**-300**	**391**	**-300**	**391**	**-300**	**391**	**-300**	**391**	**-300**	**9980**

Margalla Islamic Bank Balance Sheet, as at December 31, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	3,830	Payables and balances	400
Accounts R/A	2,000	Current deposits	3,600
Inventory (assets for sale)	500	Charity fund	4
Salam financing	500	**Total liabilities**	**4,004**
Short term investments	150	**Equities**	
Total current assets	**6,980**	PLS deposits balances	1,800
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equip-	2,000	Paid up capital	3,000
ment	**3,000**	Statutory reserves	400
Total long-term assets		R. earnings/ Unapprop	776
		Total Equities	**5,976**
Total assets	**9,980**	**Total liab & Equities**	**9,980**

At the end of the financial period, asset is depreciated by five years economic life without considering residual value because asset shall be transferred to lessee for zero price, and unearned revenue is converted to revenue realized. The following worksheet shows the impact of these transactions on balances every year.

Suppose contract includes a clause of Urboun (earnest money) amounting to Rs; 200,000 and lessee refuse from the execution of contract after the purchase of car by the bank. Bank has to dispose of the car in the open market at a loss of Rs; 100,000 by the end of March 2006. Under these circumstances bank can forfeit the amount of Urboun in full or equal to loss. If Urboun forfeited in the full bank has earned a profit of Rs; 100,000 otherwise no profit no loss. Although it is preferred to charge from lessee equal to actual loss, however, one must pay due consideration to the fact that IFIs are not charitable institution rather very much commercial institutions and have to serve the depositors, meet the operating charges and earn profit for shareholders hence zero return on investment of Rs; 1,500,000 for three months in underlying case may not be justifiable especially in banking business where depositors are free to deposit and withdraw at any time

plus expect some earnings as well. This frequency of deposits changing hands had led the banking business to calculate return on daily product basis, and prepare income statements for shorter periods including monthly and quarterly basis. Suppose car was insured for a yearly premium of Rs; 50,000 with PQFT and in the fourth year June 30th 2009, the car met a severe accident without negligence of lessee and declared a total loss, with a recovery of Rs; 100,000 by the sale of scrap. Insurance claim finally agreed at Rs; 1,000,000. The impact of the transaction is shown in the following worksheet. For four consecutive years bank is paying an amount of Rs; 50,000 to mitigate the ownership risk under Ijarah hence reducing its income. Any amount received from insurance and sale of scrap belongs to the bank. As this was the case of Ijarah Muntahia Bittamleek (transfer of ownership) through gift and lessee paid more than fair market rentals, hence, the excess amount must be refunded to him which is an amount of Rs; 700,000 [175,000 X 4]. Furthermore, 50% of the rentals received in advance should also be refunded to him because the asset was not available to him for use for six months. Consequently total refund to lessee becomes Rs; 808,000 [700,000 + 108,000]. Under these circumstances IFI earned total amount of Rs; 156,000 [Inflow – Outflow] for 3.5 years (average annual Rs; 44,600) which is 14% (average annual 4%) only.

Work Sheet (Rs in '000')

	DEC	JAN	DEC	JAN	DEC	JAN	DEC	JAN	JUN	JUN	Balances
Description	2005	2006	2006	2007	2007	2008	2008	2009	2009	2009	Jun-09
Cash	3375	-1159		341		341		341		292	3531
Account R/A	2000										2000
Inventory	500										500
Asset under Ijara	0	1500	-300		-300		-300		-150	-450	0
Salam Financing	500										500
Short term inv	150										150
Investment PLS	1000										1000
Property, Plant &	2000										2000
TOTAL	**9525**	**341**	**-300**	**341**	**-300**	**341**	**-300**	**341**	**-150**	**-158**	**9681**
Payables	400										400
Current deposits	3600										3600
Unearned revenue	0	391	-391	391	-391	391	-391	391	-391		0
Charity fund	4										4
PLS Deposits	1800										1800
Paid up capital	3000										3000
Statutory reserve	400										400
Retained earnings	321	-50	91	-50	91	-50	91	-50	241	-158	477

5.6. Concept Building

Illustration.1. Mr. Zahoor contacted Meezan Bank Islamabad for the supply of a machine on lease for five years. The cost of the machine is Rs; 500,000. Useful life is five years with a residual value of Rs; 50,000. Meezan Bank appointed the customer to purchase asset on behalf of the bank as per his desire and specification. Expenses incurred during purchase process amounting to Rs; 10,000. After the purchase of an asset, customer informed the bank. Meezan Bank agreed to deal on following terms.

1. Urboun of Rs; 70,000 is received to be forfeited in case of failure of the lessee to execute the contract after the purchase of the machine.
2. A penalty equal to 5% of amount due shall be charged if default continued for more than ten days.
3. Lease rentals are payable semiannually at the beginning amounting to Rs; 72,000 during lease period; residual value is the property of the bank.

After an exchange of offer and acceptance, contract of lease for five years, was signed at January 1st 2006.

Required:-

1. What is average annual profit and average annual return on investment of bank if transactions carried out smoothly and asset sold for Rs; 70,000 at the end of lease term?
2. What is average annual profit and average annual return on investment of bank if asset damaged without negligence of lessee and repair took 30 days for an amount of Rs; 40,000 in the fourth year while residual value fetched only Rs; 30,000?
3. What is average annual profit and average annual return on investment of bank if asset damaged with negligence of lessee and repair took 30 days for an amount of Rs; 40,000 in the fourth year while residual value fetched only Rs; 30,000?
4. What is average annual profit and average annual return on investment of bank if lessee failed in making final two payments within grace period in each of the above three cases?

Solution

1. The following worksheet shows the profit calculation and % return.

Descriptions	Rs.	Descriptions	Rs.
Amount invested	(500,000)	Lease rentals	720,000
Immediate return (first installment)	72,000	Depreciation	(450,000)
Net investment	(428,000)	Gain on sale of Asset	20,000
Cash inflows	718,000	Total profit	290,000
Net cash inflows	290,000	Average Annual profit	58,000
Total return	68%		
Average annual return	14%		

2. The following worksheet shows the impact of damage resulted in the expenditure of Rs; 40,000 and loss of rent amounting to Rs; 12,000 for one month.

Descriptions	Rs.	Descriptions	Rs.
Amount invested	(500,000)	Lease rentals	708,000
Immediate return (first installment)	72,000	Depreciation	(450,000)
Net investment	(428,000)	Loss on sale of Asset	(20,000)
Cash inflows	626,000	Repair	(40,000)
Net cash inflows	198,000	Total profit	198,000
Total return	46%	Average Annual profit	39,600
Average annual return	9%		

3. The following worksheet shows the impact of damage which resulted in the loss of benefit to lessee for one month and also the expenditure of Rs; 40,000 however, this loss shall be charged to Lessee and the bank will receive rent for the period asset remained under repair.

Descriptions	Rs.	Descriptions	Rs.
Amount invested	(500,000)	Lease rentals	720,000
Immediate return (first installment)	72,000	Depreciation	(450,000)
Net investment	(428,000)	Loss on sale of Asset	(20,000)
Cash inflows	678,000	Total profit	250,000
Net cash inflows	250,000	Average Annual profit	50,000
Total return	58%		
Average annual return	12%		

4. Profit of Bank and percentage return to the bank is unaffected by making delayed payments by the lessee, however, the lessee has to pay a penalty amounting to Rs; 3,100 with each installment which cannot form part of the income of bank and goes to charity fund being co-ordinated by Shari'a supervisory board of the bank.

Illustration.2. Mr. Zahoor contacted Meezan Bank Islamabad for the supply of a machine on lease for five years. The cost of the machine is Rs; 500,000. Lease

period is five years with the transfer of ownership for a token amount of Rs; 50,000. If MB wants to earn at least 15% p.a. on investment what should be the amount of installment on a quarterly basis? What is equal quarterly installment?

Solution

Installment Calculation table

Years	Invest-vest-ment	Depreciation	Balance	Rent	Amount Due	Quarterly Installment
1	500,000	90,000	410,000	75000	165,000	41250
2	410,000	90,000	320,000	61500	151,500	37875
3	320,000	90,000	230,000	48000	138,000	34500
4	230,000	90,000	140,000	34500	124,500	31125
5	140,000	90,000	50,000	21000	161,000	40250
Total	50,000	450,000	1,150,000	240,000	740,000	

Reduction in investment per year is Rs; 90, 0000 which must be covered in addition to 15% earnings. Hence first year amount due becomes Rs; 165,000 [500,000*15% + 90, 0000], second year Rs; 151,500, third year Rs; 138,000, fourth year Rs; 124,500 and final year Rs; 161,000 [90,000 + 140,000*15% + 50,000]. If equal amounts are agreed then installment becomes Rs; 37,000 [740,000/20].

Auto Industry remained chief source of Ijarah investments in Pakistan during 2001-10

5.7. Questions

1. What is Ijarah? How Ijarah is different from conventional leasing?
2. What is Urboun? Differentiate among Hamish Jiddiya, Urboun and Penalty?
3. Ijarah is a binding contract, however in certain cases, it can be terminated without the mutual consent of parties. Explain the circumstances which put Ijarah contract into the end, unilaterally.
4. Enlist the steps involved in Ijarah contract (with the transfer of ownership).
5. Explain Shari'a rulings in the case of damage to underlying asset in an Ijarah agreement.

Ijarah has a great potential in industrial financing

Multiple Choice Questions

1. According to SBP-2010, what is an average share of Ijarah in portfolios of IFIs working in Pakistan for last seventeen quarters (09/06-09/10)?

a. 20%
b. 22%
c. 24%
d. 26%

2. Ijarah is one of the asset based modes of financing. What is the difference between Ijarah and other modes of asset-based financing?

e. Asset is transferred to user with ownership
f. Asset can be sold under Ijarah agreement
g. Ownership of asset remains with supplier of asset
h. None of the above

3. Murabaha and Ijarah both are very dominant modes of asset-based financing used by IFIs. The difference between Murabaha and Ijarah:

a. Murabaha agreement can be concluded before purchasing of asset
b. Ijarah agreement can be concluded before purchasing of asset
c. Payment of price must be made to supplier under Murabaha
d. Payment of price must be made to supplier under Ijarah

4. MIB leased a car to Ali for one year period for an agreed rental of Rs; 30,000 per month. After passing three months car met an accident without negligence of Ali and repair took one month for Rs; 50,000. What is the cash inflow for the year for MIB?

a. 310,000
b. 410,000
c. 360,000
d. 280,000

5. MIB leased a car to Ali for one year period for an agreed rental of Rs; 30,000 per month. After passing three months car met an accident with negligence of Ali and repair took one month for Rs; 50,000. What is the cash inflow for the year for MIB?

a. 310,000

b. 410,000
c. 360,000
d. 280,000

6. Ijarah is a comparative mode of financing with the conventional lease. One of the differences between Ijarah and lease is:

a. Rentals are received in advance
b. Asset is transferred to lessee at the end
c. Asset is insured
d. Ownership risk belongs to lesser under Ijarah

7. BIP entered into car Ijarah agreement with Umar and received Urboun amounting to Rs; 100,000. After the purchase of a car for Rs; 1000,000 bank informed the customer. Umar did not show interest and contract rescinded. BIP disposed car for Rs; 950,000. What is net cash flow of bank on this transaction?

a. 50,000 outflow
b. 50,000 inflows
c. 100,000 inflow
d. None of the above (write your answer)

8. Umar entered into a binding promise with BIP to enter into lease agreement for the purchase of an asset and paid Hamish Jiddiya amounting to Rs; 100,000. After the purchase of a car for Rs; 1000,000 bank informed the customer. Umar did not show interest and BIP disposed of the car for Rs; 950,000. What is net cash flow of bank on this transaction?

a. 50,000 outflows
b. 50,000 inflows
c. 100,000 inflows
d. None of the above (write your answer)

9. Late payment charges for delay in rentals are charged under both Ijarah and lease. Which of the following is a true interpretation?

a. Penalty on Ijarah forms the income of bank
b. Penalty on lease forms income of bank
c. Penalty on Ijarah goes to charity
d. Penalty on lease goes to charity

10. One of the differences between lease and Ijarah is a liability to repair the asset in case of damages. Which of the following is the correct interpretation?

a. Under Ijarah rent is not charged and repair charge is paid by lessee
b. Under Ijarah rent is not charged and repair charge is paid by lesser
c. Under lease rent is charges and repair charge is paid by lesser
d. None of the above

True/False

Mark the following statements as True or False.

1. Under Ijarah rent is charged when the asset is made available to the lessee for use while under conventional leasing interest is charged once the contract is signed irrespective whether the asset is available for use or not.

2. Any rent received before delivery of asset is not forming income of an IFI and treated as a liability which is not the case under interest-based banking.

3. During repair and overhauling phase, IFI cannot charge the rentals while conventional banks continuously receive the installments consisting of interest as well as principal irrespective of usage of the asset by the lessee.

4. Under Ijarah sale of asset and lease of an asset takes place through two separate contracts. Contract of Ijarah is signed by the time of asset handed over for use and contract of sale is signed by the time ownership is transferred.

5. Under conventional leasing, a single contract includes sale and lease.

6. Under Ijarah risk of an asset is mitigated through Takaful only (permitted mode of risk sharing) while under conventional lease risk is minimized through insurance (prohibited mode of risk sharing).

7. Under Ijarah, all rights and liabilities of ownership lie with the IFI being the owner of the asset while usage related rights and liabilities lie with customer being user. Under conventional leasing, all such rights and liabilities are placed on the user without distinguishing.

8. Under Ijarah rentals stopped once the asset has become unusable due to any reason (e.g. theft, destruction, etc.) without negligence of customer which is not the case under conventional leasing.

9. The penalty for default in prompt payment is levied in both cases however usage of penalty is different.

10. Under conventional leasing it is the late payment charges and covers time value of money lost by leasing company hence, it is compensation for leasing company while under Ijarah it is not the income of lesser rather it goes to charity being co ordinate by Shari'a supervisory board of IFI.

5.8. Exercises

Ex.1. Mr. Gul is in need of a car to be financed by the bank and contacted to Emirates Global Islamic Bank (EGIB) to provide car under Ijarah Wa Iqtana (lease with the transfer of ownership) through a gift. The price of the car is Rs; 1,000,000 and available at Margalla Motors. Ijarah terms agreed as follow and contract of the lease signed by both parties on January 1st 2005.

1. The car is to be leased for five years.

2. Lease rentals are payable at the beginning of each year amounting to Rs; 300,000.

3. The penalty of 3% shall be imposed if payment is delayed for 15 days of due date.

4. Urboun amounting to Rs; 100,000 received to be forfeited if contract not executed by Lessee.

Required:-

1. What is total profit and average annual profit of bank if transaction executed smoothly subject to insurance as per the following schedule?

2. What is an average annual return on investment if transaction executed smoothly and EGIB had to pay annual insurance as per the following schedule?

Years	**Amount in Rs.**
2005	30,000
2006	27000
2007	23000
2008	18000
2009	12000
Total	110,000

Ex.2. Continuing from exercise 1, if Mr. Gul failed in the execution of transaction and bank entered into a contract of Ijarah with Mr. Alam on following terms.
1. The car is to be leased for five years.
2. Lease rentals are payable at the beginning of each year. Market rentals of the car are estimated amounting to Rs; 240,000 p.a. without transfer of ownership. Estimated residual value after five years is Rs; 250,000.
3. The penalty of 2% shall be imposed if payment is delayed for 15 days of due date.
4. Bank promised the customer to gift him asset at the end.
5. Insurance is the responsibility of bank.

Required:-

1. What is the amount of lease rental payable every year?
2. What is an average annual profit of bank if contract executed smoothly subject to payment of insurance?
3. What is an average annual return on investment if contract executed smoothly subject to insurance?

EX.3. In the continuity of exercise 1, the car suffered an accident in year three and repairing process took one month with expenses amounting to Rs; 50,000. As the bank was making payments for insurance during lease tenure, so a claim was

lodged with the insurance company and settled at Rs; 40,000. Last two installments were not made within the grace period. Hence, penalty charged.

Required:-

1. What is the amount of average annual profit for the bank?
2. What is percentage return on investment on annual average basis?
3. What is the amount of penalty in this transaction?

EX.4. Dubai Islamic Bank entered into an Ijarah contract with Wasim as per following terms and conditions.

1. Ijarah term is five years and at the end of the term, the asset shall be transferred to wasim without any charge.
2. Market rent of the car is Rs; 30,000 per month.
3. Expected residual value of the car is Rs; 500,000 and bank want to receive this amount as part of installment.
4. The fair value of the car at the time Ijarah is Rs; 1,500,000.
5. 10% of the installment due shall be charged as a penalty if payment delayed for more than 15 days.
6. Urboun of Rs; 100,000 received which shall form part of initial installment if contract executed.
7. Installments are due at the beginning of each month.

Following information relates to actual events happened during the lease term.

1. Installment number 5, 21, 37, 49 were delayed for a period more than 15 days.
2. Asset damaged in month number 41 and repair took one month for a charge of Rs; 50,000. The asset was insured and claim settled at Rs; 45, 0000. (Annual insurance expenses paid by bank amounting to Rs; 18,000).

Required:-

1. Calculate monthly installment payable by customer
2. Calculate net cash flows for the period
3. Calculate average profit per year
4. Calculate average return per year on original investment
5. Calculate IRR on the project

Suggested Readings

- AAOIFI. (2004). *Shari'a Standards.* P.O. Box 1176, Bahrain.
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- Khan, M.A., (1989). Economic Teachings of Prophet Muhammad: A Select Anthology of Hadith Literature on Economics, chapter 6:2, page 72. *International Institute of Islamic Economics,* P.O. Box 1647, Islamabad, Pakistan.
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IJARAH IN ACTION

Asset is responsibility of lesser throughout the lease period except it is proven that loss is occurred due to negligence of lessee. Rent for a period when asset is not available to lessee cannot be claimed. MB has to borne this loss if car was not ensured otherwise insurance company shall compensate the lesser. Lease rentals payment must be stopped once the asset is not available to lessee for use.

Part-3

Profit & Loss Sharing

A. Musharaka

B. Diminishing Musharaka

C. Mudaraba

When everyone performs, result is championship

Chapter 6

Musharaka Financing

Success and Failure is jointly shared

Musharaka means a joint enterprise formed conducting some business in which all partners share the profit according to pre-agreed ratio while the loss is shared according to the ratio of contribution. Profit and loss sharing are the modes which can create a real difference in the society not common in capitalism. By application of sharing modes, IFIs can extend financing facilities to the persons lacking provision of sufficient security in getting finance. Mudaraba could be used as a source of self-employment by putting money in the hands of skillful persons lacking resources.

Learning objectives

After going through this chapter reader should be able to understand and interpret the following:

What is Musharaka financing?

What are Shari'a rulings about operations of Musharaka financing?

What is the financial impact of Musharaka financing and how it is accounted for?

Why is Musharaka financing not as popular as other modes of financing?

6.1. Introduction

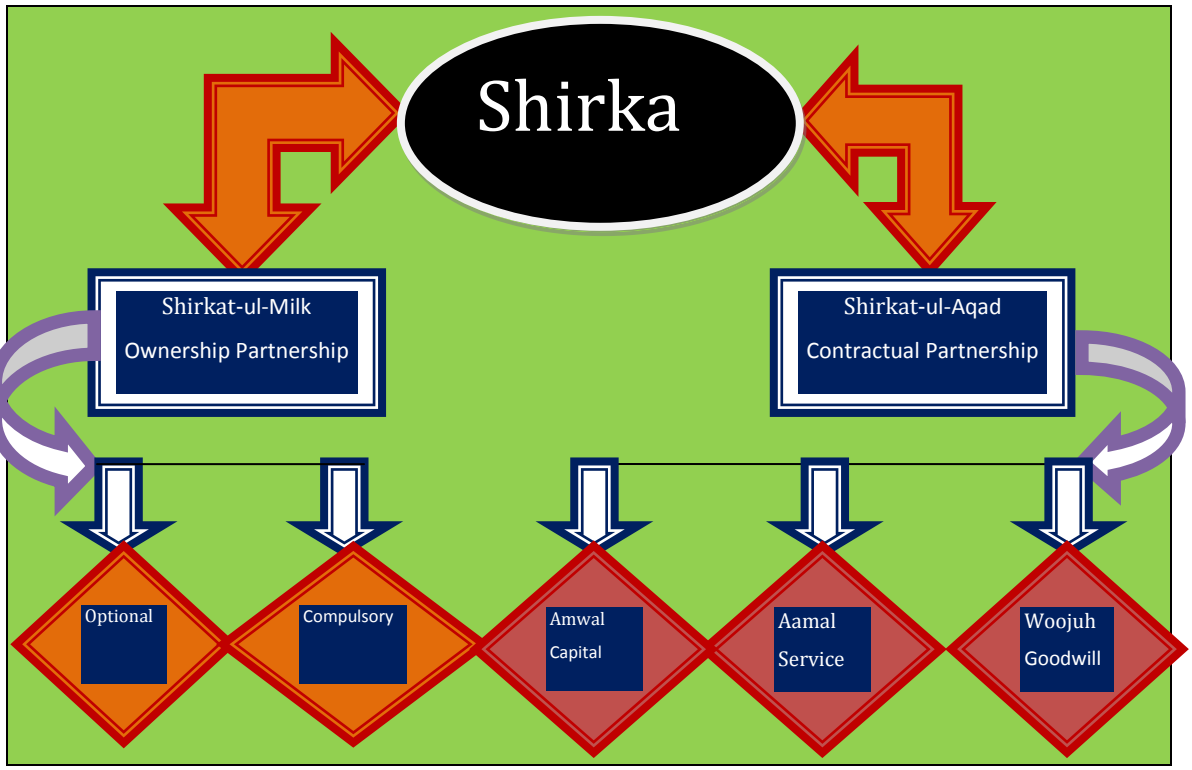
According to a Hadith Qudsi (revelation reported by Prophet Muhammad PBUH) "Indeed, Allah the Exalted says: I am the third of the two partners so long as the one does not cheat the other, and when he cheats, I withdraw myself" (Khan, 1989).

The literal meaning of Musharaka is sharing. Its root in the Arabic language "Shirka" means being a partner. Musharaka means a joint enterprise formed conducting some business in which all partners share the profit according to pre-agreed ratio while the loss is shared according to the ratio of contribution (Meezan Bank guide 2002). For a valid Musharaka fulfillment of certain conditions required. First is there must be an agreement written (verbal) among the partners stating clearly the terms and conditions including management, capital contributions, profit and loss sharing among the partners. Second capital can be contributed in cash as well as in assets. However once an asset is contributed as capital that belongs to firm and contributing partner is relieved from the bar of risks and returns attached to ownership of that asset. Third profit is distributed according to the agreement of partnership, however, a sleeping partner cannot claim a share in profit more than his proportionate share of equity. None of the partners can guarantee the capital or profit share to any other partner (Shari'a standard 12). Under Musharaka IFIs are receiving deposits and finances business requirements for profit and loss sharing.

Following figure 6.1 depicts the various types of Shirka (partnership) including partnership by agreement (Shirkat-ul-aqad) and partnership in property or joint ownership of an asset (Shirkat-ul-Milk). Joint ownership of property can be a compulsory (through operation of law) e.g. inheritance, and it can be through a contract e.g. purchase of a house under diminishing Musharaka agreement.

Partnership by agreement (Shirkat-ul-aqad) is further subdivided into three classes including partnership in goodwill (Shirkat-ul-woojuh), partnership in services (Shirkat-ul-aamal) and partnership in capital (Shirkat-ul-amwal).

Figure 6.1. Types of Shirka (Partnership)



6.2. Summary of Shari'a Rulings

Following rules are applicable to Shirkat-ul-aqad (contractual partnership) especially partnership in capital (Shirkat-ul-amwal).

Rule.1. The partnership comes into existence through an agreement (written or verbal). Objectives of partnership should be spelled out in agreement. A partnership agreement can be signed with non-Muslims for a Halal business. An IFI can enter into syndicate financing with conventional banks subject to operations are conducted by IFI.

Rule.2. The capital of partnership can be contributed in cash or kind, however, in the case of a contribution made in-kind monetary values of the assets must be expressed in currency to determine the share contributed by each partner. Net assets of a company entering into a partnership are allowed to be used as capital in partnership. It is not allowed that debt (receivables) alone be used as a contribution to the capital of the partnership. [Once an asset is contributed in Musharaka it belongs to Musharaka and ownership of contributor stands cancel, however, he is joint owner of Musharaka as per monetary value of his contribution]

Mr. X joined a partnership with Mr. Y by contributing a car amounting to PKR 1 million while Y contributed his business with net assets of PKR 2 million. Profit sharing ratio agreed as per contribution. All assets of the partnership are under joint ownership of both partners according to contribution. At any stage X cannot claim ownership of car and Y ownership of business. They are the owner of net assets in 1:2 [X & Y respectively].

Rule.3. Each partner is entitled to participate in management however if management right is vested in few or a single partner then others are bound not to interfere in affairs of business under normal course. A manager for remuneration can be appointed to run the affairs of business. Remuneration of managing partner cannot be a fixed amount (except through an independent contract) however higher share in profit is allowed.

A & B entered into a partnership by contributing equal capital PKR 10 million each. Profit sharing ratio agreed as per contribution. Management is taken over by A for a remuneration of PKR 30,000 per month as per partnership agreement. This clause of the partnership agreement is void under Islamic financial system. However other than partnership deed A can be appointed as manager for remuneration. Under partnership deed, A can demand higher profit than B for his services; however loss has to be shared according to capital contribution.

Rule.4. Guarantee of capital by a partner to other partners is not allowed. However, any third party can provide guarantee of capital subject to:-

a. Financial liability of guarantor is independent of partnership contract.
b. The guarantee is provided for zero consideration (free of charge, fee, etc.).

Nevertheless, ultimate liability rests upon the guaranteed partner if guarantor fails to meet his promise.

X & Y started a partnership by contributing equal capital and agreed to share profit according to capital contribution. X entrusted with management affairs and as per agreement X guaranteed capital of Y by bearing all the losses of business is a void contract under Islamic law. Under Islamic law, one cannot be entitled to profit without bearing the risk of loss.

A local Islamic bank entered into a Musharaka with Rawal textile to share 10% of actual profit of venture till the return of investment with a clause not to share loss keeping in view the safety and security of money of depositors is a void contract and any income so generated by bank shall be deposited in charity account maintained under the supervision of bank's Shari'a supervisory board.

Rule.5. Profit sharing is according to an agreement among the partners; however, the loss must be shared according to an equity stake in business. Profit sharing must not be in lump sum amount or percentage of capital rather it should be a percentage share in profit for partners. Profit sharing percentage should not be deferred till realization; it must be determined at the time of contract. Sleeping partner's share in profit must not be disproportionate upward to his contribution in the partnership agreement. Profit is the sum of earnings leftover after deduction of costs, expenses and maintenance of capital. Final distribution of profit is subject to valuation of assets (actual or constructive). Accounts receivables should be valued at cash value less allowances for doubtful accounts. It is not permitted to account for the present value of accounts receivables. It is allowed to allocate some profit to partners provisionally subject to final settlement after calculation of actual profit. It is permitted to create a reserve, and charity out of profit subject to agreement. It is allowed for a partner to sacrifice his share in total or a part of the

Profit sharing is according to agreement among the partners; however, loss must be shared according to equity stake in business.

profit for other(s) at the time of profit distribution without any prior contract. It is also allowed that any of the partners bear total loss at the time of loss without any prior condition.

A & B entered into a partnership by contributing 80% capital A and 20% B. Profit sharing is agreed as 50:50 because B is to manage the business. Also, loss sharing was agreed as 50:50 given the higher role of B in management affairs. This is a void partnership deed under Islamic financial system.

Margalla Islamic bank and Haji Sahib Lohey Waley entered into a partnership contract whereby bank contributed 10% of capital, and net assets of Haji Sb formed 90% of Musharaka capital. It was agreed that bank will receive 10% on its investment and rest shall go to Haji Sb is a void contract. The correct agreement would be to share a percentage of actual profit with the bank and not a percentage of capital.

Zara textile needs funding to pay operating business and entered into a partnership contract with local Islamic bank for two years. Bank paid immediately 2 million as the capital of Musharaka. At this point, worth of net assets based on market value balance sheet of Zara textile was 48 million. As per the agreement, the bank will receive a lump sum profit of PKR 200,000 per annum and rest profit shall go to the customer. This is a void contract as no partner can claim a lump sum amount of profit.

Hafiz entered into a partnership with a local Islamic bank in a project expected to complete within five years. Bank contributed 40% capital and Hafiz 60%. Hafiz took over the management and profit sharing agreed as 50:50. It is a void contract as a sleeping partner cannot claim profit more than its equity stake which is 40% in this case.

In the continuity of earlier example if the expectation of bank was at least 10% on capital invested and actual profit turned out to be PKR 400,000 and share of the bank is PKR 160,000. Hafiz sacrificed his share of profit equal to 40% for the bank. There was no such contract of compensation as per partnership deed. This is allowed under Islamic financial system that a partner can sacrifice his share of profit for another partner but without any prior commitment.

Guarantee of capital by a partner to other partners is not allowed.

In the continuity of earlier, if actual result emerged as loss and Hafiz took over all loss and no loss is being shared by the bank. There was no such commitment by Hafiz as per partnership deed; it is also allowed under Islamic financial system that a partner can bear the whole loss with his own will without any prior contract of doing so.

Rule.6. Partnership can be dissolved by any of partner after serving a due notice to others subject to (1) if a partnership is formed for a specific period then it cannot be terminated unilaterally prior to completion of period (2)[13] if a partnership is formed to complete a project then it cannot be terminated unilaterally prior to completion of project. A partner can enter into a binding promise with others to buy the assets of partnership as per agreed price at the date of buying (however entering into a promise to buy at face value is not allowed). At the dissolution of partnership (resulting in closure of business) assets should be disposed of and proceed to be distributed in the following order:-

1. Payment of liquidation expenses.
2. Payment of liabilities.
3. Distribution to the partners in accordance with their contributions. If remaining amount is less than contribution, then distribution should be made on pro-rata basis.

A & B formed a partnership for five years by contributing equal capital and sharing equal profit and loss. At the completion of the third year A intended to leave the partnership, he cannot do that without the consent of B. However at the completion of five years A can quit even if B is not willing to dissolve partnership and partnership shall stand dissolved.

A partner can enter into binding promise with others to buy the assets of partnership as per agreed price at the date of buying (however entering into promise to buy on face value is not allowed).

[13] This condition is not found in Shari'a Standard and writer think it is appropriate and in line with Islamic law (Shari'a) that a partner in a project should not be allowed to exit prior to completion except with the willingness of others.

It is allowed for a partner to sacrifice his share in total or a part of profit in favor of other(s) at the time of profit distribution without any prior contract. It is also allowed that any of the partners bear total loss at the time of loss without any prior condition.

Haji sb Lohey Waley and Molvi Sb Lohey Waley are partners for last 25 years and decided to dissolve partnership as well as business on December 31st 2010. The equity stake is equal to both partners as well as equal profit sharing ratio. Assets were sold for PKR 50 million and liabilities of ten million paid. Liquidation expenses amounted to PKR 2 million. Remaining 38 million was distributed to the partners equally [19 million each].

6.3. Financial Impact of Musharaka

Financial reporting and financial impact of Musharaka are discussed in following paragraphs. I shall illustrate with a hypothetical balance sheet and show the impact of different transactions under Musharaka financing on the balance sheet of an IFI. Balance sheet of an IFI is little different from balance sheet of a conventional bank in the sense that IFIs are accepting deposits either as loan which is in line with practices of commercial banks and does not create any difference in balance sheet; or on profit and loss sharing basis under Musharaka and Mudaraba which changes the nature of relationship between customer and IFI. Deposits under profit and loss sharing (PLS) models including Musharaka & Mudaraba are not shown as liabilities rather form part of equity. On the other hand, conventional banks lend money for interest and show advances to customers as an asset while IFIs are not lending cash rather sell the goods on credit hence resulting in receivables under Murabaha, Muajjal etc. Furthermore, IFIs are investing in businesses who need cash financing under the scheme of Musharaka & Mudaraba hence investment under Musharaka & Mudaraba is shown as an investment and not the receivables or advances. Let us look at a simple balance sheet of an IFI follows.

Margalla Islamic Bank

Balance Sheet, as at December 31, 2009

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. 000)**
Current Assets		**Liabilities**	
Cash and balances	3,830	Payables and balances	400
Accounts R/A	2,000	Current deposits	3,600
Inventory (assets for sale)	500	Charity fund	4
Salam financing	500	**Total liabilities**	**4,004**
Short term investments	150	**Equities**	
Total current assets	**6,980**	PLS deposits balances	1,800
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
Total long-term assets	**3,000**	Statutory reserves	400
		R. earnings/ Unapprop	776
		Total Equities	**5,976**
Total assets	**9,980**	**Total liab & Equities**	**9,980**

Suppose on January 1st Mr. Malik requested to participate with 50% financing for construction of a road project from Abbottabad to Mansehra. Total capital contributed in the project is Rs; 4 million hence contribution by the bank is Rs; 2 million. Profit sharing ratio agreed as 60:40 for Mr. Malik being the managing partner and bank respectively. The impact of the transaction is shown in following balance sheet.

Margalla Islamic Bank

Balance Sheet, as at January 31, 2010

Assets	Rs. (000)	Liabilities & Equities	Rs. (000)
Cash and balances	1,830	Total liabilities	4,004
Investments under PLS	3,000	Total Equities	5,976
other assets	5,150		
Total assets	**9,980**	**Total liabilities & Equities**	**9,980**

This transaction changed only cash balances and investment under profit and loss sharing and no impact on other assets, liabilities or equities. Suppose the project completed in six months and following are details of expenses, revenues, and assets. Plant and equipment were purchased for the project at the beginning for Rs; 3 million. Revenue received in three installments for completion of road amounting to Rs; 20 million and expenses incurred in cash for payment to labor amounting to Rs; 7 million, raw materials purchased and used amounting to Rs; 10 million and miscellaneous expenses incurred for salaries and site office maintenance amounted to Rs; 1.9 million. The market value of the plant and equipment is Rs; 2 million which is taken over by Mr. Khan at this price. Following is income statement of the project.

Income statement of Musharaka project (Jan to Jun 2010)

Revenue		20,000,000
Costs incurred		
Wages	(7,000,000)	
Raw materials used	(10,000,000)	
Miscelleneous expenses	(1,900,000)	
Depreciation of plant & equiment	(1,000,000)	
Total costs		(19,900,000)
Profit		100,000
Share of Mr. Malik		60,000
Share of IFI		40,000

At the completion of the project, after constructive valuation, net profit earned by the bank is Rs; 40,000. Assuming cash is collected by the bank, the impact on the balance sheet is disclosed as under as at June 30, 2010.

Balance Sheet, as at June 30, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Cash and balances	3,870	Total liabilities	4,004
Investments under PLS	1,000	Total Equities	6,016
other assets	5,150		
Total assets	**10,020**	**Total liabilities & Equities**	**10,020**

Suppose after completion of the project and before settlement, plant and equipment damaged by fire without negligence of managing partner and residual value fetched only Rs; one million, hence, a profit generating project went into loss amounting to Rs; 900,000. Although profit sharing ratio is 60:40 however under Musharaka loss must be shared according to an equity stake, consequently bank has to share 50% loss (amounting to Rs; 450,000). Note the differences in Islamic and conventional financial system. The first, Bank is sharing loss which is not the case in conventional loans. Second, under conventional partnership profit and loss is shared on agreed ratio however under Musharaka loss must be shared according to equity stake irrespective of profit sharing ratio. Following balance sheet depicts the financial impact of the transaction.

Margalla Islamic Bank
Balance Sheet, as at June 30, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Cash and balances	3,380	Total liabilities	4,004
Investments under PLS	1,000	Total Equities	5,526
other assets	5,150		
Total assets	**9,530**	**Total liabilities & Equities**	**9,530**

6.4. Concept Building

Illustration.1. Mr. Khan Owner of textile Mill requested to Bank Islami Pakistan (BIP) for the provision of financing amounting to Rs; one million to be refunded after six months on January 1st 2010. As the demand of customer is cash and not the asset, so BIP entered into Musharaka with Mr. Khan on following terms.

1. The contribution of Khan in Musharaka capital is net assets of Mill, agreed value amounting to Rs; 19 million.
2. Profit shall be distributed according to capital contribution.
3. Management is vested with Mr. Khan for no consideration

4. Musharaka is for six months only. Mr. Khan entered into a binding promise with the bank to purchase its share on market value at the end of Musharaka term.

Following is the balance sheet in market value terms of Musharaka (earlier Khan Mill) as at June 30th 2010.

BIP & Khan Musharaka

Market Value Balance Sheet, as at June 30, 2010

Assets	**Rs (000)**	**Liabilities & Equity**	**Rs (000)**
Cash	4,000	Accounts payables	2,000
Accounts Receivables (net)	5,000	Accrued expenses	500
Inventory	7,000	Equity	21,500
Property, plant & equip-ment	10,000		
Total assets	**24,000**	**Total liab & equity**	**24,000**

Required:-

1. Calculate profit earned by Musharaka and share of each partner.

2. Calculate profit of bank and percentage return per annum on investment if the share of BIP is purchased by Mr. Khan at 5% discount.

Solution

1.Total profit earned by Musharaka and share of each partner is calculated as under.

Total assets	24,000,000
less total liabilities	(2,500,000)
Net worth	21,500,000
Beginning capital	(20,000,000)
Net profit	1,500,000
Share of Mr. Khan	1,425,000
Share of BIP	75,000
Percntage return per annum on investment	15.00%

2. Following is the profit and percentage return to BIP if a share in Musharaka is sold at 5% discount.

Share in net assets	1,075,000
5% Discount	(53,750)
Net amount received	1,021,250
Beginning capital	(1,000,000)
Net profit	21,250
Percntage return per annum on investment	4.25%

Illustration.2. In continuation of illustration.1, suppose the market value of net assets contributed by Mr. Khan is on the basis of the latest available balance sheet as at Dec 31, 2010, and it was agreed that profit shall be allocated on pro rata basis for a whole year.

BIP & Khan Musharaka

Market Value Balance Sheet, as at Dec 31, 2010

Assets	**Rs (000)**	**Liabilities & Equity**	**Rs (000)**
Cash	4,000	Accounts payables	2,000
Accounts Receivables (net)	5,000	Accrued expenses	500
Inventory	7,000	Equity	21,500
Property, plant & equipment	10,000		
Total assets	**24,000**	**Total liabilities & equity**	**24,000**

Required:-

1. Calculate profit earned by Musharaka and share of each partner.
2. Calculate profit of bank and percentage return per annum on investment if the share of BIP is purchased by Mr. Khan at 5% premium.

Solution

1. Total profit earned by Musharaka and share of each partner is calculated as under.

Total assets	24,000,000
less total liabilities	(2,500,000)
Net worth	21,500,000
Beginning capital	(20,000,000)
Net profit	1,500,000
Profit earned during first 6-Months	750,000
Sare of Mr.Khan for 6 months Jan 10 to June 10	712,500
Share of BIP	37,500
Percntage return per annum on investment	7.50%

2. Following is the profit and percentage return to BIP if a share in Musharaka is sold at 5% premium.

Share in net assets	1,037,500
5% Primium	51,875
Net amount received	1,089,375
Beginning capital	(1,000,000)
Net profit	89,375
Percntage return per annum on investment	17.88%

Illustration.3. Mr. Chaudhary owner of marble factory contacted to Emirates Global Islamic Bank (EGIB) Rawalpindi to provide loan amounting to Rs; 4 million for extension of plant payable in 4 equal installments within a period of 2 years. Bank requested for last five years audited financial reports to decide about the financing facility. After Analysis of financial statements, the bank agreed to finance on following terms.

1. Financing is to be released immediately in cash.
2. During the financing period, no other financing (equity/debt) shall be taken by the customer.
3. Limit on capital expenditures is imposed up to one million during financing period.
4. Installments include only principal while profit to be settled on the closure of Musharaka after two years on prorate basis.
5. A latest balance sheet prepared on market value basis shall form part of contribution by the customer.

6. Profit sharing ratio is as per capital contribution by respective partners and management vested in Mr. Chaudhary although the bank is not sleeping, partner.

Required:-

1. Balance Sheet of Musharaka as at January 1st 2010.
2. What is profit sharing ratio based on original contributions in the capital? What is a contribution to Musharaka capital by each partner and profit sharing ratio?
3. (i)What is share in the profit of bank and percentage return p.a. on investment on the basis of balance sheets provided under?

(ii) What is share in the profit of bank if bank withdrew provisionally 10% p.a. profit subject to final settlement at closure and Mr. Chaudhary draw Rs; 30,000 per month for his cost of living. Both transactions are adjusted in following balance sheets.

Chaudhary Marbles

Condensed balance sheet, as at December 31.

Desriptions	**2005**	**2006**	**2007**	**2008**	**2009**	**Fair value, 2009**
Assets	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)
Cash	1,000	1,200	2,150	1,300	2,375	2,375
Inventory	2,000	1,800	2,200	2,100	2,300	2,415
Accounts Receivables	1,200	1,400	1,500	1,700	1,600	1,550
Plant & Equipments	5,000	4,500	4,000	5,000	4,500	6,000
Total Assets	9,200	8,900	9,850	10,100	10,775	12,340
Liabilities & Equity	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)
Accounts Payables	500	600	700	800	750	750
Accrued expenses	200	300	150	100	125	125
Paid up capital	6,000	6,000	6,000	6,000	6,000	6,000
Retained earnings	2,500	2,000	3,000	3,200	3,900	5,465
Total liabilities & Equity	9,200	8,900	9,850	10,100	10,775	12,340

Chaudhary Marbles & EGIB Musharaka

Condensed balance sheet, as at December 31.

Desriptions	**2010**	**2011**	Market value (Jan-12)
Assets	Rs in (000)	Rs in (000)	Rs in (000)
Cash	1,355	2,675	2,675
Inventory	2,800	2,500	2,500
Accounts Receivables	3,000	2,000	1900
Plant & Equipments	9,000	8,000	9000
Total Assets	**16,155**	**15,175**	**16,075**
Liabilities & Equity	Rs in (000)	Rs in (000)	Rs in (000)
Accounts Payables	900	600	600
Accrued expenses	150	50	50
Paid up capital	8,000	6,000	6,000
Retained earnings	7,104.50	8,525.40	9,425
Total liabilities & Equity	**16,155**	**15,175**	**16,075**

Solution

1. Following is opening balance sheet of Musharaka as at January 1st 2010.

Assets	**Rs (000)**	**Liabilities & Equity**	**Rs (000)**
Cash	6,375	Accounts Payables	750
Inventory	2,415	Accrued expenses	125
Accounts Receivables	1,550	Paid up capital	10,000
Plant & Equipments	6,000	Retained earnings	5,465
Total Assets	**16,340**	**Total liabilities & Equity**	**16,340**

2. Following is the calculation of capital contributed by each partner and profit sharing ratio on the basis of capital.

Contribution by Mr.Chaudhary.	Rs. In (000)
Total assets on January 1st, 2010	12,340
Total liabilities on january 1st, 2010	(875)
Net worth	11,465
Contribution by Bank	4,000
Total cpital of Musharaka	15,465
Profit sharing ratio - Chaudhary	74.14%
Profit sharing ratio - Bank	25.86%

3- (i) Calculation of profit share and % return on investment for EGIB.

Profit calculation for Musharaka and share of bank	Rs. In (000)
Retained earnings as per closing balance sheet Jan-12	9,425
Retained earnings as per closing balance sheet Jan-10	(5,465)
Net profit on Musharaka for 2 years	3,960
Semi annual profit	990
Share of bank in first 6 Months	256
Share of bank in second 6 Months	192
Share of bank in third 6 Months	128
Share of bank in fourth 6 Months	64
Total profit earned in 2 years	640
Percentage return p.a. on investment	12.80%

3.(ii) Calculation of profit share and average annual % return on investment for EGIB.

Profit calculation for Musharaka and share of bank	Rs. In (000)
Retained earnings as per closing balance sheet Jan-12	9,425
Retained earnings as per closing balance sheet Jan-10	(5,465)
Net profit on Musharaka for 2 years	3,960
Adjustment for drawings by partners	
Bank: 10% on completion of first year 300,000 +50,000	350
Bank:10% on completion of second year 100,000+50000	150
Mr. Chaudhary : 30,000 X 24	720
Total profit earned in 2 years	5,180
Semi annual profit	**1,295**
Share in profit of bank in first 6 Months	335
Share in profit of Mr. Chaudhary for first 6 Months	960
New Profit Sharing ratio as per equity stake	
Mr. Chaudhary's capital balance : 11,465,000+960,000- (30,000*6)	12,245
Bank's capital balance : 4,000,000+335,000-1,000,000	3,335
Profit sharing ratio : Mr. Chaudhary	78.59%
Profit sharing ratio : Bank	21.41%
Semi annual profit	**1,295**
Share in profit of bank for 2nd 6 Months	277
Share in profit of Mr. Chaudhary for 2nd 6 Months	1,018
New Profit Sharing ratio as per equity stake	
Mr. Chaudhary's capital balance : 12,245,000+1,018,000- (30,000*6)	13,083
Bank's capital balance : 3,335,000+277,000-1,350,000	2,262
Profit sharing ratio : Mr. Chaudhary	85.26%
Profit sharing ratio : Bank	14.74%
Semi annual profit	**1,295**
Share in profit of bank in for 3rd 6 Months	191
Share in profit of Mr. Chaudhary for 3rd 6 Months	1,104
New Profit Sharing ratio as per equity stake	
Mr. Chaudhary's capital balance : 13,083,000+1,104,000- (30,000*6)	14,007
Bank's capital balance : 2,262,000+191,000-1,000,000	1,453
Profit sharing ratio : Mr. Chaudhary	90.60%
Profit sharing ratio : Bank	9.40%
Semi annual profit	**1,295**
Share in profit of bank for 4th 6 Months	122
Share in profit of Mr. Chaudhary for 4th 6 Months	1,173
New Profit Sharing ratio as per equity stake	
Mr. Chaudhary's capital balance : 13,083,000+1,104,000- (30,000*6)	15,000
Bank's capital balance : 2,262,000+191,000-1,000,000	425
Total profit earned in 2 years	925
Average annual Percentage return on investment	16.74%
Receiveable from Mr. Chaudhary 925-500	425

6.5. Application of Musharaka

Musharaka is a type of business based on profit and loss sharing. IFIs enter into partnerships with firms to share the profit and loss of business. As per the report of State Bank of Pakistan (SBP) share of Musharaka is negligible in portfolios of IFIs working in Pakistan. Following figures 6.3 depict the progress made by IFIs working in Pakistan under Musharaka mode of financing during 17 quarters (09/06 – 09/10) which is not appreciable by any standard; given the widespread unemployment prevailing in the economy of 170 million people with the majority in the age bracket of working population. Closing amounts of investments are presented in Figure 6.2.

Musharaka and Mudaraba are the modes of financing which create a real difference in operations of IFIs in comparison with conventional banking. Undoubtedly other modes of financing too are different from interest based modes because nature of rights and liabilities are different under Islamic banking Vs. Conventional banking. However sharing modes (as termed as Shari'a based) are preferred under Islamic financial system theoretically. These are the modes which can create a real difference in the society not common in capitalism. By application of sharing modes, IFIs can extend financing facilities to the persons lacking provision of sufficient security in getting finance. Mudaraba could be used as a source of self-employment by putting money in the hands of skillful persons lacking resources. In this section, I will identify and analyze the likely hurdles in the vast spread popularity and application of Musharaka.[14]

Musharaka and Mudaraba are the modes of financing which create real difference in operations of IFIs in comparison with conventional banking.

[14] For detailed discussion reader is requested to consult "Islamic Financing: Shift from debt to equity. An analysis of business framework" published by VDM-Publishing Co.

Figure 6-2. Closing Amounts PKR Billion of investments made under Musharaka 12/06-06/13

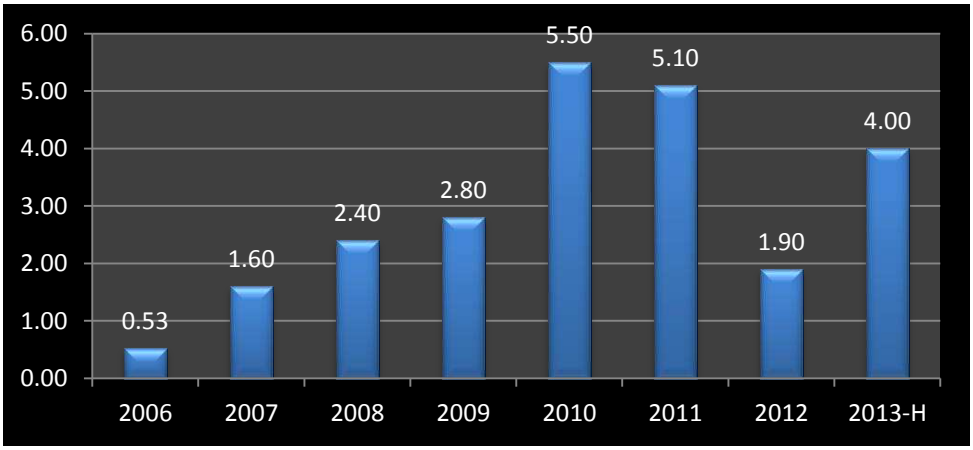


Figure 6-3 Percentage share of Musharaka financing in portfolios of IFIs

Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Jun 08	Sep 08
0.65%	0815%	0.82%	0.73%	1.56%	1.48%	1.28%	1.67%
Dec 08	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10
1.64%	0.94%	2.57%	2.60%	1.76%	1.73%	3.66%	1.16%

Source: SBP- Islamic banking bulletins

Popularity and application of Musharaka much depend upon the profit figure generated or expected by financial reports of firm (client). How this profit figure is generated is a very important issue to be understood by a practitioner of Islamic finance. Profit is calculated on the basis of certain accounting principles including, separate business entity concept, going concern concept, realization concept and historical cost concept, stable dollar assumption, matching principle, materiality, and conservatism. Calculation of profit under these principles of accounting has implications for profit and loss sharing modes of financing. How these accounting principles affect profit calculation and resultantly discourage application of Musharaka few examples are presented as under.

Going concern principle of accounting states that accounts should be prepared on the assumption of perpetual continuity of business unless contrary evidence exists.

1. The going-concern principle of accounting states that accounts should be prepared on the assumption of perpetual continuity of business unless contrary evidence exists. The result of this assumption is the preparation of balance sheet on book value ignoring the market value. This principle of accounting is developed over the years and with the due thought process. Market value is subjective, and one cannot determine the correct market value unless a product (business) sold out hence accountants preferred to report the value which is verifiable. For Musharaka, this principle of accounting creates a problem because banks are not long term partners of business and have to share short term profits generated through accounting system which is not disclosing the true picture (market value terms) of the organization.

2. Historical cost concept of accounting states that assets should be reported on cost minus accumulated depreciation to date. Whenever an asset is purchased, its economic life is estimated and accordingly depreciated over the period. Depreciation is the proxy of the cost of service provided by asset which never match the market price of service hence profit is overstated in the days of inflation and vice versa.

3. Conservatism guides the accountants to play safe hence any expected loss is immediately accounted for however expected gain is postponed till the realization. One of the results of conservatism is the creation of a provision for doubtful accounts receivables to be settled later on. For a permanent owner of the business it does not make much difference however for a temporary partner (as in the case of Musharaka by IFIs) it has implications because conservatism usually results in lower profit immediately although reversal may take place in future.

Furthermore, in certain matters, multiple options are provided to practitioners to handle underlying issue which increases subjectivity in financial reports. Opportunistic managers can manipulate profit figure by opting the choice favoring to them. Few examples are as under.

Conservatism guides the accountants to play safe hence any expected loss is immediately accounted for however expected gain is postponed till the realization.

1. Depreciation is a systematic allocation of the cost of assets used over the period of economic life. Depreciation can be charged on multiple methods (bases). It can be time-based which includes straight line basis, diminishing balance method, and the sum of years digit method. Under straight line method, the equal amount of depreciation is charged during the economic life of the asset while under the sum of year's digit and declining balance method more depreciation is charged in earlier years and lesser in following years. It can be performance based including a number of working hours and number of units produced. It can be used as tax incentive provided by government keeping in view certain specific goal in mind. For example, if the government want to increase investment in the particular sector it can enhance depreciation up to 100% in the year of purchase. Each method shall provide a different result which will directly affect earnings measurement. Which one of the method is more transparent and close to reality? The answer is none due to following reasons. First; depreciation is always charged on the basis of expected economic life or expected performance which cannot be measured accurately in advance. Second; depreciation is charged on historical cost which ignores the current value of facility used.

2. Goodwill appears in the balance sheet when it is acquired. Normally at the time of purchase of business if payment is made more than the amount of net assets the excess is treated as goodwill. Writing off goodwill has always remained in the hands of preparers of financial statements a tool of manipulation of accounts. At the inception of IAS 36, where impairment test was introduced to write off the assets including goodwill, things are becoming worse than bad[15]. Daniel 2006 concludes about the amortization decision of good will "BW provides interesting insight by examining multiple forces that might influence management's accounting choice, including contracting, equity market incentives and regulatory forces."

3. To attract and retain value able employees and managers corporations frequently offer various compensations based on performance including stock options. These stock options are either offered without any charge or at a price

[15] An interesting case of profit manipulation through impairment test is of PIA [2002].

Popularity and application of Musharaka much depends upon the profit figure generated or expected by financial reports of firm (client).

which is certainly lower than the market. What should be the accounting treatment of these compensations? Whether to charge these benefits as expenses or allocation of profit out of retained earnings.

4. Selling on credit is a general tool for increasing sales and organizations use this tool very effectively. Certain organizations including banks are doing the business of providing credit facility. A Certain portion of these credits may not be recoverable, and the organization has to forfeit the claims. Recently from 1999 to 2007 in Pakistan loans of amounting to Rs; 60 Billion issued by nationalized banks were written off by the government. To save the organization from future expected loss, a provision is created for doubt full accounts. However, the amount of provision is rest with the judgment and discretion of the preparer of financial statements.

5. Certain expenses of the businesses are beneficial for short term and others for the long term. The short-term expenditures are charged to profit, and loss account and expenditures with a benefit for the long term are capitalized and amortized over the period of benefit. Again it is upon the judgment of the management of the organization to decide whether an expenditure should be capitalized or expensed out. The decision of capitalization has an enormous effect on profit calculation. Profit and loss can be reduced or increased keeping in view the objectives of management.

6. Research and development expenditures are necessary for the success of business entities as these expenditures create and maintain the differential advantage. Research and development cost gives the organization leading role in the sector. The accounting issue involves when to capitalize the research and development cost and when to expense out? Although certain criteria's are laid down including research expenses not to be capitalized and development expenditures not to be expensed in the period of occurring. Again expensing the research spending in the period of occurring is debatable. If the criterion of capitalizing expenditures is benefit attached, then it is the research which provides a benefit up to the whole life of the product.

Can we conclude that accounting discipline has failed in meeting its objective of depiction of true results for a period of an underlying organization? Answer is NO! A strong No!

7. Organizations are building brands to gain the trust and loyalty of customers by spending a lot of money. In some cases like Coca-Cola, brand value is in billions of dollars. Generally, the value of the brand is not included in financial reports hence true net worth cannot be assessed by looking at financial reports. Again it is the discretion of management to build the brand or not (capitalize or expense out).

8. Cost flow assumptions in inventory costing methods. Last in first out (LIFO), average and first in first out (FIFO) methods of inventory costing are well known. All are suggested, and accepted methods of inventory costing, however, application of a particular method is the discretion of management and has implications for profit calculation.

Implications of issues rose above for profit figure is that it (profit) is either overstated or understated in a particular period, but the reversal is followed. Musharaka financing is for a particular period, and true depiction of profit is required in that period which can be manipulated hence discouraging its application. Can we conclude that accounting discipline has failed in meeting its objective of the depiction of true results for a period of an underlying organization? The answer is NO! A strong No! Every accounting principle has developed after due consideration and deliberation by experts in the field keeping in view the overall interest of stakeholders. However, profit calculation under present system cannot help out in the application of Musharaka financing rather discourage due to its inherent limitations. Hence, certain adjustments are required for the practice of Musharaka by IFIs including preparation of market value balance sheet of the firm (client) at the beginning and ending of Musharaka.

Why are accounts manipulated by managers of the firms? Literature on earnings management has identified various motives behind earnings manipulation including e.g. a particular reference point to be achieved including to avoid negative earnings, display profit more than last year and to meet the forecasts; avoiding technical default on debt covenants by displaying a figure suitable with debt agreement; reduction in transactions costs including favorable contracts with

The accounting issue involves when to capitalize the research and development cost and when to expense out?

suppliers, customers, employees and financiers; tax considerations as income tax is positively correlated with earnings; attracting better price at public offerings by showing consistent earnings; better management compensation especially when linked with outcome; beating financial analysts' forecast which directly affects market value of the firm; and hiding poor performance of management when actual results are not satisfactory.

Table 6.3 -Hurdles in the way of Musharaka financing in Descending order at the scale of zero to four.

Rankings	Factors	Mean	C.V
01	Dominance of conventional banks	3.07	0.37
02	Risk of Musharaka financing	2.70	0.43
03	Profit manipulation	2.50	0.48
04	Lack of trust in Musharaka partner	2.40	0.46
05	Weaker Auditing	2.20	0.55
06	Conventional accounting framework	1.80	0.82
07	Higher taxes	1.70	0.69

Hanif & Iqbal (2010), conducted a survey of professionals to get the input of market about the lesser popularity of Musharaka and documented following hindrances in the way of application of Musharaka financing. Findings are reported in Table 6.3. As per table surprisingly market opines profit manipulation at number three after the dominance of conventional banking and riskiness of Musharaka and tax considerations found the last place in the rankings.

To increase the application of Musharaka financing, professionals suggested number of steps including awareness campaign among masses about philosophy and operations of IFIs; new products development (financing modes) by IFIs focusing on Musharaka; modification of accounting methods to align with Shari'a led financial system; capacity building (especially human resource) of

Literature on earnings management has identified various motives behind earnings manipulation

IFIs; favorable regulations for Musharaka financing; support from government and general uplift in moral values of society towards honesty and transparency, as documented by Hanif & Iqbal (2010).

While it is evident from above citations that the true picture of performance is not depicted through conventional financial reports, implementation of Musharaka financing become a complex challenge for IFIs. Perhaps these are the reasons of lesser popularity of Musharaka financing. A Cultural shift is required to practice Musharaka financing, and one can hope with the increase in market share of Shari'a led financial system a new financial culture shall prevail based on profit and loss sharing instead of risk-free returns.

6.6. Questions

1. What is Musharaka? How is Musharaka financing different from conventional loans?
2. Musharaka is the mode of financing based on profit and loss sharing. Explain the Shari'a rulings for profit and loss sharing.
3. Write down the priority list for distribution of assets on termination of Musharaka?
4. Enlist the five applications of Musharaka financing?
5. Briefly, explain the management of Musharaka?

Multiple Choice Questions

1. The financial position of Margalla company as at 31st December 1990 consists of following: Current assets Rs: 2million, Plant & Equipment Rs: 4millions and other assets Rs: 1million. Current liabilities Rs: 3millions and long term loans Rs: 1million.

What is the amount of working capital?

A. 2,000,000
B. 5,000,000
C. -1000,000
D. 1000,000

2. The financial position of Margalla company as at 31st December 1990 consists of following: Current assets Rs: 2million, Plant & Equipment Rs: 4millions and other assets Rs: 1million. Current liabilities Rs: 3millions and long term loans Rs: 1million.

What is the amount of Networth?

A. 3,000,000
B. 5,000,000
C. 7000,000
D. 1000,000

3. The financial position of Margalla company as at 31st December 1990 consists of following: Current assets Rs: 2million, Plant & Equipment Rs: 4millions and other assets Rs: 1million. Current liabilities Rs: 3millions and long term loans Rs: 1million.

What is the amount of shareholders' equity?

A. 3,000,000
B. 5,000,000
C. 7000,000
D. 1000,000

4. The financial position of Margalla company as at 31st December 1990 consists of following: Current assets Rs: 2million, Plant & Equipment Rs: 4millions and other assets Rs: 1million. Current liabilities Rs: 3millions and long term loans

Rs: 1million. On this date bank provided financing of Rs: 2millions. What is the amount of shareholders' equity?

A. 3,000,000

B. 5,000,000

C. 7000,000

D. 1000,000

5. The financial position of Margalla company as at 31st December 1990 consists of following: Current assets Rs: 2million, Plant & Equipment Rs: 4millions and other assets Rs: 1million. Current liabilities Rs: 3millions and long term loans Rs: 1million. On this date bank provided financing of Rs: 2millions. What is the amount of working capital?

A. 3,000,000

B. 5,000,000

C. 7000,000

D. 1000,000

6. The financial position of Margalla company as at 31st December 1990 consists of following: Current assets Rs: 2million, Plant & Equipment Rs: 4millions and other assets Rs: 1million. Current liabilities Rs: 3millions and long term loans Rs: 1million. On this date bank provided financing of Rs: 2millions. What is the amount of Networth?

A. 3,000,000

B. 5,000,000

C. 7000,000

D. 1000,000

7. Mr. Yaqoob entered into Musharaka with Margalla Islamic bank on 1st June 2010 for 6 months. As per agreement, Mr. Yaqoob will contribute plant amounting to Rs; 300,000 and MIB shall provide working capital amounting to Rs; 200,000 to manufacture products to be sold to customers in the market by Mr. Yaqoob. During six month period profit earned is amounting to Rs; 50,000. What is the net worth of business on beginning of Musharaka?

A. 50,000

B. 300,000

C. 200,000
D. 500,000

8. Mr. Yaq entered into Musharaka with Margalla Islamic bank on 1st June 2010 for six months. As per the agreement, Mr. Yaqoob will contribute plant amounting to Rs; 300,000 and MIB shall provide working capital amounting to Rs; 200,000 to manufacture products to be sold to customers in the market by Mr. Yaqoob. During six month period profit earned is amounting to Rs; 50,000. What is the net worth of business on the closing of Musharaka?

A. 550,000
B. 300,000
C. 200,000
D. 50,000

9. Mr. Yob entered into Musharaka with Margalla Islamic bank on 1st June 2010 for six months. As per the agreement, Mr. Yaqoob will contribute plant amounting to Rs; 300,000 and MIB shall provide working capital amounting to Rs; 200,000 to manufacture products to be sold to customers in the market by Mr. Yaqoob. During six month period profit earned is amounting to Rs; 50,000. Being sleeping partner share of bank in profit could not be more than:

A. 10%
B. 30%
C. 40%
D. 50%

10. Mr. Yoob entered into Musharaka with Margalla Islamic bank on 1st June 2010 for six months. As per the agreement, Mr. Yaqoob will contribute plant amounting to Rs; 300,000 and MIB shall provide working capital amounting to Rs; 200,000 to manufacture products to be sold to customers in the market by Mr. Yaqoob. During first six-month period profit earned is amounting to Rs; 50,000 and in second six month suffered the loss of Rs; 50,000. What is a share of the bank in profit if the sharing ratio is a contribution?

A. Zero
B. 20,000
C. 30,000

D. None of the above

True/False

Mark the following as True or False.

1. Capital in Musharaka can be contributed in kind without disclosing the monetary value.

2. Capital in Musharaka can be contributed in different currencies subject to conversion in reporting currency at the date of contribution.

3. Management of Musharaka is the responsibility of all partners until it is vested in a single or few.

4. Managing partner can charge a fixed sum as salary for managing the Musharaka.

5. The ratio of profit and loss must be same so that one should bear the loss equal to acquiring the gain in Musharaka.

6. It is quite unnecessary to decide the profit sharing ratio at the time of Musharaka as it can be decided when the profit is realized.

7. Bank provides finance to business and becomes a partner for a limited period hence bank does not carry the right to interfere in affairs of business.

8. Being a sleeping partner and provider of finance bank can ask for a higher share in profit than his percentage of capital contribution.

9. The performance of Parallel Istisna'a contract must not be conditional on the completion of first Istisna'a contract.

10. The going-concern principle of accounting states that accounts should be prepared on the assumption of perpetual continuity of business unless contrary evidence exists.

11. Historical cost concept of accounting states that assets should be reported on cost minus accumulated depreciation to date.

12. Conservatism guides the accountants to play safe hence any expected gain is immediately accounted for however expected loss is postponed till the realization.

13. Depreciation is a systematic allocation of the cost of assets used over the period of economic life.
14. To attract and retain value able employees and managers corporations frequently offer various compensations based on performance including stock options.

15. Recently from 1999 to 2007 in Pakistan loans of amounting to Rs; 80 billion issued by nationalized banks were written off by the government.

6.7. Exercises

Ex.1. Following is the balance sheet Rs in (000) of Margalla textile as at December 31, 2010.

Current assets	2000	Liabilities	1000
Plant and equipment	4,000	Equity	5,000
Total assets	**6,000**	**Total equity & Liabilities**	**6,000**

Required
Which of the following is the correct choice?
1. What is the amount of working capital?
2. What is the amount of net worth to be used as a contribution to Musharaka capital?

Ex.2. Mr. ABC entered into Musharaka with first Islamic bank on January 1st 2010 for the financing of Rs; 100,000. The net worth of the business of ABC at that date before financing was Rs; 200,000. Kibor rate was 10%, and the bank wanted to earn at least equal to Kibor. It was decided that minimum profit must be given to bank equal to 10% however if profit is higher than 10% it should be allocated on the basis of contribution to capital. On completion of one-year actual profit earned was Rs; 25,000.

Required:-
Evaluate the contract on the basis of Musharaka and calculate the correct share of profit for a first Islamic bank.

Ex.3. Mr. Yaqoob entered into Musharaka with Margalla Islamic bank on 1st June 2010 for six months. As per the agreement, Mr. Yaqoob will contribute plant and MIB shall provide working capital amounting to Rs; 200,000 to manufacture products to be sold to customers in the market by Mr. Yaqoob. Profit sharing ratio decided as 60:40 for Mr. Yaqoob and MIB respectively. During six month period profit earned is amounting to Rs; 50,000.
Required:-
1. Evaluate the contract on the basis of Musharaka principles and calculate the share of profit for first Islamic bank and Mr. Yaqoob.
2. If on 25th December 2010, the plant suffered by fire and repair took the expenditure of Rs; 50,000, what is a share of profit for each party.
3. If bank insists on the figure of profit calculated in above (1) to share on the plea that plant belongs to Mr. Yaqoob hence he should bear repair charges, what is your reply?

Ex.4. Mr. Usmani entered into Musharaka with Margalla Islamic bank on 1st January 2009. Usmani contributed amounting to Rs; 1,000,000 and the bank gave a matching amount of money to start the business of children garments manufactured. Usmani is the nephew of regional manager of Bank hence amount handed over to him on the personal guarantee for two years without deciding profit sharing ratio. Usmani refunded 50% amount along with 10% return on total financing (in line with the normal rate of return) at the completion of one year and refunded the balance along with 12% of the amount (in line with the normal rate of return) at the completion of the 2nd year. During Shari'a audit, it came into knowledge of auditor who reported to Shari'a board. Shari'a board appointed you as an investigator, and you found the following.
1. No standard Musharaka contract was completed and signed.

2. As per financial reports of Usmani garments profit earned during the period was amounting to Rs; 150,000 in the first year and Rs; 300,000 in the second year. However, the market value of net worth after payment of bank's financing was Rs; 2,500,000.

Required:-

1. Evaluate the contract on the basis of Musharaka principles and calculate the correct share of profit for a first Islamic bank.
2. Write a report to Shari'a Supervisory Board suggesting actions to be taken.

Case- Rowel Textile Ltd.

Mr. Khan CFO of Rowel textile contacted First Islamic Bank (FIB) to provide long-term financing for modernization of plant and building of Mill amounting to Rs; 7 million on January 1st 2007, for a period of 3 years to be refunded as 2 million at one year expiry, 2 millions at 2nd years expiry and balance at 3rd year expiry. Regional manager credit a very experienced banker (worked for seven years in a conventional bank) called the meeting of four selected officers to decide the case. Alam CFA, Akram ACMA, Afzal CA and you MBA. By looking at financial statements (provided following) all of you are convinced to go into business with Rowel textile. Following options came under consideration.

1. Extend financing through Murabaha a secure option by charging Kibor plus 2%. However, the customer does not require an asset rather asking for cash hence option turndown.
2. Enter into Salam sale or Istisna'a sale at a concessional price to be negotiated with the customer, however keeping in view the risk exposure and difficulty in finding a purchaser of clothes this option was also turned down.
3. Enter into Musharaka for the period keeping in view the bright chances of profit on the basis of capital contribution by each partner. After certain deliberation, it was decided to go for Musharaka.

The contract was signed on January 1st 2007. Profit & loss sharing ratio agreed was capital contribution; management handed over to Rowel textile although the bank was not sleeping partner. The bank shall reduce his capital on original

amount and share profit provisionally on the basis of accounting statements for two years however after three years market value balance sheet shall be constructed to settle the account assuming equal gain or loss accrued throughout the whole period.

Textile sector is a major source of exports for many countries including Pakistan and offers investment avenues for IFIs

Towel Textile
Condensed balance sheet, as at December 31.

Desriptions	**2002**	**2003**	**2004**	**2005**	**2006**	**Fair v,2006**
Assets	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)
Cash	2,000	2,200	3,150	2,300	3,375	3,375
Inventory	3,000	2,800	3,200	3,100	3,300	3,465
Accounts Receivables	1,200	1,400	1,500	1,700	1,600	1,550
Plant & Equipments	5,000	4,500	4,000	5,000	4,500	6,000
Total Assets	11,200	10,900	11,850	12,100	12,775	14,390
Liabilities & Equity	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)
Accounts Payables	500	600	700	800	750	750
Accrued expenses	200	300	150	100	125	125
Paid up capital	8,000	8,000	8,000	8,000	8,000	8,000
Retained earnings	2,500	2,000	3,000	3,200	3,900	5,515
Total liabilities & Equ	11,200	10,900	11,850	12,100	12,775	14,390

Following is Musharaka balance sheet for three years without profit sharing or payment of provisional profit to bank along with market value balance sheet at the end of 2009.

Rowel Textile Musharaka

Condensed balance sheet, as at December 31.

Desriptions	**2007**	**2008**	**2009**	**M. Value 2009**
Assets	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)
Cash	3,050	2,500	6,780	6,780
Inventory	4,000	3,500	3,000	3,200
Accounts Receivables	1,700	1,900	1,000	950
Plant & Equipments	11,400	10,800	9,200	10,000
Total Assets	**20,150**	**18,700**	**19,980**	**20,930**
Liabilities & Equity	Rs.(000)	Rs.(000)	Rs.(000)	Rs.(000)
Accounts Payables	900	1,100	800	800
Accrued expenses	250	300	180	180
Paid up capital	13,000	11,000	11,000	11,000
Retained earnings	6,000	6,300	7,000	8,950
Total liabilities & Equity	**20,150**	**18,700**	**18,980**	**20,930**

Required:-

1. Prepare opening balance sheet of Musharaka as at January 1st 2007.
2. Calculate profit sharing ratio on the basis of original contributions to capital.
3. Calculate provisional profit for three years based on accounting income for both partners and state percentage return based on original capital contribution.
4. Calculate correct profit share for both parties on the basis of the market value balance sheet. State share in the profit of bank for three years and calculate average annual profit and average annual percentage return.
5. Suppose bank withdrew his share of provisional profit and owner of Mill took over Rs; 50,000 per month as his cost of living, (both amounts are not included in above balance sheets) what is total profit for the bank during Musharaka period and also calculate average annual profit. Also, state both partners' capital accounts after adjustments at the closure of every year. Determine final amount receivable/payable to Rowel textile mills.

Suggested readings

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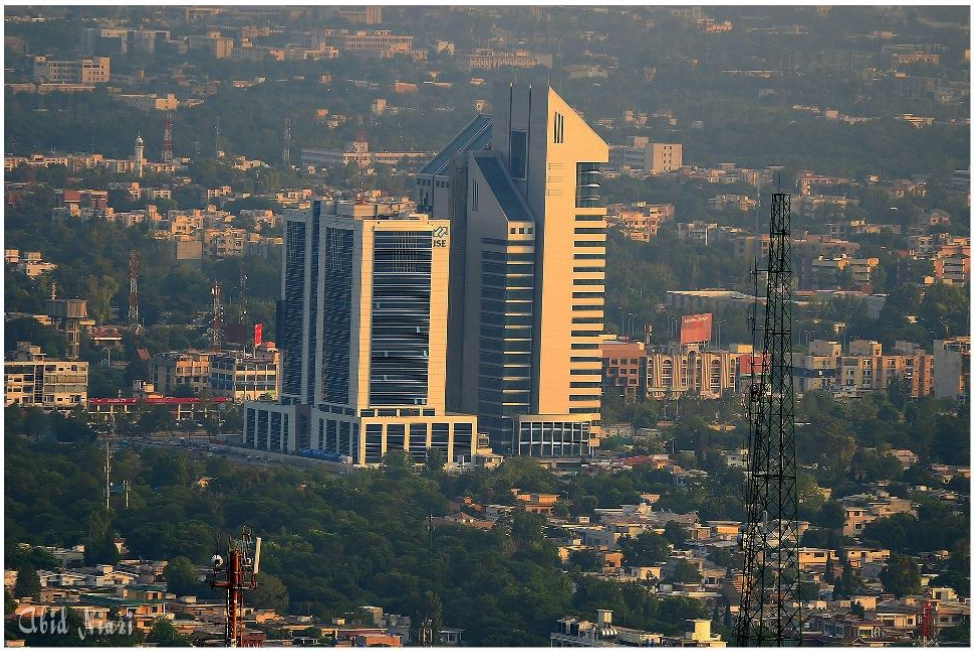
Chapter 7

Diminishing Musharaka



Housing is a dream of everyone and offers investment opportunities for IFIs, Globally

Diminishing Musharaka is a special type of partnership used in profit and loss sharing modes of financing predominantly for provion of house-financing. It has successfully replaced the conventional mortgages. To some extent the true practice of diminishing Musharaka can avoid a crisis like 2007-08. The average share of diminishing Musharaka during last seventeen quarters (09/06-09/10) is 27% in portfolios of IFIs working in Pakistan.

Learning objectives

After going through this chapter reader should be able to understand and interpret the following:

What is diminishing Musharaka financing?

What are Shari'a rulings about operations of diminishing Musharaka financing?

What is the financial impact of diminishing Musharaka financing and how it is accounted for?

How Islamic house-financing is being operated?

What are issues in the practice of Islamic house-financing?

What are similarities and differences in conventional and Islamic house financing?

7.1. Introduction

Diminishing Musharaka is a form of declining partnership between IFI and client generally used to finance real estates. When a customer requests to IFI for financing to purchase an asset IFI participates in the ownership of the asset by contributing required finance. A Certain portion (e.g.20%) must be contributed by the customer. Total equity of bank is divided into units of smaller amounts which are purchased by the client in installments. Under this mode of financing, one of the partners (client) promises to buy the equity share of the other partner (IFI) gradually until the title to the equity is completely transferred to him. Buying and selling of equity units must be independent of partnership contract and must not be stipulated in partnership contract. Generally, IFI rent out his share to the client and earns rentals. Any profit accruing on the property is distributed among the co-owners according to agreed ratio however losses must be shared in the proportion of equity (Shari'a standard 12).

The housing backlog projected in 2005, was 6 million units. The annual additional requirement was estimated around 570,000 units whereas the annual production 300,000 units resulting in a recurring shortfall of 270,000 housing units annually.

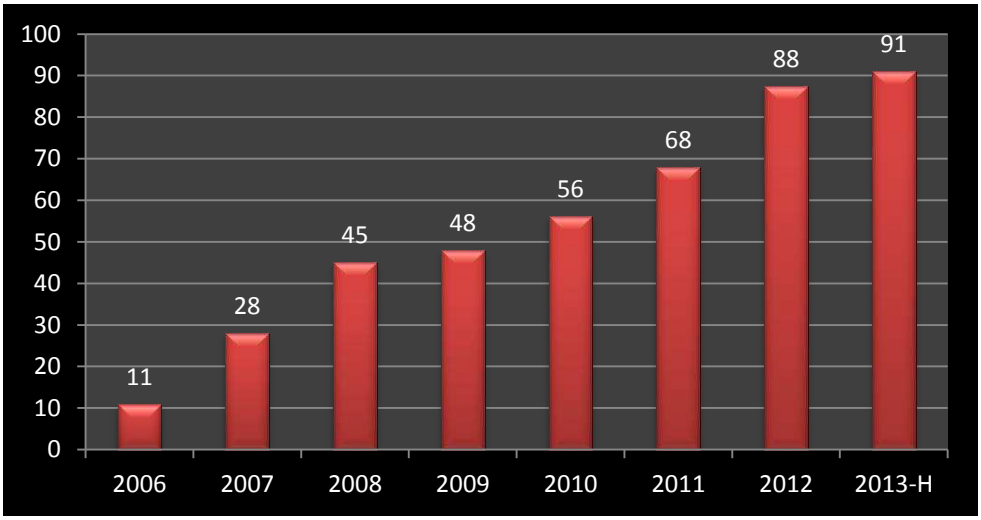
Diminishing Musharaka is used for house financing by IFIs and has replaced successfully conventional mortgages. Figures 7.1 depict the performance made so for by IFIs working in Pakistan under diminishing Musharaka financing during 17 quarters (09/06 – 09/10). Average share in portfolios of IFIs working in Pakistan of diminishing Musharaka is 26%. Figure 7-2 presents closing amounts of investments made by IFIs under Diminishing Musharaka. An appreciable performance has been displayed by IFIs under diminishing Musharaka financing, however, potential is much higher in the housing sector.

Fig 7-1. Percentage share of diminishing Musharaka in portfolios of IFIs

Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Jun 08	Sep 08
12.13%	16.14%	17.46%	19.90%	26.18%	25.68%	29.42%	30.15%
Dec 08	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10
30.56%	31.72%	31.44%	27.50%	30.37%	31.65%	28.29%	32.11%

According to economic survey of Pakistan (2004-05), the ratio of housing units to population is not acceptable by any standard. At average eight Pakistanis are living in one housing unit. 35% of housing units available are consists of a single room. According to 1998 census, the total number of housing units throughout the country was 19.3 million. It was estimated that in order to address the back-log and to meet the housing shortfall in the next 20 years the overall housing production will have to be increased to 820,000 units annually. (Economic Survey, 2004-05).

Fig 7-2. Closing Amounts PKR Billion of investments made under diminishing Musharaka



Source: SBP-Islamic banking bulletins

7.2. Summary of Shari'a Rulings

Following rules are applicable to Diminishing Musharaka. Rule.1 to 6 are common rules for any contractual partnership while rule 7 onward are specifically for diminishing Musharaka [Shari'a Standard 12].

Rule.1. The partnership comes into existence through an agreement (written or verbal). Objectives of partnership should be spelled out in agreement. A partnership agreement can be signed with non-Muslims for a Halal business. An

IFI can enter into syndicate financing with conventional banks subject to operations are conducted by IFI.

A partner can enter into binding promise with others to buy the assets of partnership as per agreed price at the date of buying (however entering into promise to buy on face value is not allowed).

Rule.2. The capital of partnership can be contributed in cash or kind, however, in the case of a contribution made in-kind monetary values of the assets must be expressed in currency to determine the share contributed by each partner. Net assets of a company entering into a partnership are allowed to be used as capital in partnership. It is not allowed that debt (receivables) alone be used as a contribution in capital of partnership.

Rule.3. Each partner is entitled to participate in management however if management right is vested in few or a single partner then others are bound not to interfere in affairs of business under normal course. A manager for remuneration can be appointed to run the affairs of business. Remuneration of managing partner cannot be a fixed amount (except through an independent contract) however higher share in profit is allowed.

Rule.4. Guarantee of capital by a partner to other partners is not allowed, however, any third party can provide guarantee of capital subject to:-

a. Financial liability of guarantor is independent of partnership contract.
b. The guarantee is provided for zero consideration (free of charge, fee etc.).

Nevertheless, ultimate liability rests upon the guaranteed partner if guarantor fails to meet his promise.

Rule.5. Profit sharing according to an agreement among the partners is allowed; however, the loss must be shared according to equity-stake in business. Profit sharing must not be in lump sum amount or percentage of capital rather it should be a percentage share in profit for partners. Profit sharing percentage should not be

Diminishing Musharaka is a form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him.

Sleeping partner's share in profit must not be disproportionate upward to his contribution in partnership agreement.

deferred till realization, it must be determined at the time of contract. Sleeping partner's share in profit must not be disproportionate upward to his contribution in the partnership agreement. Profit is the sum of earnings left-over after deduction of costs, expenses and maintenance of capital. Final distribution of profit is subject to valuation of assets (actual or constructive). Accounts receivables should be valued at cash value less allowances for doubtful accounts. It is not permitted to account for present value of accounts receivables. It is allowed to allocate some profit to partners provisionally subject to final settlement after calculation of actual profit. It is permitted to create a reserve, and charity out of profit subject to agreement. It is allowed for a partner to sacrifice his share in total or a part of the profit in favor of other(s) at the time of profit distribution without any prior contract. It is also allowed that any of the partners bear total loss at the time of loss without any prior condition.

Rule.6. Partnership can be dissolved by any of partner after serving a due notice to others subject to (1) if a partnership is formed for a specific period then it cannot be terminated unilaterally prior to completion of period (2)[16] if a partnership is formed to complete a project then it cannot be terminated unilaterally prior to completion of project. A partner can enter into a binding promise with others to buy the assets of partnership as per agreed price at the date of buying (however entering into a promise to buy at face value is not allowed). At the dissolution of partnership (resulting in closure of business) assets should be disposed-of and proceed is to be distributed in the following order:-

Capital of partnership can be contributed in cash or kind, however, in case of contribution made in kind monetary values of the assets must be expressed in currency to determine the share contributed by each partner.

1. Payment of liquidation expenses.
2. Payment of liabilities.
3. Distribution to the partners in accordance with

[16] This condition is not found in Shari'a Standard and writer think it is appropriate and in line with Islamic law (Shari'a) that a partner in a project should not be allowed to exit prior to completion except with the willingness of others.

their contributions. If remaining amount is less than contribution then distribution should be made on pro-rata basis.

Rule.7. Diminishing Musharaka is a form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him. It is necessary that buying and selling of equity shares should not be stipulated in partnership contract[17]. Contract of buying and selling must be independent of partnership contract because it is not permitted that one contract is entered into as a condition for concluding the other.

Mr. X entered into partnership agreement with an Islamic bank to purchase a house jointly. X contributed 20% and bank 80%. Profit sharing is according to equity stake. Bank let out his share to Mr. X who uses the house for residence. Accordingly X pays rent to bank equal to bank's share. In addition to rent sharing X is purchasing some portion of bank's equity every month, hence, share of X is increasing and that of the bank is decreasing. Making sale and purchase of shares as a stipulation of partnership deed is not allowed under Islamic financial system. Contract of sale and purchase must be a separate contract.

Rule.8. Contract of diminishing Musharaka must not include a clause whereby any of the partners is allowed to withdraw his share in capital.

Under Shirkat ul milk [Joint Property] it is not appropriate to allow a partner to withdraw his share, as it can be done only by selling the asset. The design of diminishing Musharaka instrument in bank financing dictates that partnership should be design in such a way that one partner should have a reasonable amount of time to purchase the equity stake of another partner.

[17] It is important to understand and appreciate the results of forming two contracts i.e one of partnership and other of sale and purchase. E.g. if sale and purchase is not taking place later on due to any reason this will not invalidate the contract of partnership.

Rule.9. Maintenance and insurance etc. are the liability of all owners hence it is not permitted to stipulate that one partner (prospective owner) shall bear all these costs.

Agha entered into diminishing Musharaka contract with a local IFI to purchase a house by contributing 30% Agha and 70% bank. According to scheme, house shall remain under use of Agha who will pay rent to the bank. If any amount spent on Takaful [insurance] and major maintenance that should either be paid out of rentals or be shared by both partners according to equity stake. Putting all the burden of repair on one partner, even if by reducing the rent, who is lessee is against the contract of lease as an unexpected rental is to be paid by him in the case of major repair. Hence, it is appropriate to share the major repair expenses by all partners as and when due.

Rule.10. profit/income/benefit sharing ratio must be clearly determined. It is permitted to agree on a ratio of profit sharing which is disproportionate to equity stake. It is also permitted to agree on a fixed profit sharing ratio or variable (according to changing equity stake) however loss must be shared according to equity stake. It is not permitted to stipulate that a partner shall receive lump sum amount of profit or a percentage of capital.

Molvi sb Lohey Waley entered into a diminishing Musharaka contract with an IFI to purchase a house by contributing 30% by customer and 70% by the bank. As per agreement, bank shall receive 10% return on receivable balance from the customer is a void contract. Bank can receive his share of rent according to equity stake.

Rule.11. Binding promise of sale and purchase of equity, gradually, at an agreed price at the time of transaction of sale of equity shares, is allowed, however it is not allowed to stipulate the sale/purchase of equity shares at their original or face value as this will constitute a guarantee of

Profit is the sum of earnings leftover after deduction of costs, expenses and maintenance of capital.

capital to selling partner which is contradicting with rule four of partnership listed above. It is allowed to divide the equity stake into shares of smaller amount so that buyer can purchase any number of shares as per his convenience.

Mr. Alam acquired a house under diminishing Musharaka scheme of a local Islamic bank. Initial equity stake was 20:80 between customer and bank. It was further stipulated that in addition to payment of rent by the customer, he will purchase equity shares of the bank at par value is a void contract. Ideally selling price should be decided by the bank after keeping into account market changes in the housing sector and should charge a price closer to market. This is the only principle of Islamic house financing which can make it different from conventional mortgages. Selling of equity shares at market price by the bank can save the economy from a crisis like 2007-08 in USA economy. The major reason for crisis was voluntary default by customers and there was a reason to do so. An increasing number of houses on sale due to non-payment by customers [defaulters] reduced the value of houses and solvent customers of banks noted that what they have agreed to pay to the bank is much higher than ever declining market price of houses; hence, they decided not to pay and go for willful default. This act of voluntary default played the role of catalyst in crisis resulted in closure of many big firms and unemployment. Had there been diminishing Musharaka in operation, no question of voluntary default as then customers were not required to pay the par value of equity stake of the bank. They would be happy to pay the reduced amount to banks according to the market price of the houses.

Rule.12. Renting or leasing the share of another partner(s) is allowed for a specified amount and for whatever duration.

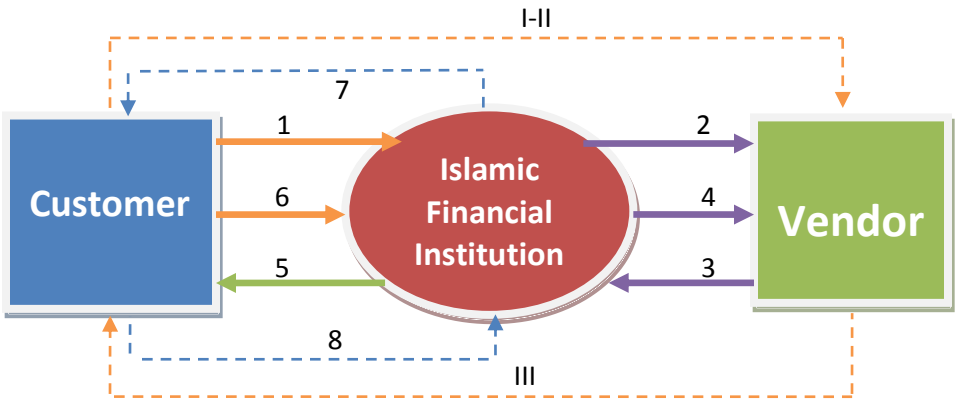
It is rather desirable that in a joint property one partner should rent out his share to other partner and if he is not willing then to someone else and even then after consulting the joint owner in the property.

Practical application of diminishing Musharaka is dominating in house financing, hence, financial impact and working under principles of diminishing Musharaka is illustrated through house financing in the following section.

7.3. Islamic House Financing

House financing is provided under the principles of a special purpose partnership generally known as Diminishing Musharaka. According to Shari'a standard 12 *"Diminishing Musharaka is a form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him"* Under Diminishing Musharaka arrangement partnership agreement is required; verbal or written; capital is contributed by both parties in cash or in kind; profit is shared as per agreement while loss is shared according to contribution in equity; cost of major repair and maintenance, insurance etc are shared by both parties; one partner (IFI) leases his share in asset to other (client) for a consideration.

Figure 7-3. Graphic presentation of Diminishing Musharaka process



Contract of buying and selling of equity units between partners cannot be stipulated in Diminishing Musharaka contract; the price of units to be sold /purchased is a fair value or else as agreed between parties but the face value of units cannot be stipulated (Shari'a Standard 12).

Figure 7-3. presents Diminishing Musharaka structure applied in house financing, explained as under:-

1-2. Customer contacts IFI for the purchase of a house as a joint owner and bank search for a builder. The customer himself can identify builder as well as housing unit of his need and inform bank for making payment (I-II). The customer makes a part payment usually 20% of value [a. The signing of partnership deed between bank and customer. b. Placing a purchase order to the vendor. c. Part payment is deposited by customer with bank].
3. The property is purchased in joint ownership of bank and customer. In certain cases, it is purchased in the name of the customer to avoid double taxation on transfer of property [Transfer of property contract either in the name of the customer or in joint ownership of bank and customer].
4. Payment in full to vendor is made by bank [cheque/cash or transfer of funds in account of vendor]
5. House is handed over to the customer for his use. Bank enters into an Ijarah contract with customer for his equity share in house [Ijarah contract is signed]
6. Customer makes periodic payment of rentals to the bank [cheques/cash deposited with bank].
7. Bank enters into sales contract of his equity divided into units of the smaller denomination as per agreed for the length of Musharaka contract whereby the customer purchases one share in the equity of bank by making payment along with Ijarah rentals. [Sale and purchase contract of equity units].
8. Customer pays amount of each equity unit purchased from bank [cash/cheques deposited with bank]

To put the concept into practice following example would clarify the working under diminishing Musharaka[18].

Mr. A wants to purchase a house amounting to Rs; 1,000,000 and requesting an IFI for financing to be repaid in eight years through eight equal installments. Under Diminishing Musharaka arrangement, the equi-

It is not allowed to stipulate the sale/purchase of equity shares at their original or face value as this will constitute a guarantee of capital to selling partner which is contradicting with rule.4 of partnership listed above.

[18] [We presented a very simple example here to demonstrate the concept ignoring any appreciation (depreciation) in value of property; further we kept the rentals fixed]

ty of Bank is divided into eight units which A will acquire annually. A Certain portion (e.g. 20%) of the total price is to be contributed by A and rest (80%) is provided by IFI at the time of acquisition. House is the joint property of IFI and A. After acquisition, the house is handed over to A and IFI is renting his share in the property to A. Suppose annual rent of the property is Rs; 1,00,000 net of repair and insurance etc. Detailed working relating to this example is provided below in table 7-1. For an easy understanding of the concept, equity shares are sold at par in this illustration. Market value effect is introduced later on.

Table 7-1 Payment schedule under Diminishing Musharaka mechanism

End of Years	Principal Payment	Rental Payment	Amount of Installments	Balance
0	0	0	0	800,000
1	100,000	80,000	180,000	700,000
2	100,000	70,000	170,000	600,000
3	100,000	60,000	160,000	500,000
4	100,000	50,000	150,000	400,000
5	100,000	40,000	140,000	300,000
6	100,000	30,000	130,000	200,000
7	100,000	20,000	120,000	100,000
8	100,000	10,000	110,000	0
Total	800,000	360,000	1,160,000	0

For the first year, the share in rent of IFI is Rs; 80,000 being the owner of 80% of the property. The first installment is Rs; 180,000 consisting of the purchase price of an equity unit and rent. For every subsequent year as the share of IFI is decreasing in property, hence, the amount of rent payable is also decreasing as shown in table 7.1. According to this model the owner and the IFI both are contributing capitals and enter into Musharaka.

The reward sharing is according to capital contribution or as may be agreed but any loss to the property is to be shared by both the parties according to their equity stake at the time of loss.

Any damage or loss occurred to the property without negligence of client is shared by IFIs according to their equity stake which is not the case in conventional mortgages.

The reward sharing is according to capital contribution or as may be agreed but any loss to the property is to be shared by both the parties according to their equity stake at the time of loss. However this is Diminishing Musharaka, by the time client is purchasing equity units of IFI the share in rent is also decreasing. The installment payment includes a share of rent and purchase price of an equity unit. Over the time equity of IFI is decreasing and share in rentals is also decreasing. With the purchase of last equity unit the share of IFI comes to an end and property as a whole is transferred in the name of the owner.

Second is the case of construction of property by the client instead of purchase. As a principle of Musharaka return (rentals) for IFI will due once the property is useable. As a general practice value of the constructed house is higher than its cost under normal circumstances. IFI and client can conclude a price covering the profit for IFI at the time of completion of the property. In this case, IFI shall receive the return in the form of rent after completion of the house and also profit over cost for the period of construction, being a partner in the construction.

In practice, IFIs are calculating the IRR on their share (payable balance) and state as a percentage return along with the principal.[19] This method of calculation makes it easier for customers to understand liability and make a comparison of various financing agencies in the process of reaching a conclusion. This method is also assisting IFIs to offer competitive rates to customers because (as it is said) Islamic banking is at an infant stage and has to compete with established conventional banking.

7.4. Conventional Vs. Islamic Mortgage

In this section, we are highlighting the difference between conventional and Islamic house financing as under.

[19] Generally in line with KIBOR (Karachi Inter Bank Offered Rate)

1. Under the conventional financial system, interest is charged which is determined on the basis of demand and supply of the capital while under Islamic financial system rent of the property is charged, determined through demand and supply of real asset. Hence, return under conventional mortgages is not linked with utility creation while under Islamic house financing financial sector is linked to the real sector. Without having a linkage between financial and real sector, it is a zero sum game which does not add any value to the society as a whole.

Fixation of prices of equity units in advance (normally to recover the principal) narrows the difference between Islamic house financing transactions and those of conventional mortgages in substance, if not in form.

2. As conventional banks do not own the underlying asset, hence sharing of risk and reward of the property is not required while IFIs are co-owners of the property and share risk and rewards attached to ownership.

3. Return for conventional banks starts from the date of loan extension facility which is not the case in IFIs. Under Diminishing Musharaka model return is due when the property is ready for use either through an acquisition or through construction.

4. Conventional banks will continuously receive the installments (containing interest & principal) even if the property is not usable and needs some repair. During the repair period, IFIs cannot receive the rent.

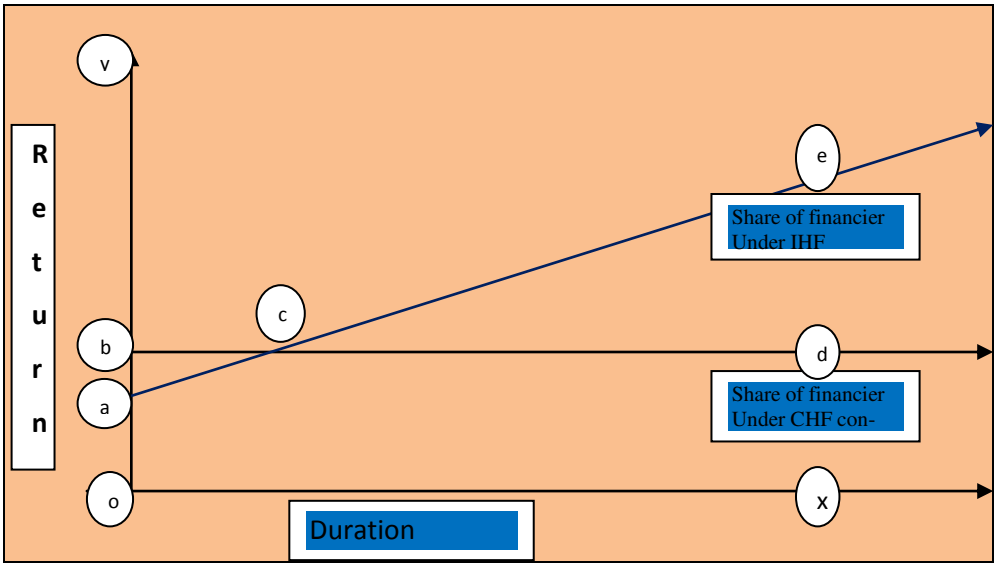
5. Return of conventional banks is fixed as interest while IFIs will receive rentals as well as share any appreciation (depreciation).

Graphic presentation of comparative returns is shown in figure 7.4. In figure 7.4 on x-axis time period and on y-axis returns are shown. Curve *bd* is representing return under the conventional financial system and curve *ae* is representing return under Diminishing Musharaka. In initial period return under Diminishing Musharaka is low *(abc)* as compare to conventional system (and during construction or repair phase may be zero) and increases with the increase in the value of property *(cde)* while return under the conventional mortgage is fixed irrespective of value appreciation (depreciation) of property (obxd). The lower return in

IFIs have to take into account the appreciation /depreciation in property value as well as actual rental value of the property in order to put true Musharaka in practice.

the earlier period and higher return later on under Diminishing Musharaka is justified on the basis of the outcome of the underlying project.

Fig 7-4. Conceptual framework (comparative returns)



7.5. Issues in Existing Practices of IFIs

As a principle, under Musharaka mode of financing risks and rewards are shared by the partners (Shari'a Standard 12). Reward or return is income received on an investment plus any change in market price (Van Horne 07). The existing model of Islamic house financing (in practice) gives rise to certain questions as follows.

1. The first and foremost; it ignores the appreciation /depreciation in value of the property. After all, how it can be justified that any appreciation /depreciation in the value of property belongs to one partner (owner) and nothing for other (financier); while in majority cases, financier provides a larger part of the capital. This is clearly against the principles of Musharaka. One can argue that if financier wants to gift his share in appreciation, or surrender his share in favor of another partner, then nothing against justice. However, the financier in question

is IFI who is not the sole owner of capital invested. Capital is provided by depositors on profit and loss sharing basis and they too are owners. So any surrender in the share of return by IFI would mean gifting the property of others, without their consent. In fact, what is practically happening in the market is due to the principle of the market itself (demand and supply). IFIs fear the loss of customers if true Musharaka is being put into practice. Sharing of appreciation would increase the amount payable by customers and they might prefer conventional mortgage. On the other hand sharing of depreciation in value would increase the risk for IFIs which they might not be able/ willing to tolerate. IFIs are trying to be competitive with conventional banks in order to attract and retain customers. This is a valid business trick but this is a hurdle in the promotion of true Islamic financial system, which differentiates itself through sharing of risks and rewards.

If products of IFIs would be costly than conventional banks they (IFIs) might lose the customers.

2. The second question is a determination of rental value in advance or linking with KIBOR (Karachi Inter-Banks Offered Rate). In this era of paper currency, inflation is hitting almost every country. In Pakistan, official figures of inflation, for last three years (2005-07) are more than 7%. The house rent inflation was 11% in the year 2004-05 (Economic survey of Pakistan 04-05). It means the rental value of the underlying property is varying (increasing) every year. How can one determine the return rate in advance assuming an artificial rental value instead of actual?

3. Third question; what IFIs are demanding from customers is rental of capital (payable balance) determined on the basis of KIBOR and not the share of rentals based on the actual rent of the property. As a matter of fact, Diminishing Musharaka explicitly states the sharing of risk and reward associated with underlying property and not the rent of capital. KIBOR determines rent of capital, used under the conventional financial system, and not the rent of the property.

After all how it can be justified that any appreciation /depreciation in the value of property belongs to one partner (owner) and nothing for other (financier); while in majority cases financier provides larger part of capital.

4. Another severe criticism on IFIs raised by certain quarters is the linkage of profit percentage with KI-

BOR. This objection is not only limited to house financing rather it is on all financing tools of IFIs. IFIs are of the view that they are competing with conventional banks which are dominating the local financial market with a share of 94%. Any other benchmark might turn the operations of IFIs uncompetitive with conventional banks. If products of IFIs would be costly than conventional banks they (IFIs) might lose the customers. The viewpoint of IFIs does carry weight however it adds in negative perception among masses about their operations. This negative perception is required to be changed as the chief motivating factor for customers to transact business with IFIs is their Shari'a compliant operations and, of course, sole reason of their existence.

4. Finally, fixation of prices of equity units to be purchased by the client guarantees the return of investment to the financier irrespective of increase /decrease in the value of the underlying project which is against the very nature of Musharaka financing (Shari'a standard 12). After the financial crisis of 2007-08, this aspect demands more consideration by experts of Islamic financial system and IFIs. It is generally argued that such a crisis cannot happen under Islamic financial system. Yes, the argument carries weight if true Musharaka is in operation then certainly such crises can be avoided. Under true Musharaka one may not witness willful default by financially sound customers during the period of fall in prices of real estate because they (customers) are not alone to bear the whole risk/loss. Fixation of prices of equity units in advance (normally to recover the principal) narrows the difference between Islamic house financing transactions and those of conventional mortgages in substance, if not in form.

To conclude, IFIs have to take into account the appreciation /depreciation of property value as well as the actual rental value of the property in order to put true Musharaka in practice. Liability of prospective owner cannot be determined in advance, which is the essence of Musharaka business. Any increase /decrease in value should be shared by both parties. As for practice is concerned, two frameworks for sharing of appreciation/depreciation in property value are suggested. First is to value the house at the time all principal has discharged an adjustment for apprecia-

In Islamic banking the return of financier is low in early years and higher in later years (according to value of property) as compared to conventional banking.

tion /depreciation should be made. Second method the most accurate is to revalue the house every year and determine the rental value accordingly, to calculate installment payable for the year and so on. In recent years, there is a booming increase in rentals as well as in the value of property in the local market. Take the example of property prices and rental values of any city center, you will see a manifold increase. In certain instances like Islamabad city prices are gone up to (50-60) times approximately in 20 to 25 years. In the case of conventional banking, the return is fixed irrespective of rental value and value appreciation. In the case of Islamic house financing, any increase in value and rental is shared with the financier. The following tables and graph will explain the phenomenon of housing values boom in Islamabad and likely impact on returns under conventional and Islamic house financing systems.

7.6. Concept Building

Illustration.1. These figures are relating to an average house in Islamabad for 27 years.

1. A house purchased in 1981 for the amount of Rs; 600,000 and rental value at that time 30,000 per annum. At present 2007 the same house is carrying a value of 41,000,000 with a rental value of Rs; 1,200,000.[20]
2. 50% contributed by bank and rest by owner.
3. Assuming customer has not returned principal to date.
4. The interest rate is 15% fixed.

Required:-

1. Prepare a table showing an increase in the value of property and rentals through IRR?
2. Present graphically, return on property, share of financier under Islamic house financing and conventional mortgage?
3. What is average annual percentage return under the conventional mortgage and Islamic house financing?

[20] The values are taken from market with personal observation and interviews with property dealers

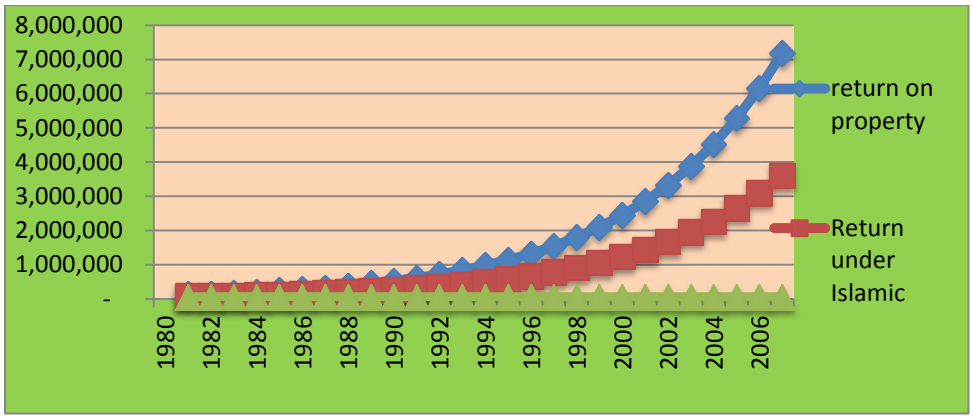
4. What is return for an investor under Islamic house financing and conventional mortgage?

Solution

Although practically increase in property value is taken place in phases however for ease of calculation and understanding I calculated the internal rate of return that becomes around 17%. Complete working is shown in following table 7.2. Figure 7.5, table 7.3 & 7.4 display return on investment (rental value and appreciation) which starts from Rs; 132,000 p.a. and reaches to Rs; seven million p.a. in 27th year. The share of investor under Islamic house financing is increasing accordingly while under conventional mortgage it is fixed of Rs; 45,000 irrespective of return.

In figure 7.5 on x-axis years and on y-axis returns are measured. Under Islamic house financing system return is increasing with the increase in the value of the property. The blue line is representing a total return of the property which has crossed the figure of Rs; 7 million and red curve depicts the return for IFI which is reached to Rs; 3.5 million in the 27th year while orange line is representing return under a conventional system which is fixed of Rs; 45,000 per annum. Percentage return under Islamic house financing is higher (average 21%) as compare to conventional (15%). By looking at graph and tables certain points worth mentioning, are as follow:-

Fig 7-5. Total return (rental +appreciation) and distribution under Islamic Financial System



1. First; in Islamic banking, the return of financier is low in early years and higher in later years (according to the value of property) as compared to conventional banking. However, it varies with the actual return on property hence, justified. It is not putting the owner into trouble by asking for a fixed return irrespective of the actual outcome of the underlying project. So by applying the practice of Diminishing Musharaka, banks can earn more than conventional financing system. Under this system bank will earn more and share accordingly with depositors as deposits are taken under profit and loss sharing system. This will result shifting of capital and savings from conventional banking to Islamic banking.
2. Second; if we look at the total return under conventional banking one can earn in 27 years Rs; 1.2 million while under Islamic banking the return in the same period is around Rs; 4 million in rentals and cumulative share in appreciation is Rs; 20 million. So the IFIs are earning approximately Rs; 22.8 million more than conventional banks which is justified as there is appreciation, in the property value, of Rs; 41 million in 27 years. As a matter of fact, this will shift the depositors to IFIs and customers—borrowers-- towards conventional banking and leave the IFIs with more funds and fewer customers-borrowers-. Here the economic principle of demand and supply will come to play i.e. determination of return for IFIs through demand-supply forces. Under such circumstances, return can be shared under any acceptable ratio-favoring customers as profit sharing can be decided through a mutual agreement under Musharaka. However if things move in opposite direction as happened in financial crisis 2007-08, the customer is relatively secured because the loss is shared according to equity under Islamic banking.

Table 7-3. Comparative return- (rental plu appreciation) under both schemes (000)

Financing scheme	**1981**	**1986**	**1991**	**1996**	**2001**	**2006**	**2007**
Value of property	702	1,539	3,374	7,398	16,220	35,561	41,607
Total Return on Property	132	284	611	1,320	2,847	6,000	7,000
Return under Islamic banking	66	140	305	660	1,423	3,000	3,500
Return under conventional banking	45	45	45	45	45	45,	45

Table 7-2. Calculation of rentals and appreciation in value and share of financier in (000)

Years	Value of Hous	Increase in value	Rentals of Hous	Increase in Rent	Return on Prop-	Share in Rent	Share in Capital	Return under Islamic	Return under Conve
1980	**600**								
1981	702	102	30	5	132	15	51	66	45
1982	821	119	35	5	154	17	60	77	45
1983	961	140	40	6	179	20	70	90	45
1984	1,124	163	46	7	209	23	82	104	45
1985	1,315	191	52	8	244	26	96	122	45
1986	1,539	224	60	9	284	30	112	142	45
1987	1,801	262	69	10	331	35	131	166	45
1988	2,107	306	80	12	386	40	153	193	45
1989	2,465	358	92	14	450	46	179	225	45
1990	2,884	419	106	16	525	53	210	262	45
1991	3,374	490	121	18	612	61	245	306	45
1992	3,948	574	140	21	713	70	287	357	45
1993	4,619	671	161	24	832	80	336	416	45
1994	5,404	785	185	28	970	92	393	485	45
1995	6,323	919	212	32	1,131	106	459	566	45
1996	7,398	1,075	244	37	1,319	122	537	660	45
1997	8,656	1,258	281	42	1,538	140	629	769	45
1998	10,12	1,471	323	48	1,794	161	736	897	45
1999	11,84	1,722	371	56	2,093	186	861	1,046	45
2000	13,86	2,014	427	64	2,441	213	1,007	1,221	45
2001	16,22	2,357	491	74	2,848	245	1,178	1,424	45
2002	18,97	2,757	565	85	3,322	282	1,379	1,661	45
2003	22,20	3,226	649	97	3,876	325	1,613	1,938	45
2004	25,97	3,775	747	112	4,521	373	1,887	2,261	45
2005	30,39	4,416	859	129	5,275	429	2,208	2,638	45
2006	35,56	5,167	988	148	6,155	494	2,584	3,077	45
2007	41,60	6,046	1,136	170	7,181	568	3,023	3,591	45
	Total	**41,007**	**8,507**	**1,276**	**49,514**	**4,254**	**20,504**	**24,757**	**1,215**

Table 7-4. Showing the % return- (rental plus appreciation) under both schemes

Financing scheme	1981	1986	1991	1996	2001	2006	2007
Return under Islamic bank	22%	22%	21%	21%	21%	20%	20%
Return under conventional bank	15%	15%	15%	15%	15%	15%	15%

Illustration.2. On January 1st 2005, Mr. Asghar an employee of a multinational company contacted Margalla Islamic Bank for the financing of a house already constructed in DHA Islamabad, to be paid within five years. The fair value of the house is Rs; 5 million. The policy of the bank for house financing is listed as under.

1. The plot must not be in a negative area. (Negative areas include where land ownership is not clear rather disputed).
2. 50% of earnings of the customer must be able to meet rental as well as the purchase price of the unit.
3. House must be acquired in joint ownership of bank and client while documents are to be kept by bank till the transfer of ownership.
4. At least customer must be able to contribute 30% of the price.
5. Maximum limit of financing is 10 years and installment must be either monthly or quarterly.

Required:-

1. What is the amount of contribution required by Mr. Asghar and Bank?
2. If rental of the property is Rs; 60,000 per month what should be income (at least) of Mr. Asghar to qualify for house financing?
3. Suppose Mr. Asghar qualifies for financing what should be the amount of installment (including rental and purchase of equity) on a monthly basis? Quarterly basis? Assuming equity units sold at nominal value.

Solution

1. First of all to check weather criteria set for house financing is met. Because the plot is locating in DHA hence it is not in the negative area. Second is a sufficiency of income of client to be answered under requirement number two. The third is purchase under joint ownership to be fulfilled once an agreement reached. Fourth is contribution amount by client that is at least 30% of fair value amounting to Rs; 1,500,000 (30% of 5,000,000). Fifth is a term of financing which is less than approved limit. Contribution of bank is Rs; 3,500,000 (5,000,000 – 1,500,000).

2. As the customer is requesting for five years only so the payment of rent and purchase of equity share must be completed within five years. Following is the calculation of per month income of Mr. Asghar to qualify for financing under diminishing Musharaka. Because working is for quarterly installment hence total equity stake to be purchased is divided into 20 units and price per unit becomes Rs; 175,000 (3,500,000/20). If equal installments agreed then quarterly installment becomes Rs; 244,300 (4,886,000/20) and as per criteria set above the quarterly income of customer must be equal to or greater than Rs; 488,600 (244,300*2) which means monthly take home earnings amounting to Rs; 162,867 (488,600/3). However if variable installments are agreed then monthly income to qualify for financing is required amounting to Rs; 200,667 [(301,000 X 2)/3]. The following worksheet shows the calculation of installments.

3. Quarterly basis installment is calculated under the 2nd requirement.

Work Sheet-Quarterly payments

Quarters	Total rent	Share of Bank	Equity unit	Installment	Sharing %
2005					
Quarter 1	180,000	126,000	175,000	301,000	70.00%
Quarter 2	180,000	119,700	175,000	294,700	66.50%
Quarter 3	180,000	113,400	175,000	288,400	63.00%
Quarter 4	180,000	107,100	175,000	282,100	59.50%
2006	-	-	-	-	
Quarter 1	180,000	100,800	175,000	275,800	56.00%
Quarter 2	180,000	94,500	175,000	269,500	52.50%
Quarter 3	180,000	88,200	175,000	263,200	49.00%
Quarter 4	180,000	81,900	175,000	256,900	45.50%
2007	-	-	-	-	
Quarter 1	180,000	75,600	175,000	250,600	42.00%
Quarter 2	180,000	69,300	175,000	244,300	38.50%
Quarter 3	180,000	63,000	175,000	238,000	35.00%
Quarter 4	180,000	56,700	175,000	231,700	31.50%
2008	-	-	-	-	
Quarter 1	180,000	50,400	175,000	225,400	28.00%
Quarter 2	180,000	44,100	175,000	219,100	24.50%
Quarter 3	180,000	37,800	175,000	212,800	21.00%
Quarter 4	180,000	31,500	175,000	206,500	17.50%
2009	-	-	-	-	
Quarter 1	180,000	88,200	175,000	263,200	49.00%
Quarter 2	180,000	18,900	175,000	193,900	10.50%
Quarter 3	180,000	12,600	175,000	187,600	7.00%
Quarter 4	180,000	6,300	175,000	181,300	3.50%
Total	3,600,000	1,386,000	3,500,000	4,886,000	0.00%

Work Sheet-Monthly payments

Months	Total rent	Share of Bank	Equity unit	Installment	Sharing %
Jan-05	60,000	42,000	58,333	100,333	70.00%
Feb-05	60,000	41,300	58,333	99,633	68.83%
Mar-05	60,000	40,600	58,333	98,933	67.67%
Apr-05	60,000	39,900	58,333	98,233	66.50%
May-05	60,000	39,200	58,333	97,533	65.33%
Jun-05	60,000	38,500	58,333	96,833	64.17%
Jul-05	60,000	37,800	58,333	96,133	63.00%
Aug-05	60,000	37,100	58,333	95,433	61.83%
Sep-05	60,000	36,400	58,333	94,733	60.67%
Oct-05	60,000	35,700	58,333	94,033	59.50%
Nov-05	60,000	35,000	58,333	93,333	58.33%
Dec-05	60,000	34,300	58,333	92,633	57.17%
Jan-06	60,000	33,600	58,333	91,933	56.00%
Feb-06	60,000	32,900	58,333	91,233	54.83%
Mar-06	60,000	32,200	58,333	90,533	53.67%
Apr-06	60,000	31,500	58,333	89,833	52.50%
May-06	60,000	30,800	58,333	89,133	51.33%
Jun-06	60,000	30,100	58,333	88,433	50.17%
Jul-06	60,000	29,400	58,333	87,733	49.00%
Aug-06	60,000	28,700	58,333	87,033	47.83%
Sep-06	60,000	28,000	58,333	86,333	46.67%
Oct-06	60,000	27,300	58,333	85,633	45.50%
Nov-06	60,000	26,600	58,333	84,933	44.33%
Dec-06	60,000	25,900	58,333	84,233	43.17%
Jan-07	60,000	25,200	58,333	83,533	42.00%
Feb-07	60,000	24,500	58,333	82,833	40.83%
Mar-07	60,000	23,800	58,333	82,133	39.67%
Apr-07	60,000	23,100	58,333	81,433	38.50%
May-07	60,000	22,400	58,333	80,733	37.33%
Jun-07	60,000	21,700	58,333	80,033	36.17%
Jul-07	60,000	21,000	58,333	79,333	35.00%
Aug-07	60,000	20,300	58,333	78,633	33.83%
Sep-07	60,000	19,600	58,333	77,933	32.67%
Oct-07	60,000	18,900	58,333	77,233	31.50%
Nov-07	60,000	18,200	58,333	76,533	30.33%
Dec-07	60,000	17,500	58,333	75,833	29.17%
Jan-08	60,000	16,800	58,333	75,133	28.00%
Feb-08	60,000	16,100	58,333	74,433	26.83%
Mar-08	60,000	15,400	58,333	73,733	25.67%
Apr-08	60,000	14,700	58,333	73,033	24.50%

Work Sheet Continued….

Months	Total rent	Share of Bank	Equity unit	Installment	Sharing %
May-08	60,000	14,000	58,333	72,333	23.33%
Jun-08	60,000	13,300	58,333	71,633	22.17%
Jul-08	60,000	12,600	58,333	70,933	21.00%
Aug-08	60,000	11,900	58,333	70,233	19.83%
Sep-08	60,000	11,200	58,333	69,533	18.67%
Oct-08	60,000	10,500	58,333	68,833	17.50%
Nov-08	60,000	9,800	58,333	68,133	16.33%
Dec-08	60,000	9,100	58,333	67,433	15.17%
Jan-09	60,000	8,400	58,333	66,733	14.00%
Feb-09	60,000	7,700	58,333	66,033	12.83%
Mar-09	60,000	7,000	58,333	65,333	11.67%
Apr-09	60,000	6,300	58,333	64,633	10.50%
May-09	60,000	5,600	58,333	63,933	9.33%
Jun-09	60,000	4,900	58,333	63,233	8.17%
Jul-09	60,000	4,200	58,333	62,533	7.00%
Aug-09	60,000	3,500	58,333	61,833	5.83%
Sep-09	60,000	2,800	58,333	61,133	4.67%
Oct-09	60,000	2,100	58,333	60,433	3.50%
Nov-09	60,000	1,400	58,333	59,733	2.33%
Dec-09	60,000	700	58,333	59,033	1.17%
Total	**3,600,000**	**1,281,007**	**3,499,980**	**4,780,987**	**0.00%**

3. Under monthly installment equity stake of the bank to be sold is divided into 60 shares which become an amount of Rs; 58,333 (3,500,000/60). Monthly basis installments are calculated in the following worksheet. If payment agreed in equal installments then monthly installment becomes Rs; 79,683 (4,780, 987/60) and desired income for qualification is Rs; 159,366 per month.

Illustration.3. In continuation of illustration 2. IF rentals and price of equity units are linked with inflation index what is the amount of installment (including rentals and purchase of equity) on Quarterly basis? Following is expected inflation index for five years.

Solution

If rent and price of equity units are tied to CPI then quarterly installment becomes amounting to Rs; 271,978 (5,439,553/20) if equal installments agreed. The calculation is shown in the following worksheet.

Work Sheet-Quarterly Payments [Inflation based]

Quarters	Total rent	Sh. of Bank	Equity unit	Installment	Sharing %	Inflation	Cum. Infla
2005							
Quarter 1	180,000	126,000	175,000	301,000	70.00%	1.00%	1.00%
Quarter 2	183,600	122,094	178,500	300,594	66.50%	1.00%	2.00%
Quarter 3	187,200	117,936	182,000	299,936	63.00%	2.00%	4.00%
Quarter 4	189,000	112,455	183,750	296,205	59.50%	1.00%	5.00%
2006	-	-	-	-			5.00%
Quarter 1	190,800	106,848	185,500	292,348	56.00%	1.00%	6.00%
Quarter 2	192,600	101,115	187,250	288,365	52.50%	1.00%	7.00%
Quarter 3	194,400	95,256	189,000	284,256	49.00%	1.00%	8.00%
Quarter 4	198,000	90,090	192,500	282,590	45.50%	2.00%	10.00%
2007	-	-	-	-			10.00%
Quarter 1	199,800	83,916	194,250	278,166	42.00%	1.00%	11.00%
Quarter 2	201,600	77,616	196,000	273,616	38.50%	1.00%	12.00%
Quarter 3	203,400	71,190	197,750	268,940	35.00%	1.00%	13.00%
Quarter 4	205,200	64,638	199,500	264,138	31.50%	1.00%	14.00%
2008	-	-	-	-			14.00%
Quarter 1	207,000	57,960	201,250	259,210	28.00%	1.00%	15.00%
Quarter 2	208,800	51,156	203,000	254,156	24.50%	1.00%	16.00%
Quarter 3	210,600	44,226	204,750	248,976	21.00%	1.00%	17.00%
Quarter 4	212,400	37,170	206,500	243,670	17.50%	1.00%	18.00%
2009	-	-	-	-			18.00%
Quarter 1	214,200	104,958	208,250	313,208	49.00%	1.00%	19.00%
Quarter 2	217,800	22,869	211,750	234,619	10.50%	2.00%	21.00%
Quarter 3	221,400	15,498	215,250	230,748	7.00%	2.00%	23.00%
Quarter 4	223,200	7,812	217,000	224,812	3.50%	1.00%	24.00%
Total	**4,041,000**	**1,510,803**	**3,928,750**	**5,439,553**	**0.00%**		

Inflation Table

Quarters	CPI	Quarters	CPI
2005		2008	
Quarter 1	1.00%	Quarter 1	1.00%
Quarter 2	1.00%	Quarter 2	1.00%
Quarter 3	2.00%	Quarter 3	1.00%
Quarter 4	1.00%	Quarter 4	1.00%
2006		2009	
Quarter 1	1.00%	Quarter 1	1.00%
Quarter 2	1.00%	Quarter 2	2.00%
Quarter 3	1.00%	Quarter 3	2.00%
Quarter 4	2.00%	Quarter 4	1.00%
2007			
Quarter 1	1.00%		
Quarter 2	1.00%		
Quarter 3	1.00%		
Quarter 4	1.00%		

Illustration.4. In continuation of illustration 2. IF rentals and price of equity units are linked with Kibor what is the amount of installment (including rentals and purchase of equity) on Quarterly basis? Following is expected quarterly Kibor for five years.

Kibor Table

Quarters	Kibor	Quarters	Kibor
2005		2008	
Quarter 1	10.00%	Quarter 1	11.50%
Quarter 2	10.50%	Quarter 2	11.50%
Quarter 3	11.00%	Quarter 3	11.00%
Quarter 4	11.50%	Quarter 4	11.00%
2006		2009	
Quarter 1	11.50%	Quarter 1	10.50%
Quarter 2	12.00%	Quarter 2	10.50%
Quarter 3	12.00%	Quarter 3	10.50%
Quarter 4	12.00%	Quarter 4	10.00%
2007			
Quarter 1	11.50%		
Quarter 2	11.50%		
Quarter 3	12.00%		
Quarter 4	12.00%		

Work Sheet-Quarterly Payments [Kibor based]

Quarters	Total rent	Share of Bank	Equity unit	Installment	Sharing %	Kibor	Change in Kib
2005							
Quarter 1	180,000	126,000	175,000	301,000	70.00%	10.00%	
Quarter 2	189,000	125,685	183,750	309,435	66.50%	10.50%	0.05
Quarter 3	198,000	124,740	192,500	317,240	63.00%	11.00%	0.10
Quarter 4	207,000	123,165	201,250	324,415	59.50%	11.50%	0.15
2006	-	-	-	-			
Quarter 1	207,000	115,920	201,250	317,170	56.00%	11.50%	0.15
Quarter 2	216,000	113,400	210,000	323,400	52.50%	12.00%	0.20
Quarter 3	216,000	105,840	210,000	315,840	49.00%	12.00%	0.20
Quarter 4	216,000	98,280	210,000	308,280	45.50%	12.00%	0.20
2007	-	-	-	-			
Quarter 1	207,000	86,940	201,250	288,190	42.00%	11.50%	0.15
Quarter 2	207,000	79,695	201,250	280,945	38.50%	11.50%	0.15
Quarter 3	216,000	75,600	210,000	285,600	35.00%	12.00%	0.20
Quarter 4	216,000	68,040	210,000	278,040	31.50%	12.00%	0.20
2008	-	-	-	-			
Quarter 1	207,000	57,960	201,250	259,210	28.00%	11.50%	0.15
Quarter 2	207,000	50,715	201,250	251,965	24.50%	11.50%	0.15
Quarter 3	198,000	41,580	192,500	234,080	21.00%	11.00%	0.10
Quarter 4	198,000	34,650	192,500	227,150	17.50%	11.00%	0.10
2009	-	-	-	-			
Quarter 1	189,000	92,610	183,750	276,360	49.00%	10.50%	0.05
Quarter 2	189,000	19,845	183,750	203,595	10.50%	10.50%	0.05
Quarter 3	189,000	13,230	183,750	196,980	7.00%	10.50%	0.05
Quarter 4	180,000	6,300	175,000	181,300	3.50%	10.00%	0.00
Total	**4,032,000**	**1,560,195**	**3,920,000**	**5,480,195**	**0.00%**		

7.7. Conclusion on House Financing

There is a huge potential for house financing in the local market. The existing model (in practice) of Islamic house financing is lacking the consideration of appreciation /depreciation in value and variable rentals, hence demands change if true Musharaka is required to be practiced. IFIs while competing with conventional banks are trying to remain very close to them in products as well as the total cost to customers which is a valid business trick. However, this practice raises questions in the minds of people and adds to negative perception about operations of IFIs. Islamic financial system is not based on the principles of capitalism and should be visible in practices of IFIs. It cannot be

If IFIs want to be closer to conventional banking in serving the depositors and customers then certainly they have to depart with certain principles and practices of Islamic financial system, which cannot be appreciated.

comparative in practice with capitalism. It has its own principles, which create a different economic system based on justice and equity. If IFIs want to be closer to conventional banking in serving the depositors and customers then certainly they have to depart with certain principles and practices of Islamic financial system, which cannot be appreciated.

After all, what is the essence of Islamic financial system? It is Sharing; sharing of risks and rewards by both parties. Islamic house financing is unique and unmatched with traditional mortgages and possesses the feature of avoiding financial crisis like2007-08. IRR cannot be determined in advance. It is true Musharaka, which demands the sharing of risk and reward by both partners. Under Islamic house financing financier is earning more as compared to conventional banking (in case of appreciation) but after capacity building of customer, and shares loss (in case of depreciation in value of asset) while under conventional mortgages return is fixed which put the client in trouble in early years and lead to prosperity in following years if property value appreciates and vice versa.

One important aspect is of competition with conventional mortgages which demands due consideration while practicing Islamic financing, however, under this fear (of losing customers) IFIs should not and must not lose their identity and jeopardize their future. The sole reason for existing of IFIs is Shari'a compliance and this feature must not be compromised in spite of non-conducive existing business and legal framework. Undoubtedly practice is tough than theory and demands wisdom and tactfulness but that is the challenge and way to change and achieve the goal. Practitioners of Islamic financial system have to display extraordinary wisdom and skill to lead the society towards a new system duly certified by Shari'a experts according to revelations.

7.8. Questions

1. Explain Diminishing Musharaka. How is it different from Musharaka?
2. What is the difference in conventional and Islamic mortgages?
3. Critically analyze the existing model of house financing practiced by IFIs?
4. Briefly, state, at least, five applications of diminishing Musharaka?

5. Purchasing of equity units on face value/original purchase value is not allowed why?
6. What is meant by binding promise? How is it different from the contract of sales?

Multiple Choice Questions

1. As per the economic survey of 2004-05, what is number of a recurring short-fall of housing units per year in Pakistan?
   a. 570,000
   b. 300,000
   c. 270,000
   d. None of above
2. What percentage of available housing units consists of the single room according to economic survey 2004-05?
   a. 30%
   b. 33%
   c. 35%
   d. 38%
3. What is an average share of Diminishing Musharaka financing in portfolios of IFIs working in Pakistan during last seventeen quarters (09/06-09/10)?
   a. 24%
   b. 26%
   c. 28%
   d. 30%
4. Which of the following is an essential ingredient of Musharaka according to Shari'a standard number 12?
   a. More than two partners
   b. Capital in cash
   c. Agreement
   d. Equal profit and loss sharing
5. Which of the following makes Musharaka agreement void?
   a. Verbal agreement

b. Net assets contributed as capital
c. Receivables contributed as capital
d. Unequal profit sharing ratio

6. Which of the following is not an essential condition of Musharaka?
a. Agreement
b. Management by all partners
c. Capital contribution by all partners
d. Profit and loss sharing by all partners

7. Which of the following makes Musharaka void as per Shari'a standard number 12?
a. Sacrifice of profit by a partner in favor of others
b. Appointment of a manager
c. Guarantee of capital by one partner to another partner
d. Profit & loss sharing according to equity stake

8. At the time of dissolution, assets are valued then distributed among partners. Which of the following is the correct value for distribution?
a. Book value
b. Market value
c. Residual value
d. Historical value

9. Which of the following is the correct order of distribution of proceeds from the sale of assets at the time of the dissolution of Musharaka?
a. Liquidation exp. Liabilities, partners
b. Liabilities, liquidation exp. Partners
c. Partners, liquidation exp. Liabilities
d. None of the above

10. Which of the following makes Diminishing Musharaka agreement void?
a. Renting of asset
b. Purchase of share of another partner gradually
c. Contract binds the partners to sell and purchase the share of each other
d. Profit sharing ratio is different from equity sharing ratio

7.9. Exercises

Ex.1. Mr. Attiq wants to acquire a house in British Homes. He has searched and finalized a house with a fair value of Rs; 3 million. He has requested to local Islamic bank for financing for a period of five years payable in quarterly installments. You are a house financing officer in the bank and have to prepare the case on the basis of following standard operating procedures.

1. The plot must not be in a negative area. (Negative areas include where land ownership is not clear rather disputed).
2. 50% of earnings of the customer must be able to meet rental as well as the purchase price of the unit.
3. House must be acquired in joint ownership of bank and client while documents are to be kept by bank till the transfer of ownership.
4. At least customer must be able to contribute 30% of the price.
5. Maximum limit of financing is 10 years and installment must be either monthly or quarterly.
6. Rentals of property must be able to provide bank a return of 15% net of insurance and maintenance cost.

Required:-

1. What is the share of contribution by client and bank?
2. What is a minimum amount of rentals of property to meet the required return?
3. What should be minimum income of Mr. Attiq to qualify for financing facility?
4. What is nominal value of an equity unit of the bank to be sold on a quarterly basis?
5. What is the amount of quarterly installment if equal installments are agreed and equity units are sold at nominal value?
6. What is the amount of quarterly installment if equal installments are agreed and equity units are sold at 1% above the nominal value per quarter (i.e. unit one at 1% and unit 10 at 10%)?

Case – Diminishing Musharaka

Margalla Islamic Bank was established on January 1st 2005 with a capital of Rs; 500 million.

Following is balance sheet of the bank as at December 31st 2010. So for the bank has not invested in real estates and now looking for diversification in housing.

Following policy guidelines approved by the board of directors for investment in real estates.

House financing would be a mixture of diminishing Musharaka and Ijarah contracts.

Maximum financing limit would be Rs; 10 million and maximum financing duration would be 10 years.

No financing for property situated in negative areas.

50% of earnings of the customer should be sufficient to service installment including unit price and rent of the property.

Financing for completed houses ---ready to purchases only.

Minimum 30% of the property value must be contributed by the customer.

Mr. Sadik a very successful professional contacted to the bank for the acquisition of a house in Sector F-11/4, Islamabad. Property value is Rs; 20 million. Customer requests financing for 10 years payable in semiannual installments. Property rental value is Rs;2 million per annum. Equity units are to be purchased by the customer as per adjusted for CPI. It is expected 1% inflation per quarter.

Required:

1. Whether this deal is appropriate keeping in view the financing policy?
2. What is minimum income required from customer to finalize the deal? If Variable installment plan followed? If Fixed installment plan followed?
3. If bank wants to earn at least 10% whether this deal is appropriate?
4. Complete the installment schedule for ten years.
5. Prepare the balance sheet as at December 31, 2011.

Margalla Islamic Bank
Balance Sheet, as at December 31, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	500,375	Payables and balances	400
Accounts R/A	2,000	Current deposits	3,600
Inventory (assets for sale)	500	Charity fund	4
Salam financing	500	**Total liabilities**	**4,004**
Short term investments	150	**Equities**	
Total current assets	**6,525**	PLS deposits balances	1,800
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	500,000
	3,000	Statutory reserves	400
Total long-term assets		R. earnings/ Un approp	321
		Total Equities	**4,521**
Total assets	**506,525**	**Total liab & Equities**	**506,525**

Suggested Readings

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Chapter 8

Mudaraba Financing

Mudaraba is a combination of skill and capital, offers self-employment opportunities

Mudaraba financing is a profit sharing mode of financing whereby partnership is created between capital and skill. It is a source of financing which has the potential to really change the shape of the economy in less developed countries including Muslim countries by extending financing to skilled unemployed factions of society. Although sharing modes of financing including Musharaka and Mudaraba are the real difference between conventional and Islamic financial system, however, progress so for made on these fronts by IFIs is not very encouraging. The average share of Mudaraba in portfolios of IFIs working in Pakistan during the period of 09/06-09/10 is less than half percent.

Learning Objectives

After studying this chapter one should be able to understand and interpret the following:

What is Mudaraba financing?

What role Mudaraba can play in uplifting skilled unemployed youth of less developed countries?

What are Shari'a rulings about operations of Mudaraba financing?

What is the financial impact of Mudaraba and how it is accounted for?

8.1. Introduction

Mudaraba is a partnership in profit whereby one party provides capital (Rab al maal) and the other party provides labor (Mudarib). Mudaraba is a type of partnership whereby skill and money brought together to conduct business. Profit is shared according to an agreement while the loss is borne by capital provider only. Under this scheme of financing, IFIs provide capital to financially weak but skillful people to do the business and share the outcome with IFIs. This scheme is also used in deposit collection. Mudaraba contract can be restricted or unrestricted. No one can claim a lump sum amount of profit it must be based on actual outcome (Shari'a standard 13).

Mudaraba financing by IFIs can play the role of catalyst in the provision of self-employment to skillful youth resulting in economic prosperity and reduction in unemployment in the society. It has the potential to work as venture capital for scientific inventions by the able but poor scientists. The essence of Mudaraba is to bring together money and mind to form a partnership fruitful for both partners. Mudaraba can be used by IFIs to finance small-scale businesses including self-employment of tailors, barbers, electricians, accountants, doctors, advocates etc. Empirics suggest low default rate on small-scale financing[21], however, the practice of IFIs working in Pakistan is very much disappointing in the promotion of Mudaraba as a tool of financing and investment. Figures 8.2 depict the percentage share of Mudaraba in portfolios of IFIs working in Pakistan during 17 quarters (09/06 – 09/10). The average share of Mudaraba in portfolios of IFIs is less than half percent. Figure 8-1 presents closing amounts of investments made by IFIs under Mudaraba financing in Pakistan from 12/06 to 06/13.

Mudaraba is a type of partnership whereby skill and money brought together to conduct business. Profit is shared according to agreement while loss is borne by capital provider only.

One of the major problems of Pakistan is unemployment and poverty which can be reduced by application of Mudaraba. Perhaps the chief hurdle in the application of Mudaraba is trust deficit as for investment and financing is concerned (however this trust in IFIs prevails as for depos-

[21] For example case of Grameen bank established by Dr. Yunis.

Empirics suggest low default rate on small scale financing however the practice of IFIs working in Pakistan is very much disappointing in promotion of Mudaraba as a tool of financing and investment.

its are concerned). In order to mitigate this risk, two options could be very helpful. First is a guarantee of capital (in the case of negligence) by either government or a person(s) of sound financial position for every Mudaraba project. Second is effective monitoring by IFIs; however this will increase cost and reduce profit. One of the ways to reduce monitoring cost is the capacity building of Mudaribs (especially uneducated and poor) through training and education.

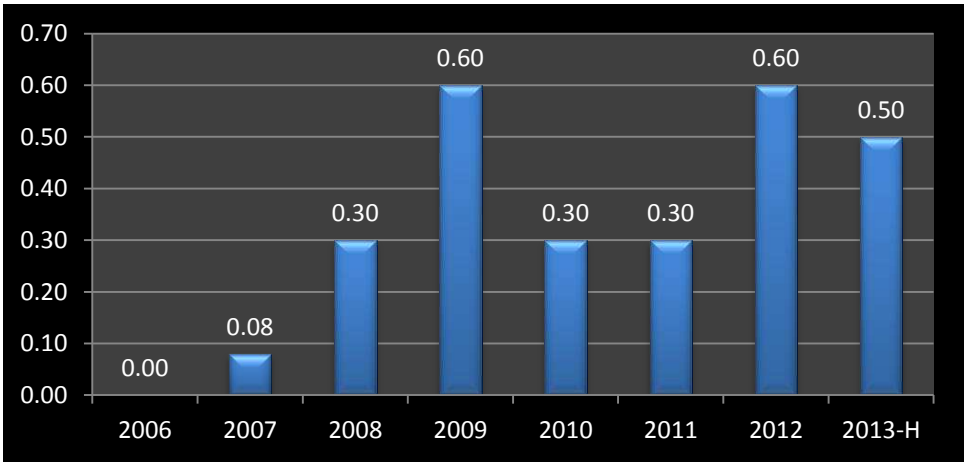
Proponents of Islamic banking have envisioned the system as a mean to distributive justice, however so for IFIs could not make much progress on this front. If financing through IFIs is available to persons of sound financial position only as is the case in conventional banking (although without charging interest) then Islamic financial system cannot be termed as a source of distributive justice (rather a better name would be Islamized capitalism). Islamic banks should have to think out of the box and identify a new customer base in the area of unemployed and poor but talented youth. A mechanism to promote Mudaraba in its true spirit is required focusing on poverty reduction and employment generation. It is suggested that a Mudaraba department should be established in each IFI, responsible to research and develop financing models based on Mudaraba including the development of a plan to identify, educate and train the potential talent which is being destroyed by unemployment and poverty. This will bring good name and reputation (vital to succeed) for Islamic financial system in addition to business and profits.

Fig 8-2. Percentage share of Mudaraba financing in portfolios of IFIs

Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Jun 08	Sep 08
0.00%	0.00%	0.00%	0.00%	0.09%	0.25%	0.29%	0.31%
Dec 08	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10
0.20%	1.15%	0.62%	0.36%	0.38%	0.25%	0.24%	0.25%

Source: SBP-Islamic banking Bulletins

Fig 8-1. Closing Amounts PKR Billion of investments made under Mudaraba from 12/06 to 06/13



8.2. Summary of Shari'a Rulings

Rule.1. Mudaraba contract (preferably written) is required to state the terms and conditions relating to profit sharing and guarantees (regarding negligence etc) if any. It is not binding agreement except:-

(1) Mudarib has already started business then till the liquidation

(2) If it is made for a specified period then till the completion of the period.

Under restricted Mudaraba contract, Mudarib is obliged to act within the scope of the agreement while under unrestricted agreement Mudarib is free to invest according to his expertise and market conditions to fulfill the objective of Mudaraba partnership (profit generation).

Islamic banks mobilize deposits by application of unrestricted Mudaraba contract to enable themselves to invest in any Shari'a compliant investment opportunity.

Rule.2. Rab al maal (partner with capital) is allowed to obtain guarantee/Security from Mudarib (partner with skill) to be enforced in case of negligence, misconduct or breach of contract by Mudarib.

Proponents of Islamic banking have envisioned the system as a mean to distributive justice, however so for IFIs could not made much progress on this front.

Rule.3. The capital of Mudaraba can be contributed in the form of cash and or in kind, however if capital is contributed in-kind fair value of the asset(s) should be determined. The amount of capital in Mudaraba must be known to both parties. Debt receivable from Mudarib or third party cannot be treated as a contribution to the capital of Mudaraba. For the validity of Mudaraba access to capital by Mudarib is required.

Mr. Arif entered into a Mudaraba with Malik to do the business of rice export. Malik contributed 40 tons of Basmati rice as the capital of Mudaraba without disclosing the cost/market value, while Arif contributed management skill. Profit sharing ratio was decided as 50:50 is a void contract as the value of capital is unknown.

Rule.4. Profit sharing ratio must be determined at the time of contract. Profit sharing must be a percentage share in profit and not a lump sum amount or percentage of capital. It is permitted to stipulate a lump sum amount for a partner if profit exceeds from the certain limit. Profit calculation and sharing must be based on total profit earned by business. (Profit on one transaction to A and on second to B, profit for the first year to A and for the second year to B etc. is not allowed). It is not permitted to charge a fee for a service in addition to profit except through a separate agreement. If profit sharing is not decided at the time of contract then reference should be made to general practices. If nothing found in general practices then Mudaraba is void *ab initio* and Mudarib should be paid according to the market price of services provided. Final profit distribution must be made on the basis of valuation of business (actual or constructive), however, it is allowed to allocate the profit on account to be settled later on. It is required to maintain the capital of Mudaraba intact prior to distribution of profit. If Mudarib is using some portion of his funds in Mudaraba then first profit should be apportioned between two capitals then profit allocated to the capital of Rab al maal should be distributed as per Mudaraba agreement.

Capital of Mudaraba can be contributed in the form of cash and or in kind

Mr. X having technical skill of running a cement factory entered into an agreement of Mudaraba with a local Islamic

bank. Bank invested money and Mr. X's contribution is services. It is agreed that bank will receive at least 10% per annum on investment, is a void contract.

It is permitted to stipulate a lump sum amount for a partner if profit exceed from certain limit. Profit calculation and sharing must be based on total profit earned by business.

Mr. Adil entered into a contract of Mudaraba with a local Islamic bank to do the business of computer supplies to a large telecom company for one year. Profit sharing is postponed until the completion of the project. Mr. Adil cannot claim a share in profit, however, he should be paid for his services only.

Mr. Kazi entered into a Mudaraba agreement with Margalla Islamic bank to do the business of rice export. Bank provided the capital of 25 million and profit sharing ratio agreed as 50:50. Keeping in view the nature of banking business [where depositors get replaced], it was agreed that bank will receive an interim profit equal to 1% of investment on a monthly basis to be settled after preparation of annual accounts of Mudaraba is a valid contract subject to a final settlement based on actual results of business.

Guidance bank collects deposits by applying unrestricted Mudaraba mode of investment. It is agreed that bank will retain 70% of gross profit and 30% shall be distributed among depositors. For last quarter deposits with the bank were of 200 million and bank's own funds were 100 million. Any gross profit generated shall be allocated for bank equal to one-third for its investment. Out of remaining, two third 30% shall be distributed among depositors while 70% shall be kept for the bank. Hence, if the profit for the quarter is 18 million, depositors will get 3.6 million [30% of 12 million] and the bank shall retain 14.4 million.

Sabir entered into a Mudaraba contract with a local Islamic bank. As per agreement bank shall provide capital and Sabir shall manage the business of textile. It was agreed that Sabir shall get a bonus profit of one million [beyond the target amount] if profit exceeds from 10% return on capital, however under normal course profit of Sabir would be 30% of actual profit. If Capital invested is 50 million and profit earned is 7 million, the share of Sabir would be 2.8 million [1M + 30% of 6M].

Rule.5. Mudarib is obliged to execute the operations as per customs of the field and work with due diligence if it is unrestricted Mudaraba, however under restricted Mudaraba; Mudarib is bound to act within the scope determined by contract. Rab al maal cannot stipulate to participate in management. If Mudarib hires a third person to perform the job of Mudarib (as per custom which is the responsibility of Mudarib) then any amount paid should be charged to the personal account of Mudarib. The cost of living and traveling expenses to Mudarib is allowed as per agreement or custom. Gift, loan and charity out of Mudaraba funds and waiver of receivables by Mudarib are allowed subject to the approval of capital provider.

Zahoor entered into a Mudaraba contract with a local university to invest accumulated provident fund of employees with a profit sharing ratio of 30:70. As per the agreement, stock market investment was not allowed. If Zahoor invests in the stock market to earn a superior return, consequently ended up in losing money would be responsible for making the loss good.

Rule.6. Liquidation of Mudaraba is taken place due to any of the following.

(1) With the agreement between both parties.

(2) On maturity if it is time-based Mudaraba.

(3) After losses remaining funds are insufficient to run the business.

(4) The death of Mudarib or liquidation of institution acting as Mudarib.

(5) Completion of project/purpose if it is purpose based Mudaraba[22].

8.3. Financial Impact of Mudaraba

Financial reporting and financial impacts of Mudaraba are discussed in following paragraphs. I shall illustrate with a hypothetical balance sheet and show the impact of different transactions under Mudaraba on the balance sheet of an IFI. Balance sheet of an IFI is little different from balance sheet of a conventional bank in the sense that IFIs are accepting deposits either as loan which is in line with practices of commercial banks and does not create any difference in balance

[22] Not reported in Shari'a standards but author thinks it appropriate.

sheet; or on profit and loss sharing basis under Musharaka and Mudaraba which changes the nature of relationship between customer and IFI. Deposits under profit and loss sharing (PLS) models including Musharaka & Mudaraba are not shown as liabilities rather form part of equity.

On the other hand, conventional banks lend money for interest and show advances to customers as an asset. IFIs cannot lend cash for interest and sell the goods on credit hence resulting in receivables under Murabaha, Muajjal etc. Furthermore, IFIs are investing in businesses that need cash financing under the scheme of Musharaka & Mudaraba hence it is shown as an investment under profit & loss sharing (PLS) and not the receivables or advances. Let us look at a simple balance sheet of an IFI as at Dec 31, 2009, as under.

Margalla Islamic Bank

Balance Sheet, as at December 31, 2009

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	3,830	Payables and balances	400
Accounts R/A	2,000	Current deposits	3,600
Inventory (assets for sale)	500	Charity fund	4
Salam financing	500	**Total liabilities**	**4,004**
Short term investments	150	**Equities**	
Total current assets	**6,980**	PLS deposits balances	1,800
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
	3,000	Statutory reserves	400
Total long-term assets		R. earnings/ Un approp	776
		Total Equities	**5,976**
Total assets	**9,980**	**Total liab & Equities**	**9,980**

Suppose following Murabaha contract executed during the month of January 2010.

1. Mr. Malik a tailor by profession requested Rs; 100,000 to pay advance rental of shop and purchase machines and furnish the shop, payable in four equal installments semi-annually in two years. Profit sharing ratio is equal.
2. Mr. Arif a motor mechanic by profession requested amounting to Rs; 300,000 to establish a state of the art workshop payable in six semiannual installments. Profit sharing ratio is equal.
3. Mr. Mahboob a certified accountant requested Rs; 500,000 to establish consultancy firm payable in 5 equal installments yearly basis. Profit sharing ratio as under:-

Years	Bank	Mudarib	Years	Bank	Mudarib
First	60	40	Second	50	50
Third	40	60	Fourth	30	70
Fifth	20	80			

The impact of these Mudaraba transactions is shown in following balance sheet.

Margalla Islamic Bank

Balance Sheet, as at January 31, 2010

Assets	Rs. (000)	Liabilities & Equities	Rs. (000)
Cash and balances	2,930	Total liabilities	4,004
Investments under PLS	1,900	Total Equities	5,976
other assets	5,150		
Total assets	**9,980**	**Total liabilities & Equities**	**9,980**

These transactions changed only cash balances and investment under profit and loss sharing and no impact on other assets, liabilities or equities. Suppose, at the completion of one year following information are available.
1. Malik produced a profit of Rs; 30,000 and also paid two installments.
2. Arif suffered the loss of Rs 5,000 and could not refund the installment of capital.
3. Mehboob earned a profit of Rs; 300,000 and paid the installment.

Balance sheet of the bank is shown as under. Impact on account balances is calculated as under. Change in equities is Rs; 190,000 [(50% of 30,000)-(100% of 5,000)+60% of 300,000)] and new balance is Rs; 6,166,000[5,976,000+ 190,000]. Change in cash is Rs; 345,000 [(25,000 X 2)+ (50% of 30,000) + 100,000 + (60% 0f 300,000)] and closing balance is Rs; 3,275,000. Investment under PLS reduced by 5,000 loss suffered, 150,000 capital refunded and new balance is 1,745,000 [1,900,000-5000-50,000-100,000].

Margalla Islamic Bank

Balance Sheet, as at December 31, 2010

Assets	**Rs (000)**	**Liabilities & Equities**	**Rs (000)**
Cash	3,275	Liabilities	4,004
PLS investments	**1,745**	**Equities**	**6,166**
Other Assets	5,150		
Total	**10,170**	**Total**	**10,170**

Suppose at the end of the 2nd year following information are available.

1. Malik produced a profit of Rs; 40,000 and also paid two installments.
2. Arif suffered the loss of Rs 35,000 and could not refund the installment of capital.
3. Mehboob earned a profit of Rs; 200,000 and paid the installment.

Keeping in view the negative outcome in workshop business, it is decided to close the business of workshop and auction of workshop taken place for an amount of Rs; 200,000 only.

Balance sheet of the bank is shown as under. Impact on account balances is calculated as under. Change in equities is Rs; 25,000 [(50% of 40,000)-(100% of 95,000)+50% of 200,000)] and new balance is Rs; 6,191,000[6,166,000+ 25,000]. Change in cash is Rs; 470,000 [(25,000 X 2) + (50% of 40,000) + 100,000 + (50% 0f 200,000) + 200,000] and closing balance is Rs; 3,745,000. Investment under PLS reduced by 445,000 [100% of 95,000 + 200,000 + 50,000 + 100,000] and new balance is 1,300,000.

Margalla Islamic Bank

Balance Sheet, as at December 31, 2011

Assets	Rs (000)	Liabilities & Equities	Rs (000)
Cash	3,745	Liabilities	4,004
PLS investments	**1,300**	**Equities**	**6,191**
Other Assets	5,150		
Total	**10,195**	**Total**	**10,195**

Net result after two years for the bank on these transactions is disclosed in the following worksheet.

Work Sheet

Outcome	Malik	Arif	Mehboob	Net
Year 1	15,000	(5,000)	180,000	190,000
Year 2	20,000	(35,000)	100,000	85,000
Closure of a project		(60,000)		(60,000)
Total earnings	35,000	(100,000)	280,000	**215,000**
Avg. annual ROI				11.94%

Although average annual return is about 12% and monthly 1% however IRR is higher because during the period bank received a certain portion of investment back. An important observation is that how a bank can tolerate loss under Mudaraba while the bank has invested depositors' money. This issue is very important and deserves due consideration of practitioners of Islamic finance. Practically a joint pool of deposits under Musharaka and Mudaraba is created by bank and investments are made out of this pool. So the loss on a project is not the loss of a single or few depositors. Whatever outcomes are shared with depositors, that are results of investments made out of the joint pool. Any loss on a project is

compensated by the profit on the other project. IFIs are investing after due consideration about the probable outcome of the project and one must not assume that whole portfolio shall suffer loss. The investment portfolio is made up of Murabaha, Salam, Istisna'a, Ijarah, Musharaka, diminishing Musharaka and Mudaraba; hence, profits and losses are averaged out. Furthermore, as Musharaka and Mudaraba are riskier than other modes of financing, so IFIs are very much conservative and invest in only those projects which are able to give superior returns with higher probabilities.

8.4. Concept Building

Illustaration.1. Margalla Islamic bank received deposits under Mudaraba from depositors and shares profit with 50:50 ratios. Following are the results of operation for the first year.

Depositor money	9,000,000
Owners' money	6,000,000
Investments:-	
Murabaha on 15% profit	11,000,000

Salam with capital of Rs; 500,000 earned a profit of Rs; 90,000.

Profit on Musharaka with a capital of Rs 1000,000 amounting to Rs; 350,000.

Operating expenses of the branch for the period, amounting to Rs; 600,000.

It is the policy of bank to service the deposits, at least, equal to conventional banks which are offering a return of 7% on one-year deposits.

An important observation is that how a bank can tolerate loss under Mudaraba while bank has invested depositors' money. This issue is very important and warrants due consideration of practitioners of Islamic finance.

Required:-

1. What is share in the profit of bank and depositors?
2. What is percentage return on capital contributed by bank and depositors?
3. Does the bank need to sacrifice a certain amount of profit in favor of depositors?
4. What is net profit of branch?

Solution

1. Total profit earned Rs; 2,090,000 [1,650,000+90,000+350,000]
Share of profit on the basis of capital
Depositors 9/15 X 2,090,000 = 1,254,000
Bank's share 6/15 X 2,090,000 = 836,000
Share of bank as mudarib 1,254,000 /2 = 627,000
Total profit of bank Rs; 1,463,000 [627,000 + 836,000]
Net profit of bank Rs; 863,000 [1,463,000-600,000]
Net profit of depositors is Rs; 627,000.
2. Percentage return to depositors is 6.97% per annum [627,000/9,000,000]. Percentage return to bank on investment is 14.38% [863,000/6,000,000]
3. Bank has to sacrifice profit of his share amounting to Rs; 3,000 to compensate depositors.
4. Net profit of branch is Rs; 860,000 [863,000-3000]

8.5. Questions

1. What is Mudaraba? Differentiate between restricted and unrestricted Mudaraba?
2. Explain Shari'a rulings about profit sharing in Mudaraba?
3. Briefly, explain the rights and duties of partners in Mudaraba?
4. What is meant by the liquidation of Mudaraba? How can a Mudaraba be liquidated?

True/False

Mark the following statements as true or false.

1. Rab al maal (partner with capital) is allowed to obtain guarantee/Security from Mudarib (partner with skill) to be enforced in case of negligence, misconduct or breach of contract by Mudarib.
2. The capital of Mudaraba can be contributed in the form of cash and or in kind, however if capital is contributed in-kind, the fair value of the asset should be determined.

3. Debt receivable from Mudarib or third party cannot be treated as a contribution to the capital of Mudaraba. For the validity of Mudaraba access to capital by Mudarib is required.

4. Profit sharing ratio must be determined at the time of contract. Profit sharing must be a percentage share in profit and not a lump sum amount or percentage of capital.

5. It is permitted to stipulate a lump sum amount for a partner if profit exceeds from the certain limit.

6. Profit calculation and sharing must be based on total profit earned by business.

7. It is not permitted to charge a fee for a service in addition to profit except through a separate agreement.

8. If profit sharing is not decided at the time of contract then reference should be made to general practices. If nothing found in general practices then Mudaraba is void *ab initio* and Mudarib should be paid according to the market price of services provided.

9. Final profit distribution must be made on the basis of valuation of business (actual or constructive) however it is allowed to allocate the profit on account to be settled later on.

10. It is not required to maintain the capital of Mudaraba intact prior to distribution of profit.

It is permitted to stipulate a lump sum amount for a partner if profit exceed from certain limit. Profit calculation and sharing must be based on total profit earned by business.

11. If Mudarib is using some portion of his funds in Mudaraba then first profit should be apportioned between two capitals then profit allocated to the capital of Rab al maal should be distributed as per Mudaraba agreement.

12. Liquidation of Mudaraba cannot take place with an agreement between both parties.

13. Liquidation of Mudaraba is taken place on maturity if it is time-based Mudaraba.

14. Liquidation of Mudaraba cannot take place after losses, consequently, remaining funds are insufficient to run a business.

15. Liquidation of Mudaraba is taken place on the death of Mudarib or liquidation of the institution acting as Mudarib.

16. Liquidation of Mudaraba cannot take place on completion of project/purpose if it is purpose based Mudaraba

Multiple Choice Questions

1. Partnership between capital and skill is called:
   a. Musharaka
   b. Diminishing Musharaka
   c. Mudaraba
   d. Murabaha
2. Average share of Mudaraba in portfolios of IFIs working in Pakistan for period of 09/06-09/10 is:
   a. Less than half percent
   b. More than five percent
   c. Exactly four percent
   d. None of the above
3. Which of the following can play the role of catalyst in the provision of self-employment in underdeveloped countries?
   a. Musharaka
   b. Mudaraba
   c. Diminishing Musharaka

d. Ijarah

4. Which of the following is an essential ingredient of Mudaraba according to Shari'a standard number 13?

a. More than two partners
b. Capital in cash
c. Agreement
d. Equal profit and loss sharing

5. Which of the following makes Mudaraba agreement void?

a. Verbal agreement
b. Net assets contributed as capital
c. Receivables contributed as capital
d. Unequal profit sharing ratio

6. Which of the following is not an essential condition of Mudaraba?

a. Agreement
b. Management by all partners
c. Capital contribution by at least one partner
d. Profit and loss sharing by all partners

7. Which of the following makes Mudaraba void as per Shari'a standard number 13?

a. Sacrifice of profit by a partner in favor of others
b. Appointment of a manager
c. Guarantee of capital by one partner to another partner
d. Profit & loss sharing equally

8. Final distribution of profit should be made on the basis of valuation of assets. At the time of dissolution, assets are valued then distributed among partners. Which of the following is the correct value for distribution?

a. Book value
b. Market value
c. Residual value
d. Historical value

9. Which of the following is the correct order of distribution of proceeds from the sale of assets at the time of the dissolution of Mudaraba?

a. Liquidation exp. Liabilities, partners
b. Liabilities, liquidation exp. Partners
c. Partners, liquidation exp. Liabilities
d. None of the above

10. Which of the following makes Mudaraba agreement void?
a. Renting of asset
b. Purchase of share of another partner gradually
c. Contract binds the partners to sell and purchase the share of each other
d. Profit sharing ratio is unequal

8.6. Exercises

Ex.1. Margalla Islamic Bank's opening balance sheet as at January 1st 2010, and operation of the year ending December 2010 is given below.

Margalla Islamic Bank

Balance Sheet, as at December 31, 2010

Assets	Rs (000)	Liabilities & Equities	RS (000)
Cash & Balnces	20,000	Accounts Payables	4,000
Murabaha R/A	5,000	Current deposits	8,000
Salam Investment	2,000	PLS deposits	20,000
Istisna'a Investment	4,000	Paid up capital	30,000
Plant & Equipment	37,000	Retained Earnings	6,000
Total	**68,000**	**Total**	**68,000**

Following is a summary of transactions complete during the year.

1. Change in current account deposits includes inflow of Rs; 16 million and outflow of Rs; 14 million.
2. Change in PLS deposits includes inflow of Rs; 4 million and outflow of Rs; 5 million.
3. Profit earned on Murabaha transactions amounting to Rs; 1 million. All transactions completed during the year.
4. Rentals on leasing earned amounting to Rs; 800,000. All transactions completed during the year.

5. Miscellaneous receipts earned during the year amounting to Rs; 500,000.
6. Operating expenses paid amounting to Rs; 1,200,000 during the year. Depreciation of plant and equipment was amounting to Rs; 500,000.
7. A house financing project executed during the year amounting to Rs; 5 million. 20% paid by customer and balance by the bank. Customer shall purchase share of the bank within 20 quarters (two already purchased). Rental value of house agreed is Rs; 50,000 per month. The customer paid the share of bank promptly so for.
8. Following Mudaraba projects were executed during the period.

I-Aslam Khan a Scientist invented instant water heating system and need funds to market and produce his product. Bank supplied capital amounting to Rs; 2 million at a profit ratio of 50:50. First-year results show a loss of Rs; 100,000.

II-Bashir Mughal an MBA started a business of online books selling with capital provided by bank amounting to Rs; 1,500,000 at a profit sharing ratio of 60:40 respectively for Bashir and bank. The first-year operation gave a profit of Rs; 200,000. Bashir also refunded 1/3rd of capital provided by the bank.

III- Musa Malik chemical engineer requested for the financing of crockery manufacturing factory amounting to Rs; 3 million. Bank provided the required finance at 40:60 ratio of profit sharing respectively for Musa and bank. First-year operation shows loss of Rs; 200,000.

9. Salam goods received and sold for 10% profit and Istisna'a goods disposed of at 15% profit.
10. 50% Murabaha receivables converted into cash with a penalty of Rs; 100,000.

Required:-

1. Prepare a worksheet showing the closing trial balance of bank.
2. What is net position on Mudaraba portfolio?
3. What is closing cash balance?
4. What is the amount of profit earned by bank and depositors if the average ratio is 70:30 for bank and depositors excluding operating expenses?

5. What is the amount of profit earned by the bank after payment to depositors and charging for operating expenses?
6. Prepare closing balance sheet of the bank.

Suggested Readings

- AAOIFI. 2004. *Shari'a Standards.* P.O. Box 1176, Bahrain.
- Khan, M.A., (1989). Economic Teachings of Prophet Muhammad: A Select Anthology of Hadith Literature on Economics, chapter 6:2, page 72. *International Institute of Islamic Economics,* P.O. Box 1647, Islamabad, Pakistan.

Part-4
Deposits

Profit and loss sharing deposits are investments, deserve sharing of actual outcome

Chapter 9

Deposits Management by IFIs

Current deposits are loans with Islamic banks, and return on demand is obligatory

Deposits are very important part of the equation in a banking business and Islamic banking has no exception. Deposits are collected either as a loan (current account) or equity participation (profit & loss sharing). IFIs working in Pakistan have shown tremendous growth in deposits during last nine and half years (01/04-06/13) which is evidence of public trust in IFIs.

Learning Objectives

After studying this chapter one should be able to understand and interpret the following:

What are underlying principles in deposit management of IFIs?

What is daily product system in the banking business?

What are principles regulating deposits servicing in IFIs?

What is the financial impact of deposits and how it is accounted for?

9.1. Introduction

Banking is a business of intermediation between savers (depositors) and users (investors) of funds, and Islamic banking has no exception. However, the nature of the relationship between the Islamic bank and its customers is entirely different from conventional banking. In previous chapters (2 to 8) I have discussed the nature of the relationship between Islamic bank and users of funds along with financial impact and legal rights and liabilities. In this chapter, I will present the mechanism of deposits management by Islamic Financial Institutions (IFIs). Like conventional banking IFIs are also offering the facility of current, savings, and fixed deposits, however, no risk-free return is offered rather deposits are accepted either interest-free loans (current deposits) or under Musharaka and Mudaraba modes of financing.

Current deposits are accepted as loans from depositors which can be withdrawn on demand by depositors. Some of the Islamic banks are accepting these deposits as Amanah. There are two important aspects of Amanah as under.

1. If Amanah deposits are lost without negligence of bank, making the loss of depositors good is not the responsibility of the bank.
2. Amanah deposits cannot be utilized by the bank for his personal gains.

Hence, Amanah deposits are not recommended to safeguard the interest of both bank and customers. The interest of customer is the refund of money while the interest of the bank is to use the funds in current accounts. Under loan current deposit scheme bank has the flexibility to use the funds and the customer is protected from loss of amount in case of any miss-happening (burglary, fire, theft etc.) in any branch of the bank.

Saving [investment] deposits are accepted under profit and loss sharing schemes hence, Shari'a rulings of Musharaka and Mudaraba apply; as the case may be. Generally, banks accept deposits under Mudaraba then mix the funds of the bank and create a joint pool for investment. Out of this pool after meeting the statutory reserve requirements investment portfolio is created and managed by

If deposits under current account are Ammanah based then as per Shari'a amount cannot be invested for benefit of bank or any else. Returning of Ammanah deposits is not ensured like deposits under loan.

Under the scheme deposits are accepted for a fixed period which provides opportunity to IFI to invest in more profitable long term projects hence depositors of this scheme are getting higher profit

IFIs. Investment Portfolios of IFIs consist of Murabaha (cost plus profit sale), Salam sale (spot payment with deferred delivery), Istisna'a sale (manufacturing transactions), Ijarah (leasing), Musharaka (partnership in capital), diminishing Musharaka (used in house financing) and Mudaraba (partnership in skill and capital). The share of each mode of financing is determined on the basis of risk and return. Any profit generated by investment portfolio is shared by bank and depositors. As deposits are not fixed hence depositors are free to deposit and withdraw which had created a problem in profit distribution. IFIs came up with a solution of profit distribution on a daily product basis (discussed in the following section).

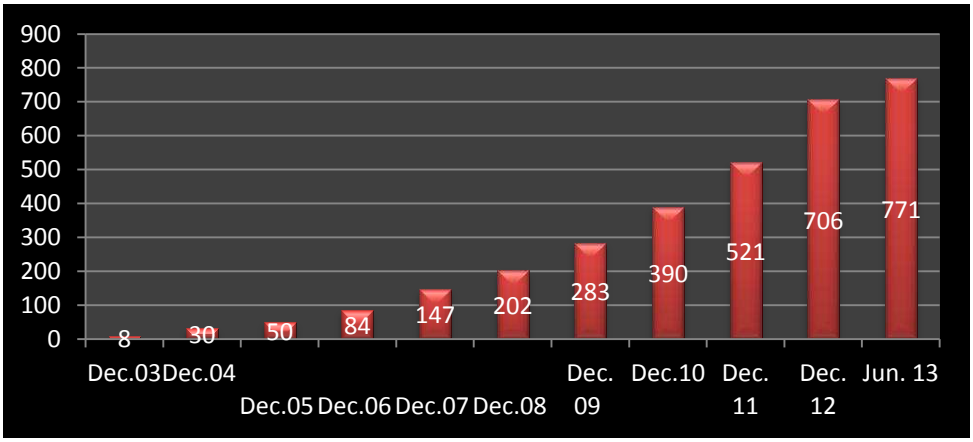
The third category of deposits is time deposits under profit and loss sharing system. Under the scheme deposits are accepted for a fixed period which provides an opportunity to an IFI to invest in more profitable long term projects hence, depositors of this scheme are getting higher profit in comparison to the second scheme discussed above. Longer the period, higher the rate of return is earned. This is happening through a weight-age system (discussed in the section of daily product). Higher return to longer period deposits is justified because it provides an opportunity to IFI to invest the funds in long-term projects, generally giving a higher return, without the fear of returning to depositors on demand.

Investment deposits can be further classified as restricted and unrestricted Mudaraba accounts. Under restricted Mudaraba scheme bank can only invest in approved investment schemes (which are approved by depositors). Under this scheme special deposits schemes (e.g. Housing, civil works including roads, dams, bridges etc) can be launched by banks to attract funds based upon sharing of actual profit or loss. Unrestricted Mudaraba could not be exploited up to the scale so for by IFIs. IFIs prefer to accept savings deposits (investment deposits) under the scheme of unrestricted Mudaraba in order to enable their selves to invest in any Shari'a compliant profitable scheme.

Daily product is calculated by multiplying the amount of a deposit with number of days remained in bank

IFIs working in Pakistan have shown tremendous growth in deposit collection on the basis of profit and loss during last nine and a half years 01/04-06/13 as depicted in Figure 9.1. An increasing number of deposits on profit and loss sharing basis provides evidence of successful application of sharing modes and trust of masses in IFIs working in Pakistan. IFIs working in Pakistan accept current deposits as loans, hence having the liberty to use the funds of depositors for investment and liquidity management as well as bearing the liability to refund on demand, even if bank suffers losses. It is a good scheme which ensures depositors' interest; as well as an incentive for IFIs to use funds, as compared to Amanah scheme, where neither funds can be used, nor can guarantee of return be granted.

Fig 9-1. Deposit collected (PKR Billion) by IFIs during 01/04-06/13



Under profit and loss sharing scheme IFIs accept deposits by application of unrestricted Mudaraba agreement having full liberty to use funds in Shari'a compliant investment opportunities. Gross profit is shared with customers based on actual results. Usually, an effort is made to remain competitive within the banking industry as for profit distribution is concerned. Also, IFIs have to follow the regulations issued by the central bank. There are certain tools in the hands of IFIs for smoothing of return on deposits to customers. In case profit earned and allocated to depositors is higher than industry a profit equalization reserve can be created

and in case of actual profit distributable to depositors is lesser than industry, Hiba [sacrifice of profit share by bank in favor of depositors] can be applied, however it depends upon the approval of Shari'a advisor and Shari'a board of the bank.

9.2. Summary of Shari'a Rulings

Under Islamic banking regime, three types of funds are at the disposal of IFIs including current deposits (loan from customers), investment deposits (time and demand deposits) and shareholders' funds (equity). According to Shari'a standards, 19& 40 following rules should be observed in deposits management process by IFIs.

Rule 1. Status of Current account is a loan account, hence, the bank is allowed to use the money for his benefits and also, the bank is bound to return the money on demand. Any charge on current account by the bank from account holders is permitted as the cost of services rendered. It is also permitted for the institution to render services relating to deposits and withdrawals to the owners of current accounts for or without compensation (cheque book, ATM etc).

Rule 2. Equality in investment opportunities should be ensured between shareholders funds and investment account holders funds unless it is clearly stated before disposition.

ABC bank has deposits of PKR 50 million and shareholders' equity of PKR 20 million during a reporting period. During the period, only 50 million could be invested. ABC cannot claim 40% of profit based upon equity contribution as it would give preference to shareholders over depositors [It can only be justified if it is clearly disclosed in investment account contract that preference would be given in investment to shareholders funds]. If nothing stated otherwise in accounts opening form [which gives preference to shareholders funds] profit sharing ratio would be 5:2 for depositors and shareholders respectively.

Rule 3. IFI should guarantee full repayment of the amounts under current accounts, however, it should not assume/announce a commitment to pay any in-

cremental return (fixed/variable). IFI cannot provide a guarantee of return of funds under investment accounts. Also, IFI cannot announce/promise any predetermined return on investment accounts. The responsibility of IFI is to ensure distribution of actual profit and loss.

Ancholi branch of a local Islamic bank suffered burglary and lost an amount of 20 million. Islamic bank cannot charge the loss to current account holders, however, same can be deducted from PLS account holders in the absence of any Takaful/insurance arrangements.

Landhi branch of an IFI announces a deposits scheme carrying 10% return for one year is a void transaction as it carries fixed return, however, an expected rate of return can be announced after due consideration to the business plan. This expected rate of return cannot be guaranteed by the bank in any case. However if negligence by the bank is proved the case would be different.

Rule 4. Saving accounts which carry no authorization for investing them to the benefit of their holders carries the status of the current account.

Rule 5. It is permitted to charge a fee (commissions) for the services of opening investment accounts. Fee ought to be a lump sum amount based upon average actual cost and should be charged once. It is also permitted to charge a fee for transportation, storage, and counting of the deposited amounts.

Rule 6. In the case of money transfer between accounts, legal possession is sufficient whether for the same currency or different currencies subject to currency exchange rules as per Shari'a standard # 1.

Mr. A sends money from UAE to his family in Pakistan through banking channel by depositing AED which is to be credited to designated account in Pakistan in local currency is a legal transaction. When money is credited to designated account, it would be a legal possession and it is sufficient for completion of the transaction, physical possession is not required.

Rule 7. Any funds which cannot be transferred to owners due to lack of contact should be kept in a suspense account for the specified period and then may be transferred to charity account. However if later on contact established; the same amount should be transferred to customer from charity account. A clause should be added in this regard in account opening form.
Mr. A deposited money in a local IFI and disappeared. After six month period account declared dormant [due to non-transaction]. Bank is required to wait for a reasonable designated [in the account opening form] period and if during that period bank could not trace Mr. A then transfer the funds to charity account. If later on Mr. A contacts the bank for his amount, the bank may transfer funds from charity account to Mr. A's account.

Rule 8. If there is any change in conditions or profit sharing ratio, the institution should contact account holders individually, however keeping in view the difficulties and cost; it is also permitted to send notifications or update website to obtain implicit acceptance if no protest is received from related parties within a specific period.
Margalla Islamic bank collected deposits from customers by declaring gross profit sharing ratio of 70:30 for bank and customers respectively. After the first financial period bank is intending to change this sharing ratio to 80:20, it is essential that consent of customers must be attained either through individual correspondence or through public media including website. Bank should also set a specific date for any protest/decent by customers. If no protest is received from customers till that date then proceed with new profit sharing ratio.

Rule 9. It is permissible to stipulate authoritative status of the documents and financial statements of the institution unless proved wrong by the account holder.

Rule 10. Profit is realized after recovery of capital. Profit is realized on liquidation of Mudaraba assets. Liquidation can be actual (conversion of all assets in cash by selling) or legal (valuation of assets by experts). Direct expenses of operations are deductible. Any expense incurred to perform the job of Mudarib (bank)

cannot be deducted. [e.g. Expenses relating to investment departments, follow up and accounting]. It is also permitted to stipulate a ceiling of expenses above which Mudarib shall be responsible.

Rule 11. Allocation for bad debts and reserve for the rate of returns have to be deducted from gross profit, whereas reserve for investment risks has to be deducted after deduction of the Mudarib's share.

Rule 12. It is permitted to cover the loss of one Mudaraba operation from a profit of another and if the loss exceeds then from capital. The loss of a certain financial period should not be covered by the profit of another period; however it can be covered from reserves. Given the fact that unrestricted investment accounts of continuous participatory Mudaraba lack coincidence in the beginning and end of the process of depositing funds in the accounts, the profit from the operations which extend to succeeding periods has to be distributed over the whole period of such operations in proportion to the duration of each operation [period].

Kashmir Bank collected deposits of 5 billion from customers under Mudaraba investment accounts. As per the agreement, the bank is entitled to 75% of gross profit while depositors 25%. Bank invested the funds so collected in five projects and earned profit amounting to PKR 100 million on four projects and loss of PKR 10 million on the fifth project. After deducting the loss distributable profit is 90 million to be allocated 67.5 million to the bank and 22.5 million to account holders.

Khyber Bank collected deposits of 5 billion from customers under Mudaraba investment accounts. As per the agreement, the bank is entitled to 75% of gross profit while depositors 25%. Bank invested the funds so collected in five projects and earned profit amounting to PKR 10 million on four projects and loss of PKR 20 million on the fifth project during the first year of operation. However, the second year turned out very profitable and produced a profit of PKR 80 million. Bank cannot postpone distribution of loss to the second year. It is required to debit accounts of investors with a loss in the first year and credit accounts of investors with profit in the second year. It is further to be noticed that whole loss of

the first year is to be borne by investors only in the absence of any investment by the bank.

Rule 13. The method of profit distribution should be well known so that no room is left for uncertainty and dispute. Profit sharing should be in terms of ratios and not by specifying a lump sum amount or a percentage of capital for any party.
Zubair bank collected deposits under PLS scheme. As per agreement depositors will receive 12% of capital is a void contract.

Rule 14. Ideally, profit sharing ratio should be decided at the time of the signing of the contract, however if such ratio is not decided then normal practice can be sought- if any-. If there is no normal practice to be sought then Mudaraba contract becomes null and void, and the Mudarib is entitled to the wages normally paid for similar work and whole profit goes to Rab al-mal.

Rule 15. The institution can specify different ratios for distribution of profits between itself and different categories of investment account holders or a unified ratio for all. The ratios for distribution of profits among the holders of the investment accounts can also be unified or varying on the basis of certain weights.

Rule 16. It is permitted to have an agreement between both parties [account holders & institution] that if the profit exceeds from certain limit or index the excess amount belongs to only one of them [institution].
Raz bank collected investment deposits under Mudaraba agreement. According to contract profit is to be shared by bank and depositors as per 60:40 ratio respectively, however once the depositors achieved 12% rate of return, whole excess profit would be taken over by the bank as an incentive.

Rule 17. It is prohibited to stipulate that profit of a transaction, type, portion of capital, assets into which capital is converted and/or a period belongs to one and other(s) to second.

Raj bank collected deposits from account holders to be invested in multiple projects under review. Bank decided to apportion result of Ijarah and DM transactions to group A and rest to group B. It is against the law if deposits were collected upon a single agreement [account opening form]. However if deposits of group A and B were collected under different contracts[account opening forms] stating clearly the intentions and boundaries of investments, that would be a legal transaction.

Rule 18. The method agreed upon for distribution of profit can be fixed for the whole period or variable according to specific sub-periods of partial liquidation.

Rule 19. The owner of Mudaraba profits are account holders and IFI, however, both can agree on the allocation of certain part of the profit to the benefit of the third party.

Rule 20. If IFI mixes shareholders' funds with depositors' funds, it assumes the position of a partner by capital as well as Mudarib. In this case, profit has to be divided between two amounts of capital so that IFI can get the benefit of his capital as well as Mudarib.
Neelam bank collected deposits of PKR 30 million under PLS scheme and contributed PKR 20 million from its own resources. As per the contract, it is Mudaraba investment with profit sharing ratio of 60:40 for bank and customers respectively. During the period under review, the bank earned profit amounting to PKR half million. Bank will receive two shares of profit being a partner with capital as well as partner with skill. Hence, the share of the bank is 200,000 [2/5 of profit] as a partner with capital and 180,000 [60% of 300,000] as a partner with services.

Rule 21. It is permitted for an account holder to exit from the Mudaraba with all his funds or part of them.

Rule 22. If the amount of cash reserve kept with the central bank or in the treasury of IFI for repayment to account holders, nothing is earned to share, however if amount invested in short-term liquid investments, any amount earned should be shared by both parties as per agreed ratio. In the case of loss, it is to be borne by account holders.

Rule 23. Scoring method for profit distribution is allowed. Such method takes into account the amount invested and period of stay by the account holder (currency unit X time unit).

Rule 24. It is permitted to set an expected rate of return based on IFI's calculation, however, it can never be binding and account to be settled as per actual profit and loss.

Rule 25. It is allowed to distribute provisional profit subject to a final settlement based on actual results.

Rule 26. Mutual relief from commitments in case of exit should be stipulated in the contracts of Mudaraba based investment accounts. [Outgoing partner should relieve the staying partners from any undistributed profit such as reserves and staying partner should relieve the outgoing from any loss yet to be apparent]. It is also recommended to stipulate that on liquidation such reserves may be used for charitable purposes.

Rule 27. IFIs should liquidate Mudaraba and distribute the realized profit between the Mudarib and account holders as per conditions of Mudaraba contract. After the liquidation of Mudaraba, if shareholders decide to relinquish part of their profit share to the benefit of account holders [it is allowed], the institution should disclose that.

9.3. Daily product system

In banking business facility of deposits and withdrawals is provided to depositors as per their needs and preferences except under time deposits. It created a problem in the calculation of share in profit and loss of each depositor because profits on investments are generated and disclosed periodically (monthly, quarterly, semiannually and annually). IFIs responded the issue by the creation of daily product formula to share the outcome with all depositors except current account holders. The daily product is calculated by multiplying the amount of a deposit with a number of days remained in the bank, hence the daily product of a deposit amounting to Rs; 1,000 remained in the bank for one month is double in comparison with a deposit of the same amount remained in the bank for 15 days. Keeping other things same share in the profit of earlier deposit is double than later. Under daily product system, profit and loss of a period are shared among depositors on the basis of tenure of deposits.

Another invention of IFIs is the allotment of weight-age to deposits as per tenure. Generally, weight of 1 is awarded to a deposit remained in the bank for one year and less than 1 is awarded to deposits remained in the bank for a period less than one year. what should be weight-age of a deposit of six months, three months and a month depends upon number of factors including nature of investment projects executed by bank, risk-free rate offered by conventional banks, because IFIs are competing with conventional banks in costs and profits to customers in order to maintain their competitiveness and saving the customers to pay additional cost or forego return as a cost of being Muslims and transacting business with IFIs. Reasons for matching the costs and revenues with conventional banking are obvious including lack of benchmark for IFIs and capturing of minor market share.

However financial impact of deposits under profit and loss sharing system is entirely different from conventional banking savings account irrespective of demand and time deposits.

9.4. Financial Impact

The financial impact of deposits under a current account is same for an IFI as it is under conventional banking i.e current account deposits are liabilities of the bank and reported under short-term liabilities in the balance sheet of the bank. However the financial impact of deposits under profit and loss sharing system is entirely different from conventional banking savings account irrespective of demand and time deposits (figure 9-2). Under conventional banking saving accounts are liabilities of the bank while under Islamic financial system savings deposits form part of equity. Conventional banks are bound to return principal amount of deposits along with interest except in the case of insolvency which is not the case under Islamic banking. Under Islamic banking, these deposits are under profit and loss sharing system and Islamic banks are required by the agreement to share the outcome with depositors which can be negative as well as positive.

Fig 9-2. Margalla Islamic Bank

Balance Sheet, as at December 31, 2009

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	3,830	Payables and balances	400
Accounts R/A	2,000	Current deposits	3,600
Inventory (assets for sale)	500	Charity fund	4
Salam financing	500	**Total liabilities**	**4,004**
Short term investments	150	**Equities**	
Total current assets	**6,980**	PLS deposits balances	1,800
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
	3,000	Statutory reserves	400
Total long-term assets		R. earnings/ Un approp	776
		Total Equities	**5,976**
Total assets	**9,980**	**Total liab & Equities**	**9,980**

Guarantee of capital is not provided under Musharaka and Mudaraba hence depositors can even lose their principal as well if a heavy loss is being incurred in the bank. However empirical evidence suggests that loss of principal by depositors has never happened in a short history of Islamic banking and, of course, one should keep in view the efficient team of professionals working on banking business and prudential regulations issued by central bank while thinking about the riskiness of deposits under profit and loss sharing. Following balance sheet displays the deposits of Islamic banking under Musharaka and Mudaraba system.
Note the difference; all types of deposits under conventional banking are reported under liabilities of the bank while under Islamic banking only current deposits form part of liabilities while savings deposits are displayed under the heading of external equities which means the bank is not obliged to return the amounts except in the case of negligence on behalf of the bank. This system is reducing the risk of banking business by sharing with depositors and give confidence to depositors being partners in banking business which create sense of ownership and soft corner for the success of banking enterprise among masses.

9.5. Concept Building

Illustration.1. bank Islami Ltd; received the following deposits during the first quarter of its operation in Suburbs Islamabad.

Name	deposits in PKR	deposit date	withdrawal date	# of days
Khan	100,000	01/01/09	01/03/09	59
Malik	500,000	15/01/09	14/02/09	30
Warraich	200,000	20/01/09	not yet	70
Chaudhry	400,000	01/02/09	01/03/09	28

If profit of bank for the quarter without charging for operating expenses is Rs; 200,000 and operating expenses are Rs; 140,000 what is share in the profit of bank and each depositor assuming a share of Mudarib is 80%? What is percentage return per annum on amounts deposited?

Solution

Following worksheet shows the profit distribution. Bank is receiving Rs; 160,000 [80% of 200,000] as a share of Mudarib and spends Rs; 140,000 operating expenses consequently profit earned is Rs; 20,000 for the quarter. Balance amounting to Rs; 40,000 is distributed among the depositors on daily product basis.

Work Sheet

Name	Amount	Days	Daily product	% Share	Profit	% Return p.a.
Khan	100,000	59	5,900,000	12.80%	5,119	31.67%
Malik	500,000	30	15,000,000	32.54%	13,015	31.67%
Warraich	200,000	70	14,000,000	30.37%	12,148	31.67%
Chaudhry	400,000	28	11,200,000	24.30%	9,718	31.67%
Bank	-	-	-	0.00%	160,000	0.00%
Total	1,200,000	187	46,100,000	100.00%	200,000	0.00%

Illustration.2. In continuation of illustration 1. Suppose following weights are assigned to the deposits on the basis of tenure.

Tenure	Weight
3 Months	1.00
2 Months	0.80
1 Month	0.60

Required:

Calculate the profit and percentage return per annum on each deposit.

Solution

Following worksheet depicts the calculations.

Name	Amount	Days	Daily product	Weight	W.Product	% Share	Profit	% Return p.a.
Khan	100,000	59	5,900,000	0.80	4,720,000	13.70%	5,482	33.91%
Malik	500,000	30	15,000,000	0.60	9,000,000	26.13%	10,453	25.44%
Warraich	200,000	70	14,000,000	1.00	14,000,000	40.65%	16,260	42.39%
Chaudhry	400,000	28	11,200,000	0.60	6,720,000	19.51%	7,805	25.44%
Bank	-	-	-	-	-	0.00%	160,000	0.00%
Total	1,200,000	187	46,100,000	3.00	34,440,000	100.00%	200,000	0.00%

Illustration.3. In continuation of earlier illustrations, suppose it is the policy of bank to match the return on deposits with conventional bank and following rates are offered by conventional banks on deposits.

Tenure	Percentage returns p.a.
3 Months	45%
2 Months	30%
1 Month	20%

Solution

In case of one and two months return under Islamic bank is higher hence no adjustment is required and Islamic bank cannot deduct the additional amount from customer which is his (customer's) share in Mudaraba. In case of three months, deposit return is lesser than conventional bank and in order to retain customer Islamic bank can sacrifice his share of profit in favor of customer. Hence, IFI has to sacrifice an amount of Rs; 1,000 out of his share of profit to retain the customer. This compensation must not form part of Mudaraba agreement, however at the time of distribution if IFI wants to sacrifice a portion of profit in favor of depositors, it is allowed by Shari'a scholars.

Illustration.4. First Islamic bank started operation with a capital of Rs; 10 million on January 1st 2010. Following transactions completed during the first month of operation.

January 02 Received current deposit from Mr. Khan Rs; 2,000,000.

January 04 Entered promise with Saqib for the supply of 10 computers.

January 08 Khan withdrawn from his account Rs; 500,000.

January 10 Malik deposited in fixed PLS deposit for a quarter Rs; 1,000,000.

January 12 Margalla Corporation deposited in current account Rs; 2,000,000.

January 14 Murabaha sales contracted concluded with Mr. Saqib for the sale of 10 computers with 15% markup on cost price amounting to Rs; 50,000 each computer payable in 2 equal installments semiannually.

January 15 Entered into a lease contract with Hasham for a car purchased amounting to Rs; 500,000. Monthly rent agreed amounting to Rs; 10,000.

January 20 Entered into Mudaraba contract with Shabir with a capital of Rs; 500,000 on profit sharing ratios 50:50.

January 25 Received deposit of Rs; 1,000,000 on profit and loss sharing from Alam.

January 30 Paid operating expenses amounting to Rs; 100,000.

Required: Prepare trial balance of the bank as January 31, 2010.

Solution: Following is the worksheet depicting closing balances of accounts.

Work Sheet-Trail Balance (Rs in '000')

Accounts	1-Jan	2-Jan	8-Jan	10-Jan	12-Jan	14-Jan	15-Jan	20-Jan	25-Jan	30-Jan	Closing
Assets & Expenses											
Cash	10,000	2,000	(500)	1,000	2,000	(500)	(500)	(500)	1,000	(100)	13,900
Murabaha R/A						575					575
Inventory							500				500
PLS Investments								500			500
Lease rentals R/A										5	5
Operating Expenses										100	100
Total	**10,000**	**2,000**	**(500)**	**1,000**	**2,000**	**75**	**-**	**-**	**1,000**	**5**	**15,580**
Liabilities & Equities											-
Current Deposits		2,000	(500)		2,000						3,500
PLS Deposits				1,000					1,000		2,000
Capital	10,000										10,000
Retained Earnings						75				5	80
Total	**10,000**	**2,000**	**(500)**	**1,000**	**2,000**	**75**	**-**	**-**	**1,000**	**5**	**15,580**

Illustration.5. Based on information in illustration 4 calculate the profit of bank for the first month of operation and prepare a balance sheet as at January 31, 2010.

Solution: Following is profit and loss statement and balance sheet of the bank.

First Islamic Bank

Income Statement, for the month of January 2010

Revenue Earned	
Lease rentals	5,000
Murabaha	3,125
Total revenue	8,125
Operating expenses	(100,000)
Net Profit	(91,875)

First Islamic Bank

Balance Sheet, as at January 31, 2010

Assets	**Rs.**	**Liablities & Equities**	**Rs.**
Cash	13,900,000	Current Deposits	3,500,000
Murabaha R/A	575,000	PLS Deposits	2,000,000
Lease Rentals R/A	5,000	Deffered Profit	71,875
Inventory	500,000	Capital	10,000,000
PLS Investments	500,000	Retained Earnings	(91,875)
Total	**15,480,000**	**Total**	**15,480,000**

9.6. Questions

1. Explain the nature of current deposits accepted by IFIs. What is the difference in loan and Amanah deposits?
2. What is meant by PLS deposits? What is the difference in savings and PLS deposits?
3. Enlist the Shari'a rulings applicable in deposits management by IFIs under Mudaraba and Musharaka?

True/False

1. Status of Current account is an Amanah account, hence, bank is allowed to use the money for his benefits and also, bank is bound to return the money on demand.

2. Any charge on current account by the bank from account holders is not permitted as the cost of services rendered.

3. It is not permitted for the institution to render services relating to deposits and withdrawals to the owners of current accounts without compensation (cheque book, ATM etc).

4. Equality in investment opportunities should be ensured between shareholders' funds and investment account holders funds unless it is clearly stated before disposition.

5. IFI should not guarantee full repayment of the amounts under current accounts, however, it should assume/announce a commitment to pay any incremental return (fixed/variable).

6. IFI cannot provide a guarantee of return of funds under investment accounts. Also, IFI cannot announce/promise any predetermined return on investment accounts.

7. In the case of money transfer between accounts, legal possession is sufficient whether for the same currency or different currencies subject to currency exchange rules as per Shari'a standard # 1.

8. Any funds which cannot be transferred to owners due to lack of contact should be kept in a suspense account for the specified period and then may be transferred to shareholders account.

9. If there is any change in conditions or profit sharing ratio, institution is not bound to contact account holders

10. Allocation for bad debts and reserve for the rate of returns is not allowed from Mudaraba investment accounts.
11. It is not permitted to cover the loss of one Mudaraba operation from a profit of another.

12. The loss of a certain financial period can be covered from a profit of another period; however it cannot be covered from reserves.

13. Profit sharing can be in any terms including ratios, by specifying a lump sum amount or a percentage of capital for any party.

14. Ideally, profit sharing ratio should be decided at the time of the signing of the contract, however if such ratio is not decided then it can be agreed at the completion of an accounting period.

15. The institution cannot specify different ratios for distribution of profits between itself and different categories of investment account holders.

16. It is permitted to have an agreement between both parties [account holders & institution] that if the profit exceeds from certain limit or index the excess amount belongs to only one of them [institution].

17. It is permitted to stipulate that profit of a transaction, type, portion of capital, assets into which capital is converted and/or a period belongs to one and other(s) to second.

18. The method agreed upon for distribution of profit can be fixed for the whole period or variable according to specific sub-periods of partial liquidation.

19. The owner of Mudaraba profits are account holders and IFI, however, both can agree on the allocation of certain part of the profit to the benefit of the third party.

20. If IFI mixes shareholders' funds with depositors' funds, it assumes the position of a partner by capital as well as Mudarib. In this case, profit has to be divided between two amounts of capital so that IFI can get the benefit of his capital as well as Mudarib.

21. It is permitted for an account holder to exit from the Mudaraba with all his funds or part of them.

22. If the amount of cash reserve kept with the central bank or in the treasury of IFI for repayment to account holders, nothing is earned to share, however if amount invested in short-term liquid investments, any amount earned should be shared by both parties as per agreed ratio.

23. Scoring method for profit distribution is not allowed. Such method takes into account the amount invested and period of stay by account holder (currency unit X time unit).

24. It is permitted to set an expected rate of return based on IFI's calculation, however, it can never be binding and account to be settled as per actual profit and loss.

25. It is allowed to distribute provisional profit subject to a final settlement based on actual results.

Multiple Choice Questions

1. A scheme of deposits whereby neither return is shared with depositors nor guarantee of funds return is provided is called:
   a. Current deposits
   b. PLS deposit
   c. Amanah deposit
   d. None of the above
2. A scheme of deposits whereby return is not shared with depositors, however, guarantee of funds return is provided is called:
   a. Current deposits
   b. PLS deposit
   c. Amanah deposit
   d. None of the above
3. A scheme of deposits whereby return is shared with depositors, however, guarantee of funds return is not provided is called:
   a. Current deposits
   b. PLS deposit
   c. Amanah deposit
   d. None of the above
4. Which type of deposits are assigned higher weight-age while profit is distributed under PLS
   a. Fixed term deposits
   b. PLS deposits
   c. Current deposits
   d. Amanah deposits
5. Current deposits are reported in balance sheet as:
   a. Liability
   b. Asset
   c. Equity

d. Unearned income

6. PLS deposits are reported in balance sheet as:

a. Liability
b. Asset
c. Equity
d. Unearned income

7. A deposit of Rs 1,000 remained in the bank for 25 days during a quarter. What is the daily product of this deposit for profit sharing?

a. 12,500
b. 25,000
c. 50,000
d. None of the above (write your answer)

8. Any funds which cannot be transferred to owners due to lack of contact should be: - for the specified period and then may be transferred to shareholders account.

a. Kept in suspense account
b. Transferred to shareholders
c. Transferred to SBP
d. Transferred to government

9. Neelam bank collected deposits of PKR 30 million under PLS scheme and contributed PKR 20 million from its own resources. As per contract, it is Mudaraba investment with profit sharing ratio of 60:40 for bank and customers respectively. During the period under review, the bank earned profit amounting to PKR half million. Share of bank in profit is amounting to PKR:-

a. 200,000
b. 180,000
c. 120,000
d. 380,000

10. Margalla Bank collected 500 million under investment accounts scheme with a profit sharing ratio of 60:40 for bank and customers respectively. During the period bank earned a profit of 60 million. What is a share of the bank in profit?

a. 36 million
b. 24 million

c. 30 million
d. None of the above (write your answer)

9.7. Exercises

Ex.1. Following transactions incurred during the first quarter in a branch of a first Islamic bank. [See PLS depositors' sheet; w1 to w13 represents weeks]

PLS Depositors' sheet Rs (000)

Depositors	O.B	W1	W2	W3	W4	W5	W6	W7	W8	W9	W10	W11	W12	W13	C.B
Alam	200	0	10	0	0	2	-3	2	0	1	-4	0	0	-9	199
Bahar	300	-10	13	0	0	0	2	5	0	2	3	0	0	-8	307
Dawood	250	20	-23	0	0	3	-3	6	0	3	-4	0	0	-7	245
Farhan	50	0	10	0	0	0	4	0	0	4	3	0	0	-6	65
G.Rasool	100	0	-23	0	0	4	-4	7	0	5	-4	0	0	-5	80
Hamza	125	0	-20	0	0	0	0	3	0	6	3	0	0	-4	113
Inaam	45	-23	12	0	0	3	0	2	0	7	0	0	0	-3	43
Khawaja	95	5	-7	0	0	0	0	1	0	8	0	0	0	-2	100
Noor	55	-2	10	0	0	9	0	4	0	9	0	0	0	-1	84
Total	**1220**	**-10**	**-18**	**0**	**0**	**21**	**-4**	**30**	**0**	**45**	**-3**	**0**	**0**	**-45**	**1236**

Bank earned Gross profit of Rs; 3 million in the quarter and profit sharing ratio is 70:30 respectively between bank and depositors.

Required:-

1. What is the amount of profit to be distributed among depositors?
2. What is the daily product of each depositor assuming all cash flows occurred at the end of the week?
3. What is the amount of profit on each deposit?
4. What is percentage return on each deposit?
5. If the conventional bank is offering 3% per quarter to depositors, what amount bank has to sacrifice to retain the customers?

Case– First Quarter of Operations

First Women Bank was established to provide exclusive service to the 50% population of the country. In order to address the general trend in banking First women bank limited established Islamic banking division in its head office and started

operation by opening independent Islamic banking branch in Liberty market Lahore with a capital of Rs; 5000,000 on January 1st 2009. Following is selected detail of its first quarter's (Jan to Mar 2009) operations.

Deposits' Schedule

Name	deposits in PKR	deposit date	withdrawal date
Saima Khan	100,000	01/01/09	01/03/09
Tasneem Ch	500,000	15/01/09	14/02/09
Mrs.Warraich	200,000	20/01/09	not yet
Mrs. Chaudhry	400,000	01/02/09	01/03/09
Maria Baluch	600,000	05/02/09	Not yet
Ayesha Butt	300,000	09/02/09	Not yet
Fatima Tareen	700,000	25/02/09	Not yet
Total	2,800,000		

Following are financial/accounting policies laid down by the board of directors.

a. Accounts are finalized quarterly, profit is accounted for provisionally.
b. Profit is distributed quarterly on daily product basis.
c. Gross profit is distributed between bank and depositors as per 75:25 ratios.
d. In order to allocate the higher incentive for long-term deposits highest weight of 1:00 is assigned to a deposit remained for 3 months, 0.90 to two months and 0.80 to one month deposit. Any deposit exceeds 10 days period from a group is counted in next group (a deposit remained in the bank for 41 days shall fall in two months group and a deposit remained in the bank for less than 10 days period shall not get any profit).
e. It is the policy of the bank to match return to depositors with a conventional branch if actual is less than 10% offered by conventional branch.

Operating expenses of branch for the quarter is Rs; 1,200,000
Following investments were executed during the quarter.

Investments' Schedule

Investment	Execution date	Term of investment	Amount of investment	Profit rate Per annum
Murabaha 1	Jan 10	1 year	2,100,000	14%
Murabaha 2	Jan 12	2 years	1,500,000	16%
Murabaha 3	Feb 01	6 Month	100,000	12%
Ijarah 1	Jan 20	03 years	1400,000	15%
Ijarah 2	Feb 20	05 years	500,000	17%
Salam	Jan 15	06 month	100,000	20%
Sukuk Certificate	Feb 01	liquid	800,000	12%
Total			6,500,000	

Required:

What is gross revenue earned by the bank during the quarter?

What is share in the profit of bank as Partner in the first quarter?

What is share in the profit of depositors during the first quarter?

What is a total profit of bank during the first quarter?

What is per annum percentage return to each depositor?

What is the amount of sacrifice in profit made by the bank, if any, to match the profit with a conventional branch?

Suggested Readings

- AAOIFI. 2004. *Shari'a Standards.* P.O. Box 1176, Bahrain.
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- Meezan bank Guide to Islamic Banking. On line available at www. Meezanbank.com.pk

Part-5

Special Topics in Islamic Finance

1. Capital Market- Equity
2. Capital Market- Sukuk
3. Islamic Insurance
4. Challenges

Chapter 10

Capital Market–Equity

Capital market offers opportunities of Liquidity management for IFIs as well as returns for investors.

Liquidity management is the real test of any banker including Islamic banker. Banking is a business where depositors are normally free to deposit and withdraw their savings according to their preferences and financial plans. This unpredictability of behavior put the managers under intense pressure and requires a high level of skill to achieve optimality of resources at hand. Traditionally banks manage their liquidity by investing in short-term interest based securities which is not the cup of tea for an Islamic banker. Islamic bankers have the option to invest in marketable equity securities and Sukuk subject to Shari'a compliance of securities. Chapter 10 and 11 are dedicated to capital market operations within Shari'a constraints covering equities and Sukuk respectively.

Learning Objectives

After studying this chapter one should be able to understand and interpret the following:

What is meant by liquidity management by an IFI?

What is meant by Shari'a compliance of a security?

What are implications for investors of filtering securities through Shari'a compliance tests?

What are valuation methods of Shari'a compliant securities?

What are Shari'a rulings about the trading of securities?

10.1. Introduction

Liquidity is the ability to meet obligations as and when due. Banking is a business of financial intermediary whereby money is collected from depositors and provided to business and industry to meet short and long term requirements. Deposits are collected under any of the three forms of accounts including current account, profit and loss sharing account and profit and loss fixed deposits. Except profit and loss fixed account depositors are free to deposit and withdraw the amount according to their preferences and financial plans, which creates uncertainty as for cash requirements of a bank are concerned to return the money of depositors. This uncertainty of cash requirements makes the job of modern banker challenging because of required skill in funds management to utilize the funds prudently keeping in view the liquidity requirements as well as to earn a normal rate of return for depositors and shareholders.

Liquidity risk management is a challenging task for any bank including Islamic banks. Conventional banking has numerous opportunities to mitigate and manage liquidity risk including investment in short-term interest based instruments issued by the government and corporate sector. The most secure form of short term investment is treasury bills and other money market instruments. Likewise for medium to long term investments interest based bonds are available to conventional banks with a ready market for disposal without losing much in the value of the underlying security. Conventional banks have the opportunity to invest in equities through the stock exchange and earn a return in the form of dividend and price appreciation, at the same time to convert into cash as and when required. Another important source of meeting the liquidity crisis is help from the central bank in rainy days by providing required hard currency for interest. Furthermore interbank balances of conventional banks are also rewarded in the form of interest by each other. Majid (2003), identified the following causes of liquidity problem in Islamic Financial Institutions:-

Conventional banks have the opportunity to invest in equities through stock exchange and earn return in the form of dividend and price appreciation, at the same time to convert into cash as and when required.

- Small number of participants

- The slow development of Islamic financial instruments
- No Islamically acceptable inter-bank market
- Absence of a liquid Islamic secondary market
- No lender of last resort facility
- Different Shari'a interpretations

Islamic banks cannot invest in any interest bearing instrument consequently all interest bearing money and capital market instruments based on interest are eliminated as for liquidity management of Islamic banks is concerned. The job of Islamic banking practitioner has become very challenging as for liquidity is concerned. Naturally in such circumstances Islamic bank has to be very prudent while deciding the ratio of reserve and availability of funds for investments and financing. In Pakistan central bank has directed through prudential regulations to all Islamic banks to maintain a higher cash reserve with the central bank as compared to conventional banks because conventional banks are allowed to maintain a cash reserve in a combination of short-term liquid securities and cash balance with the central bank. Islamic banks can invest in any instrument of money or capital market if and only if it is based on variable return. Investment in equities through stock exchange is the only avenue of investment left with Islamic banks as for liquidity management is concerned, however, as we know Islamic financial institutions are required to ensure Shari'a compliance in all of their operations, hence, IFIs are not free to invest in any security issued on profit and loss sharing basis. Shari'a compliance of the company issuing securities with variable returns is required. Ideally, a security should have two features, at least, to be called as Shari'a compliant, including Halal business (business of the company should not consist of an activity which is prohibited by Islamic law e.g. liquor, pornography, pork, speculation, hoarding etc.etc.) and free from interest in its operations.(e.g interest received on bank deposits, interest paid on overdrafts and loans, discounting of bills of exchange, interest paid on bonds and even on preferred stocks are all interest-based transactions and contradict with Shari'a compliant financial

Ideally a security should have two features at least to be called as Shari'a compliant, including Halal business and free from interest in its operations.

system). If we filter the investment opportunities available at hand with these two criteria, we will find none or a minor number of companies meeting both criteria. Even if we found a small number of companies meeting both criteria, the issue of listing with stock exchange (which is vital for the ready market to convert into cash) and low financial performance of these companies might hinder investment by IFIs.

This led the Shari'a experts and finance professionals to pay due consideration to the underlying problem of liquidity management by IFIs and come up with solutions. Any of the solution to the problem through financial engineering is deemed fit if it is not violating basic principles of Islamic financing. In the following sections, I have explained the solutions offered as for investments of IFIs are concerned into readily convertible securities.

10.2. Investment in Equities

Investment in marketable equity securities of public companies is permitted in Shari'a being providing variable returns. However, adherence of underlying company to Shari'a principles of trade and commerce is required in order to make its equity security Shari'a compliant. In this section, two issues relating to investment in equities are discussed in the light of Shari'a principles. Section one discusses the filtering criteria to determine the status of a security as Shari'a compliant while section two addresses issue of asset pricing under Shari'a framework.

10.2.1. Shari'a Compliance of a Security

Following is the established criteria for checking Shari'a compliance status of a security prior to investment by an IFI. This Shari'a compliance criterion consists of six tests and meeting of all requirements is essential by a company prior to qualifying for investment in its equity by an IFI (KMI-2010).

1. Halal Business of the Investee Company: Core business of the company must be HALAL and in-line with the dictates of Shari'a. Hence, investment in secu-

rities of any company whose principal activity consists of a haram (unlawful) business, e.g. dealing in conventional banking, conventional insurance, alcoholic drinks, tobacco, pork production, arms manufacturing, pornography or related un-Islamic activities, is not permissible.

2. Interest Based Financing: Interest based debts to asset ratio should be less than 40%. Debt, in this case, is classified as any interest bearing debts. Zero cou-

FTSE NASDAQ Dubai Shariah Index

1. Companies involved in the following activities will be considered to be non-permitted business sectors:
a) Conventional Finance (non-Islamic Banking, Finance and Insurance, etc.)
b) Alcohol
c) Pork related products and non-halal food production, packaging and processing or any other activity related to pork and non-halal food
d) Entertainment (Casinos, Gambling, Cinema, Music, Pornography and Hotels)
e) Tobacco
f) Weapons, arms and defence manufacturing
This list is not exhaustive and is provided as a basic guidance to the broad principles involved.

2. After companies have been screened by their business sector activity, the remaining companies are further examined on their finances to ensure that those companies are Shariah compliant. Only those companies that pass the following financial ratios will be considered Shariah compliant:
a) Debt is less than 33.333% of total assets
b) Cash and Interest bearing items are less than 33.333% of total assets
c) Accounts receivable and cash are less than 50% of total assets
d) Total interest and non compliant activities income should not exceed 5% of total revenue

Companies that change financial compliance between two successive quarters will be monitored to check if their debt, and/or cash/interest bearing ratios fall within 33.333% +/- 5% (i.e. below 31.667% and 35% or above). If during the monitoring period any company remains above or below 33.333% +/- 5% for two consecutive quarters, the compliance of that company will change accordingly.
Appropriate purification of dividends at 5%. This ratio calculates the recommended purification amount to be paid by the investor.

[Source: Ground Rules for the Management of the FTSE NASDAQ Dubai Shariah Index Series 2 Version 1.6 March 2013]

pon bonds and preference shares are, both, by definition, part of the debt[23].

3. Shari'a Non-compliant Investments: The ratio of non-compliant investments to total assets should be less than 33%. Investment in any non-compliant security shall be included in the calculation of this ratio.

4. Purification of Shari'a Non-complaint Income: The ratio of Shari'a non-compliant income to total revenue should be less than 5%. Total revenue includes Gross revenue plus any other income earned by the company. This amount is to be cleansed out as charity on a pro rata ratio of dividends issued by the company.

5. Net Liquid Assets to Share Price: The market price per share should be greater than the net liquid assets per share calculated as (Total Assets – Illiquid Assets – Total Liabilities) divided by the number of shares. A liquid asset means the asset which cannot be traded except at par value as per Shari'a rulings and includes cash, bills receivables, promissory notes, accounts receivables, bonds, preferred shares etc.

6. Illiquid Assets to Total Assets: The ratio of illiquid assets to total assets should be at least 20%. Illiquid assets, here, is defined as any asset that Shari'a permits to be traded at value other than the par and includes physical assets (land, building, furniture, machinery, computer, office equipment etc) inventory (raw materials, work in process and finished goods), equity investments (ordinary shares, PTCs, TFCs and Sukuk etc), intangibles (goodwill, patents and copyrights etc).

In order to understand the impact of these tests let us look at the available equity securities in the capital market. All securities of financial sector including conventional banking, insurance companies, special-

Naturally in such circumstances Islamic bank has to be very prudent while deciding the ratio of reserve and availability of funds for investments and financing.

[23] As per Shari'a Standard # 21, amount of interest based loans should not be more than 30% of market capitalization of the Company.

It is very interesting to note that as per accounting practices and national taxation laws (almost in every country) interest charge on debts is treated as pretax cost and deducted from revenue to calculate income tax. It means regulator himself is promoter of interest based financing in firms.

ized financial institutions, leasing companies etc. and securities of all companies engaged in haram businesses e.g. liquor, pornography, pork, speculation, hoarding, tobacco, casinos, night clubs, adultery etc. are excluded through test one.

We left with halal businesses of real sectors including manufacturing, trade and services sectors, however, a large number of companies may not be able to qualify second test restricting interest based debts to total assets ratio less than 40%. Practically many large firms employ a huge amount of debts to meet the expansion, growth, and asset replacement requirements. One of the strongest motivations to employ interest-based debt financing by firms is the tax incentive. It is very interesting to note that as per accounting practices and national taxation laws (almost in every country) interest charge on debts is treated as a pre-tax cost and deducted from revenue to calculate income tax. It means regulator himself is a promoter of interest based financing in firms. Had we not have this incentive of interest based debt financing, firms would lose the benefit and motivation to employ debt financing. With the application of second test IFIs lost a reasonable number of financially sound and profit generating firms.

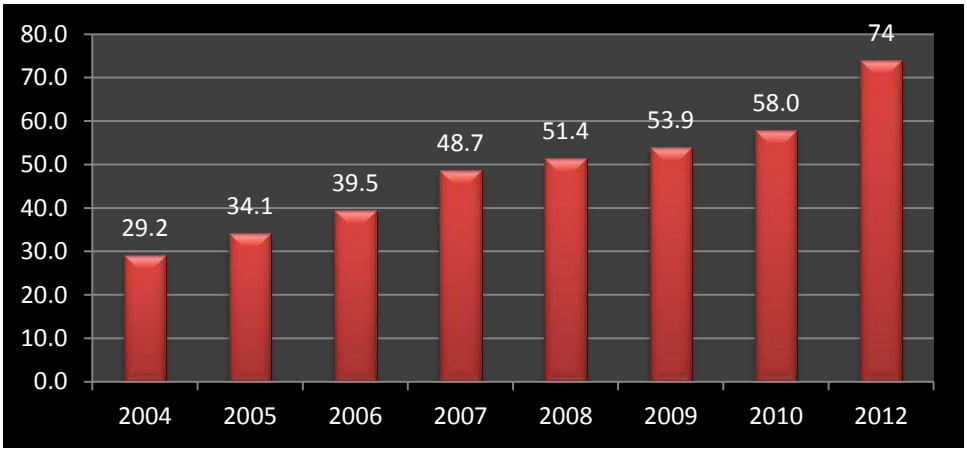
Tests three and four deal with a portion of investment and revenue generated from haram sources. Ideally answer of test three and four should be zero, however, except a small number of firms, results are always positive and it is really difficult for firms to avoid Shari'a non-compliant investments and revenue till the maturity of Islamic financial system (e.g. reach of Islamic banking in Pakistan is limited in the economy with branch network of 684, covering around 7% of market share in assets and deposits and only around 5% of financing and investments by the end of September 2010 (SBP-2010).

All securities of financial sector including conventional banking, insurance companies, specialized financial institutions, leasing companies etc. and securities of all companies engaged in haram businesses e.g. liquor, pornography, pork, speculation, hoarding, tobacco, casinos, night clubs, adultery etc. are excluded through test one.

Tests five and six are about the mixture of liquid and illiquid assets and market to book ratio of net liquid assets. Meeting of these criteria is not very difficult for

a large number of firms because almost every firm in the business of manufacture, trade and service can easily qualify both tests of having illiquid assets more than 20% and price to book ratio of net liquid assets more than one.

Islamic Funds worldwide US $ Billion



There are around 900 funds worldwide. According to Ernst & Young potential is US $ 500 Billion. Saudi Arabia, Malaysia, UAE and Kuwait are centers of funds management. Equity funds account for the largest segment of the market: around 40% of funds, followed by commodities 15%, other investments including alternative investments and feeder funds 13%, fixed income 12%, money market 9% and balanced 2%. [IFSL-2013]

10.3. Valuation of Securities

In this section, I have elaborated valuation of securities under Shari'a compliant financial system. As IFIs are entering into equity markets for investment hence guidance in the field of risk and return trade off and security pricing under Shari'a framework is required. Risk taking (but not Gharar) in business is accepted by Shari'a, and experts in business/finance are in consensus about the positive relationship between risk and return. Islamic Law discourages risk-free return by banning charging of interest. Security pricing is at the heart of financial literature and numerous valuation models have been developed so for including cash flows discount models and technical models. There is a need to analyze the existing security pricing models within the filter of Shari'a compliance, document any

Opportunity cost is the reward foregone, attached with second best alternative of investment with same risk level

mismatching with Shari'a financial system and suggest alternatives where required.

An important question for an investor is how to determine the rate of return (profit) to be used in determining the intrinsic value of a security. Certain answers from the literature are provided hereunder.

10.3.1. Opportunity Cost

First and foremost is the opportunity cost of the project at hand should be used as required rate of return. Opportunity cost is the reward foregone, attached with the second best alternative of investment with same risk level (because the first best option of investment is exercised by the rational investor). To illustrate, an investor with a fund of Rs; 100,000 and with a risk preference of only 10% (standard deviation) shortlisted two securities A & B with the return of 12% and 10%. Naturally a rational investor will go for security A being carrying superior return. The only option left is security B, hence, opportunity cost of A is the reward forgone attached with B, so the required rate of return/discount rate/profit rate is 10% in this case. After deciding the discount rate the second step is to determine the intrinsic value of security A. Suppose after one year price of security A is expected to be Rs;25, without any dividend during the year, the current value of the security becomes Rs;22.72. If prevailing market price of security is less than or equal to intrinsic value, it is recommended to invest in the security.

10.3.2. Weighted Average Cost of Capital

The second method to determine the required rate of return on an underlying investment is the weighted average cost of capital (WACC). Following is the basic equation of WACC.

$$WACC = W_e K_e + W_d K_d + W_p K_p \qquad (1)$$

W is the weight, K is the cost (demand of return), e is equity, d is debt and p is preferred stock. IFIs should look into the demands of depositors and owners of the bank and determine the profit rate. Being competitor with conventional

banks, normally IFIs use the interbank offered rate (IBOR) plus certain basis point based on the risk of underlying investment opportunity. However given the special nature of the relationship between depositors and IFIs, makeup of WACC is different from conventional banks. Under conventional framework all deposits (except current deposits) are treated as loans with fixed financial charge, which is not the case under Islamic financial system. IFIs receive deposits under profit and loss sharing modes (Musharaka and Mudaraba), hence, no fixed charge obligation. The component of Kd (cost of debt) and Kp (cost of preferred stock) is missing from traditional WACC equation because both types of financing source are not allowed under Shari'a led financial system. To determine the Ke, (the only component left) for IFI, which is to be used as required return rate/discount rate, discussion follows.

10.3.3. Capital Asset Pricing Model

Capital asset pricing model (CAPM) developed by Nobel Laureate William Sharpe (1961), states that expected return on an asset is the linear function of expected risk. According to the model total risk of a security is distributed between systematic risk and unsystematic risk. Whereas unsystematic risk can be reduced/ eliminated through efficient diversification while systematic risk is priced by the market. As the total risk of a security is measured by standard deviation while systematic risk is measured by Beta hence the Beta is a relevant measure of risk for expected return. Beta measures the co-movement of the security with the market. Beta is calculated by applying the formula:-

$$[\beta_x = \frac{CovXM}{VarM}] \quad (2)$$

Whereby β_x is the Beta of security x; $CovXM$ is the covariance of returns of security x with the market returns; and $VarM$ is the variance of market returns. Once

the Beta of a security is determined required return is calculated by applying following equation:-

$$[R_j = R_f + B_j(R_m - R_f)] \quad (3)$$

CAPM advocates; investors need to be rewarded in two ways: firstly for the time value of money and secondly risk associated with the security. The first half of formula represents risk-free return (RF) that compensates the investors for placing money in any investment over a period of time. The other half of the formula represents [β(Rm-Rf)] risk premium for bearing additional risk.

Empirical evidence on the explanatory power of CAPM is mixed. Since the development of the CAPM, a number of studies has been conducted for testing the validity of the model. Results are although mix but favoring inapplicability of CAPM in its original form and demands modification. CAPM relies on a single measure of risk (Beta) and ignores the other factors contributing in risk of a security. The basic risk-return relationship is not rejected hence model retains its place in literature and can be a helping hand to investors with certain modifications especially the inclusion of more risk factors as suggested in APT/ multifactor models.

10.3.4. Arbitrage Pricing Theory

Arbitrage pricing theory was developed by Ross in 1976. Unlike CAPM theory of arbitrage pricing advocates, that, multifactor are contributing in security risk hence during calculation of required return one should not rely on the single risk factor. Following is the basic equation depicted from Reilly, and Brown, (2003):

$$[E(R_i) = \lambda_0 + \lambda_1 b_{i1} + \lambda_2 b_{i2} \dots \dots \dots \dots \lambda_k b_{ik}] \quad (4)$$

In the equation λ_0 represents the intercept/ constant which is like risk free return in CAPM while λ_1 to λ_k represents the risk premium of each factor and b_{i1} to b_{ik} represent sensitivity of the security with the relevant risk factor.

The original theory has not specified either identity or number of risk factors to be included while determining required return. Identification of factors relevant to a

However given the special nature of relationship between depositors and IFIs, make up of WACC is different from conventional banks.

security or portfolio had left with the investor. Factors used in testing the multi-factor models by researchers are grouped by Reilly, and Brown, (2003), as Macroeconomic based risk factors and microeconomic level factors.

10.3.5. Shari'a Compliant Asset Pricing Model

What is the essence of asset pricing models (CAPM, APT)? These help in determining the profit rate (required) on an investment. Under Shari'a framework profit charging is allowed in business. Practically profit rate is determined by market forces of demand and supply of underlying commodity offered for sale. Investment in equities (shares) is the ownership right of an investor and, of course, the price of a share is also determined by the demand for and supply of the underlying security. Demand and supply of shares are also affected by futures, forwards and short selling which have turned equity investment into speculative businesses. As for Islamic financial system is concerned; ownership, possession and existence of a commodity, to be sold, is required except for Salam and Istisna'a. Whether Salam and Istisna'a sale is applicable to equity shares? Contract of Istisna'a sale is permitted for only the goods which require a transformation of material through manufacturing process into finished goods and also Istisna'a contract cannot be executed on already manufactured goods. As for the application of Salam sale in share trading is concerned, it is expressly prohibited in Shari'a standard # 21. The essence of Salam is dealing in agricultural products and of Istisna'a is dealing in manufactured commodities.

CAPM advocates; investors need to be rewarded in two ways: firstly for time value of money and secondly risk associated with the security.

Traditional CAPM is developed in interest based environment which does not exist under Shari'a based financial system. Under Shari'a (Islamic law) risk and return mechanism is a bit different from the conventional business environment, as no risk-free investment opportunity exists (allowed), hence original equation of risk and return is not workable.

Theory of arbitrage pricing advocates, that, multifactor are contributing in security risk hence during calculation of required return one should not rely on single risk factor.

While the component of RF is not present in Shari'a compliant financial environment so the original equation of required return after modification for Shari'a Compliant Asset Pricing Model (SCAPM) becomes as documented by Tomkins & Karim

$$[R_j = (R_m)B_j] \quad (5)$$

Whereby required return of investor depends upon the relationship of individual security with benchmark (e.g. stock market) measured through beta and there is no minimum compensation in the form of Risk-free return.

Now the important question is should there be minimum compensation (as RF in conventional frame work) for investor in Shari'a compliant financial system.

Sheikh (2010) proposed the linkage of debt servicing with nominal gross domestic product growth rate and replacement of RF with Nominal Gross domestic product growth rate. Under his proposed model equation of SCAPM turns into the following shape:-

$$[R_j = NGDP + (R_m - NGPD)B_j] \quad (6)$$

Whereby required return of investor depends upon two components; Nominal GDP growth rate and risk premium measured through the beta of a security in relation to a benchmark (e.g. stock market).

According to Ashker (1987) RF Should be replaced by Z which is equal to ([Zaka rate)/(1-Zaka rate]) which is 2.56% because in order to attract capital for investment it is minimum return to an investor for investment (to cover Zaka), otherwise investor would prefer spending instead of investing. Hence equation of SCAPM becomes as follows (adapted from Ashker, 1987):-

$$[K_e = Z + (R_m - Z)B_j] \quad (7)$$

As for application of Salam sale in share trading is concerned, it is expressly prohibited in Shari'a standard # 21.

Whereby required return of investor depends upon two components; return to cover Zaka and risk premium measured through the beta of a security in relation to a benchmark (e.g. stock market).

Now the important question is should there be minimum compensation (as RF in conventional framework) for an investor in Shari'a compliant financial system.

To answer this question we have to look into composition and justification of RF in conventional framework. Nominal RF is composed of two things (1) is real RF and (2) is inflation charge. Real RF represents time value of money. It is the rent of money for use. According to Keynes' liquidity preference theory, it is the compensation for sacrificing liquidity by the investor. Under Shari'a framework money is the medium of exchange and not a commodity (which can satisfy any need of humanity by its own….. like medicine cures the disease) hence deserve no rent. Time value of money is not recognized by Shari'a scholars in the area of finance. Money can be used in the utility creation process (production and delivery of goods and services) and deserve a return on profit and loss sharing basis. Time value/ rent of money falls into the category of 'Riba' (interest) which is forbidden in all known revealed religions including Judaism, Christianity, and Islam.

The second component of RF is inflation charge. Under paper currency regime due to inflation purchasing power of currency reduces and owner of currency loses it wealth. It should be the prime responsibility of Islamic state to protect the wealth of its citizens along with life, faith, lineeeage/next generation, and honor[24]. Wealth is reducing due to excessive inflation in the economy and government of Islamic country should not let this phenomenon unchecked. Under Shari'a compliant financial system, Should the investor be compensated for at least equal to the inflation rate in the economy is an issue which is being debated among the Shari'a scholars and we expect an early outcome. Leaving apart the debate on indexation, let us consider the makeup of required return under SCAPM. Any investor who is willing to invest in a business, foremost priority is the capital maintenance and then profit. Without covering the reduction in capital due to inflation through profit one cannot maintain his capital under paper currency regime. Furthermore, inflation hits all the investments irrespective of risk level and im-

Wealth is reducing due to excessive inflation in the economy and government of Islamic country should not let this phenomenon unchecked.

[24] Objectives of Shari'a (Maqasid-e-Shari'a, urdu language), Nijatullah Siddiqi, Islamic Research Institute, IIU, Islamabad.

pact of inflation should not be linear with the riskiness of a security. Equation (4) developed by Tomkins & Karim (1987) missing this fact and put the inflation in a linear relationship with the riskiness of a security. In order to accommodate foregoing observations following equation of Shari'a compliant asset pricing model (SCAPM) looks appropriate:-

$$[R_j = N + (R_m - N)B_j] \qquad (8)$$

Whereby Rj is required the return of a security; N is inflation charge; Rm average return on market portfolio and Bj is a beta of security (relationship of returns between security and benchmark such as stock market). For inflation proxies of Consumer Price Index (CPI), wholesale price index (WPI), Basket of selected commodities or even basket of selected currency can be used.

Under Shari'a frame work money is medium of exchange and not commodity (which can satisfy any need of humanity by its own….. like medicine cures the disease) hence deserve no rent.

Traditional CAPM was criticized on account of relying on a single factor as a measure of risk (Beta) and multifactor models were presented as an extension of CAPM including Arbitrage Pricing Theory (APT) by Ross in 1976. Unlike CAPM theory of arbitrage pricing advocates, that, multifactor are contributing in security risk hence during calculation of required return one should not rely on the single risk factor. Following is the basic equation depicted from Reilly, and Brown, (2003).

$[E(R_i) = \lambda_0 + \lambda_1 b_{i1} + \lambda_2 b_{i2} \dots\dots\dots\dots \lambda_k b_{ik}]$ In the equation λ0 represents the intercept/ constant which is like risk free return in CAPM while λ1 to λk represents the risk premium of each factor and bi1 to bik represent sensitivity of the security with relevant risk factor. Following the Tomkins & Karim (1987), the only objectionable component in the equation is λ0 representing RF and without it equation becomes:-

$$[E(R_i) = \lambda_1 b_{i1} + \lambda_2 b_{i2} \dots\dots\dots\dots \lambda_k b_{ik}] \qquad (9)$$

Whereby E(R_i) is the expected return/ required return of security and λ1 to λk is the risk factors while bi1 to bik is the beta coefficients. However as discussed earlier inflation impact is same for all investment opportunities, hence, it should not depend on riskiness of a security and must be accommodated separately. If

we delink the inflation charge from risk premium then original equation of Ross (1976) remains intact with a slight modification as follow:-

$$[E(R_i) = N + \lambda_1 b_{i1} + \lambda_2 b_{i2} \dots \dots \dots \dots \lambda_k b_{ik}] \quad (10)$$

Whereby N is inflation while λ1 to λk represents the risk premium of each factor and bi1 to bik represent the sensitivity of the security with the relevant risk factor.

10.4. Summary of Shari'a Rulings

In this section summary of Shari'a rulings in respect of issue and dealing in securities as per Shari'a standard # 12 & 21, including acquiring a security as long-term investment, and/or held for sale (short term investment) is provided.

1. The issuance of shares by a corporation is permitted if objectives are lawful according to Shari'a. Recovery of issuing expenses by adding a percentage in share value is allowed. Underwriting of an issue by another party is allowed without any consideration. Subscription in installments is allowed and the subscriber is bound to pay the balance of capital. Preference shares and *tamatu* (enjoyment) shares are not allowed. Bearer certificates of shares are allowed.

Inflation impact is same for all investment opportunities; hence, it should not depend upon riskiness of a security and must be accommodated separately.

2. It is allowed to buy and sell shares of [Shari'a compliant] corporations on a spot or deferred basis. It is prohibited to purchase securities by raising interest bearing loans through a broker or another (margin sale), and; It is also prohibited to sell shares that the seller does not own (short sale), likewise futures, swaps and options contracts of shares are not allowed.

3. It is prohibited to lend and/or rent the shares, and trading of shares by application of Salam contract is also not allowed. It is permitted to pledge shares that are lawful according to Shari'a. Shares of corporations can be traded at a nominal value only and with the condition of delivery, if total assets are in cash and; if total assets are in debt then rules for dealings in debts shall apply.

4. It is permitted, in the legitimate public interest, for the relevant authorities to organize trading in shares in such a way, that trading will not take place except through specifically licensed stockbrokers.

5. All interest bearing bonds are not allowed which carries a stipulation for the return of amount of loan and excess in any form [irrespective of whether excess is payable in installments during life of loan or at maturity; whether it is a lump sum or a percentage; whether bonds are issued at discount and redeemed at par; whether issued by private sector or public sector]. Prize bonds are also not allowed.

6. It is permissible to issue new shares in order to increase the capital provided the new shares are issued at the fair value of the old shares.

7. It is permissible to restrict the liability of a company to its paid-up capital, if this is made public, in order to make the customers of the company aware of the financial position of the company without any uncertainty or lack of transparency.

10.5. Questions

1. What is meant by liquidity? How Islamic banks manage liquidity?
2. What is meant by Shari'a compliance of a security? Enlist the meeting of six tests required to determine the Shari'a compliance status of equity.
3. What is meant by the valuation of securities?
4. Explain concept of opportunity cost.
5. Critically analyze the application of traditional security pricing models under Islamic financial system.
6. Explain Shari'a rulings about the trading of securities.

True/False

Mark the following statements as true or false

1. In order to be Shari'a compliant company, Core business of the company must be HALAL and in-line with the dictates of Shari'a.

2. Investment in securities of any company whose principal activity consists of a Haram (unlawful) business, e.g. dealing in conventional banking, conventional insurance, alcoholic drinks, tobacco, pork production, arms manufacturing, pornography or related un-Islamic activities, is not permissible.

3. To be a Shari'a compliant company, Interest based debts to asset ratio should be less than 30%. Debt, in this case, is classified as any interest bearing debts.

4. As per Islamic financial system, Zero coupon bonds and preference shares are, both, by definition, part of the debt.

5. As per Shari'a Standard # 21, the amount of interest based loans should not be more than 25% of market capitalization of the Company.

6. To be a Shari'a compliant company, The ratio of non-compliant investments to total assets should be less than 33%.

7. In a Shari'a compliant company, The ratio of Shari'a non-compliant income to total revenue should be less than 5%. Total revenue includes Gross revenue plus any other income earned by the company.

8. In order to purify income, Shari'a non-compliant amount is to be cleansed out as charity on a pro rata ratio of dividends issued by the company.

9. in a Shari'a compliant company, The market price per share should be greater than the net liquid assets per share calculated as (Total Assets – Illiquid Assets – Total Liabilities) divided by the number of shares.

10. A liquid asset means the asset which cannot be traded except at par value as per Shari'a rulings and includes cash, bills receivables, promissory notes, accounts receivables, bonds, preferred shares etc.

11. In a Shari'a compliant company, The ratio of illiquid assets to total assets should be at least 20%.

12. Illiquid assets, here, is defined as any asset that Shari'a permits to be traded at value other than the par and includes physical assets (land, building, furniture, machinery, computer, office equipment etc) inventory (raw materials, work in process and finished goods), equity investments (ordinary shares, PTCs, TFCs and Sukuk etc), intangibles (goodwill, patents and copyrights etc).

13. It is not prohibited to purchase securities by raising interest bearing loans through a broker or another (margin sale).

14. It is not prohibited to sell shares that the seller does not own (short sale).

15. It is permitted to deal in futures, swaps and options contracts of shares.

16. It is prohibited to lend and/or rent the shares, and trading of shares by application of Salam contract is also not allowed.

17. Preference shares and *tamatu* (enjoyment) shares are not allowed.

18. It is permitted, in the legitimate public interest, for the relevant authorities to organize trading in shares in such a way, that trading will not take place except through specifically licensed stockbrokers.

Multiple Choice Questions

1. Ability to meet the obligations as and when due is called:
    a. Liquidity

b. Profitability
c. Solvency
d. Efficiency

2. Islamic banks cannot invest in short-term government securities because of:

a. Risky return
b. Interest based
c. Low return

All of the above

3. One of the Shari'a compliance tests is debts to total assets ratio. Which of the following is an acceptable ratio?

a. Less than 40%
b. Less than 30%
c. More than 40%
d. Exactly 50%

4. In order to qualify for Shari'a compliance prohibited investments to total assets ratio of the company should be:

a. Less than 33%
b. More than 33%
c. Less than 30%
d. Exactly 40%

5. Islamic financial system encourages real sector and discourages paper economy. In order to qualify as Shari'a-compliant equity firm must possess illiquid assets. An acceptable ratio of illiquid asset to total assets is:

a. At least 20%
b. Greater than 25%
c. Up to 33%
d. None of the above

6. One of the Shari'a compliance tests is Halal (permitted) business of the underlying firm. Due to this restriction which of the following sectors eliminated as for investment by IFIs is concerned?

a. Oil and Gas
b. Manufacturing and Cement

c. Medicines and surgical
d. Banking and insurance

7. Which of the Shari'a compliance tests is really tough for many companies (keeping in view dominance of conventional banking) otherwise doing a valuable job for society?

a. Halal business
b. Debt to total assets
c. Illiquid to total assets
d. Purification of income

8. The World-over role of regulators is viewed as supporters of conventional banking in comparison with Islamic banking. Which of the following justifies this impression?

a. Interest is cheaper source of funds
b. Interest is tax deductible expense
c. Negotiation of interest based funds is easier
d. Capital markets are imperfect

9. According to author risk-free rate under CAPM should be replaced with:

a. Zakah rate
b. GDP rate
c. Inflation rate
d. Any of the above

10. Benefit attached with second best investment option foregone to achieve the best is called:

a. Return
b. Investment
c. Opportunity Cost
d. All of the above

10.5. Exercises

Ex.1 Following is the selected information from the balance sheet of Maple Leaf cement for the Year 2003. Determine the Shari'a compliance status of the firm by applying Shari'a compliance filters.

Maple Leaf Cement Factory Ltd.	Rs in Millions
Items	**2003**
A.Capital Structure:	
1.Ordinary Share Capital	1,804.9
2.Surplus	1,148.3
3.Shareholder's Equity (A1+A2)	2,953.2
4.Preference Shares	0.0
5.Debentures	208.3
6.Other Fixed Liabilities	2,732.7
7.Total Fixed Laibilities (A4+A5+A6)	2,941.
8.Total Capital Employed (A3+A7)	5,894.2
B.Liquidity:	
1.Liquid Assets:	135.9
(i)Cash	130.9
(ii)Investments	5.
2.Other Current Assets	1,333.
3.Inventories	98.2
4.Current Assets (B1+B2+B3)	1,567.1
5.Current Liabilities	1,170.4
6.Total Liabilities(A7+B5)	4,111.4
7.Net Current Assets(B4-B5)	396.7
8.Contractual Liabilities	3,708.1
9.Net liquid assets (B1-B5)	-1,034.5
C.Fixed Assets:	
1.Fixed Asset At Cost	8,996.7
2.Fixed assets after deducting accumulated depreciation	5,497.3
3.Depreciation for the year	338.4
4.Total assets (B4+C2)	7,064.4

Case – Shari'a Compliance of securities

Margalla Islamic bank was registered as a subsidiary of National Bank of Pakistan on 1st January 2009. As per local laws 15% cash reserve maintenance (8% cash and 7% short-term liquid securities) is required out of total demand and time deposits. As the bank has to service all deposits as a customary practice even if not invested, hence idle funds in the form of cash is not suitable economically. Conventional banks have the opportunity to invest in short-term interest based government and private sector risk-free securities which is not the case under Islamic financial system. However Islamic banks can invest in Shari'a compliant equity securities for which selection must be based on the economic performance of the securities to minimize the risk. In addition, to economic viability, Shari'a compliance of the security is a must. Following companies selected on the basis of economic viability by financial analyst however Shari'a compliance is yet to be tested.

Description	**Cement**	**Textile**	**Oil & Gas**	**Sports**
	000	000	000	000
Revenue	1,000	2,000	3,000	4,000
Interest income	20	50	60	70
Operating expenses	600	900	2,100	2,300
Depreciation	25	40	70	90
Fixed assets net	500	1,200	2,500	3,100
Cash	100	300	500	2,500
Accounts R/A	400	700	1,200	3,000
Interest based debts		800	1,600	3,400
Total # of shares	390	200	400	600
Market capitalization	100	2,500	3,200	6,600
Accounts payable	1,200	400	700	1,200
Accrued expenses	200	100	160	325
Retained earnings	50	500	900	700
Dividends	300	150	300	400

Required:

1. Determine Shari 'a compliance status of each company through the application of Shari'a compliance filters? Present your results in a table as follow.

Company	Test name	Test name	Test name	Test name	Test name	Test name
A	Pass	Fail	Pass	pass	pass	pass

2. What recommendations will you offer to a company failed in qualifying Shari'a compliance, if any?

Suggested Readings

- AAOIFI. 2004. *Shari'a Standards.* P.O. Box 1176, Bahrain.
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Chapter 11

Capital Market–Sukuk

Sukuk are the major sources of liquidity management for Islamic banks

Liquidity management is the real test of any banker including Islamic banker. Banking is a business where depositors are normally free to deposit and withdraw their savings according to their preferences and financial plans. This unpredictability of behavior put the managers under intense pressure and requires a high level of skill to achieve optimality of resources at hand. Traditionally banks manage their liquidity by investing in short-term interest based securities which is not the case under Islamic finance. Islamic bankers have the option to invest in marketable equity securities and Sukuk subject to Shari'a compliance of securities. Chapter 10 and 11 are dedicated to capital market operations within Shari'a constraints covering equities and Sukuk respectively.

Learning Objectives

After studying this chapter one should be able to understand and interpret the following:

What are Sukuk and how Sukuk are different from conventional bonds?
What is current status of global Sukuk industry?
What are Shari'a rulings about operations of Sukuk?
How is Sukuk process completed?
What are different types of Sukuk?
How Sukuk Al-Ijarah operates/works?
How Sukuk Al-Wakala transaction is completed?
What are question marks [Shari'a risks] on existing Sukuk transactions?

11.1. Introduction

Sukuk is a creation of IFIs to meet their liquidity requirements. Sukuk provides an opportunity to distribute the value of an asset/enterprise/project/usufruct into smaller amount certificates of equal value to create an opportunity for small investors to share the benefits of investment which is otherwise impossible keeping in view the larger amounts required to acquire or build an asset or enterprise/project. According to Shari'a standard # 17 investment Sukuk are certificates of equal value representing undivided shares 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. All Sukuk are tradable in the secondary market.

Hong Kong

Since 2007, Hong Kong has been looking at ways to encourage the development of a sukuk market in Hong Kong, which has historically been limited by the potentially adverse tax treatment of such instruments. On 19 July 2013, the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 was gazetted, conforming the tax treatment for Islamic securities to conventional debt securities.

http://www.cliffordchance.com accessed on 07/11/2013

There is empirical evidence to suggest that Sukuk structures were used within Muslim societies as early as the Middle Ages, where papers representing financial obligations originating from trade and other commercial activities were issued. The word, "Sukuk", can also be traced back to classical commercial Islamic literature, used in reference to certificates for goods or groceries ("sakk al-bada'i") as the method of paying the salaries of government officers, who would later redeem such certificates in line with their day-to-day consumption of such goods or groceries. However, the Sukuk, as understood in its contemporary form, lies in a decision of the Islamic Jurisprudence Council (the "IJC") dated 6-11 February 1988 which provided that, *"any combination of assets (or the usufruct of such assets) can be represented in the form of written*

financial instruments which can be sold at a market price provided that the composition of the group of assets represented by the Sukuk consist of a majority of tangible assets."[DIFC Sukuk Guide]

Sukuk market has got momentum under Shari'a compliant financial system. According to ISI Emerging Markets[25], approximately 2000 issues of Sukuk were held with the Global volume of around US $200 Billion by the end of June 2010. In addition to corporate Sukuk, Sovereign Sukuk are also issued by the governments including Pakistan, Jordan, UAE, Thailand, Malaysia, Turkey, Indonesia, Bahrain, Qatar, Cayman Islands, Singapore, Germany, Brunei, Gambia, and Kuwait.

The concept of Sukuk is initially developed to replace the conventional bonds having features of fixed return, money back security/guarantee and ready market for liquidation. However under Islamic financial system, even Sukuk cannot guarantee of all the features of conventional bonds listed above. Different types of Sukuk are offering varying degree of feature(s) of conventional bonds. Objective classification of Sukuk places them into either fixed return Sukuk or variable return Sukuk. Variable return Sukuk are very much similar to equity securities rather than conventional bonds, however, fixed return Sukuk are having some of the features of conventional bonds. Practically almost all Sukuk

JAPAN

Historically, it had been difficult to structure *Shari'a*-compliant financing structures in Japan due to a number of factors, including the tax treatment of the distribution of profits to overseas Islamic investors. However, a recent amendment to the Japanese Asset Securitisation Law together with certain tax reforms have made investing in Japan in a *Shari'a*-compliant manner more attractive and have helped to level the playing field between conventional financing and Islamic financing for such investments in Japan. These amendments came into effect on 24 November 2011.
http://www.cliffordchance.com
accessed on 07/11/2013

[25] http://www.securities.com/ accessed on 5th July, 2010.

issues [so for] have been designed in such a way that normal rate of return [usually linked with IBOR] could be provided to Sukuk-holders.

11.2. Summary of Shari'a Rulings

Rule.1. Issuing document (Prospectus) of Sukuk must contain the following:-

a. It must include all contractual conditions, information about participants in the issue along with their rights and obligations; including issue agent, issue manager, originator, investment trustee, the guarantor (of capital, returns), payment agent and any other related party along with conditions of appointment and dismissal.

b. It must include the identification of the contract, on the basis of which Sukuk are launched i.e. Ijarah, Murabaha, Salam etc.

c. It must clearly mention the Shari'a compliance of issue duly certified by Shari'a board.

d. It must clearly state that investment of realized funds will be taken through Shari'a compliant modes of investment.

e. It should state that each owner of a certificate participates in profits and losses.

Redemption of Sukuk by issuer at market price or an agreed price at the time of redemption is allowed, however it is not allowed to stipulate in the prospectus by issuer as of redemption at nominal value.

f. It must not include the guarantee of capital or return by the issuer to Sukuk holders except in cases of negligence. However, it is allowed to an independent third party to provide guarantee free of charge.

Rule.2. Underwriting is allowed without any charge. Sukuk of any duration are allowed including short term, medium term, long term and indefinite period of time. Risk mitigation through profit equalization reserve and permissible insurance is allowed.

Rule.3. Trading in Sukuk and redemption on profit/loss is allowed after closing subscription, allotment of Sukuk and commencement of the activity. However in

following cases rules of debts and currency trade shall be applicable in trading and redemption of Sukuk.

a. Ijarah Sukuk (ownership in an asset), after subleasing
of the underlying asset by the lessee.

b. Ijarah Sukuk (ownership in usufruct), before ascertainment of an asset to be leased.

c. Istisna'a Sukuk, when the price paid in parallel Istisna'a contract and/or manufactured goods are delivered to the ultimate purchaser.

d. Salam Sukuk (cannot be traded except on par as per rules of trading of debts).

e. Murabaha Sukuk, prior to the purchase of an asset and after selling
of asset under Murabaha.

f. Prior to commencement of the activity. (Conversion of cash into assets).

g. Liquidation of activity and assets converted into receivables.

Rule.4. Redemption of Sukuk by the issuer at market price or an agreed price at the time of redemption is allowed, however, it is not allowed to stipulate in the prospectus by the issuer as of redemption at nominal value.

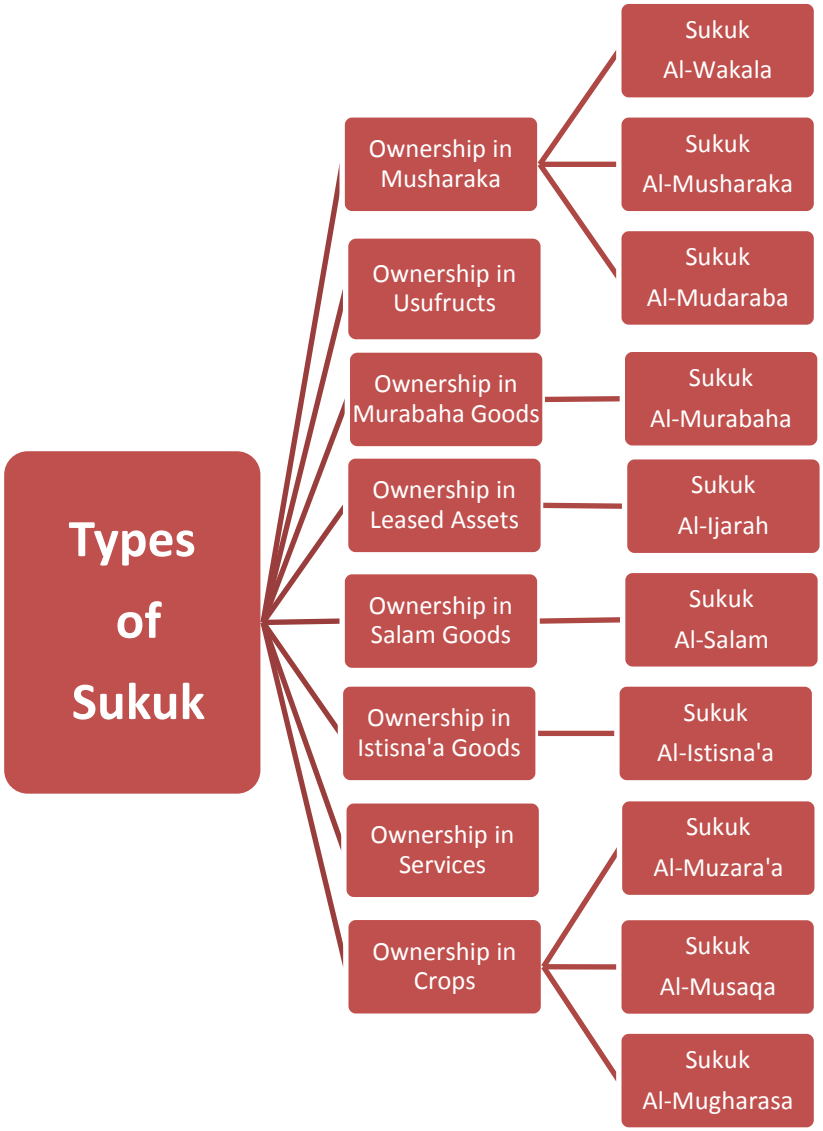
Approximately 2000 issues of Sukuk were held with Global volume of around US $ 200 Billion by the end of June 2010.

Rule.5. It is permitted, immediately upon the issue and up to the date of maturity, but after the passing of ownership of the asset(s) to the Sukukholders, to trade in Sukuk that represent ownership of existing leased assets or assets to be leased on the promise.

11.3. Sukuk Process

In order to issue Sukuk normally issuer creates a special purpose vehicle (SPV) and transfers the ownership to it which ultimately passes on to Sukuk holders in the form of certificates. Bank collects the amount from users of the facility (in the case of Ijarah Sukuk) on behalf of SPV and ultimately return is distributed to certificate holders.

Figure- 1. Types of Sukuk

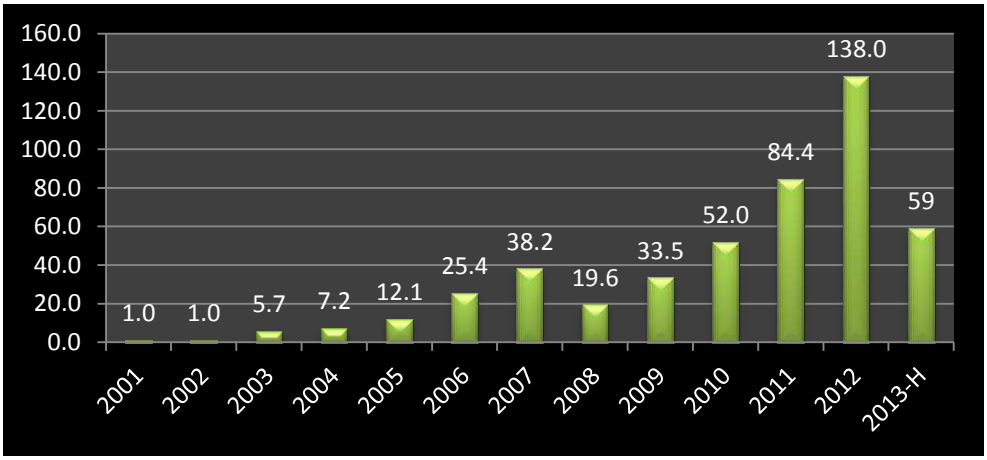


Depending upon the circumstances some or all of the following parties participate in the process including the issuer, arranger, underwriter, the rating agency, auditor, and guarantor. Most important document in Sukuk issue is the prospectus (offering document). It includes overview of issue, business plan, parties involved, management, terms of Sukuk issue, payment procedure, expected return to Sukuk holders, listing, sale and purchase of Sukuk, clearing procedure, applicable laws, redemption of certificates on due date, premature dissolution of project, rating of the issue, risk analysis etc. although prospectus includes business plan which incorporates expected return, however, such returns cannot be guaranteed by issuer, however, an independent person (organization) can guarantee of such returns to investors in order to build confidence among investors in the issue. Such guarantee must be without any charge or interest in the issue. In the following sections, an overview of different types of Sukuk is provided.

11.4. Sukuk Al- Ijarah

Ijarah Sukuk are further subdivided into two types. (1) Certificate of ownership in leased asset(s) or asset(s) to be leased on the promise (2) certificate of ownership in usufruct of existing asset(s) or asset(s) to be made available in future. Under first case Sukuk holders are the buyers of asset(s) and funds mobilized are the purchase price of the asset(s).The Sukuk holders jointly owns the asset(s) through an undivided ownership sharing the profits and losses on the basis of partnership. Under second case, Sukukholders are buyers of usufruct while funds mobilized are the purchase price of the usufruct.

Global Sukuk Issues US $ Billion

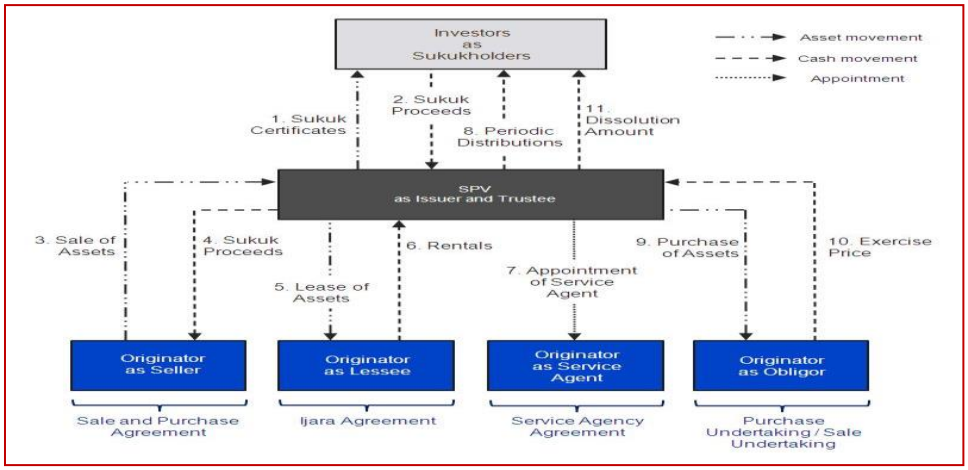


Source: IFSL-2013

The certificate holders become joint owners of the usufruct sharing its benefits and risks. Ijarah Sukuk are very much similar to conventional bonds offering fixed return subject to sharing of ownership risks. Under Ijarah Sukuk after giving the asset on rent IFIs can sell the Sukuk to investors bearing fixed return because the amount of rent is known with certainty. However stipulated redemption at par value and guarantee of return by the issuer is not allowed. It is allowed to redeem the Sukuk at market price or an agreed price at the time of redemption. It is however permitted that an independent third party provides the guarantee free of charge. Issuing document of Sukuk (prospectus) must state that each owner of a certificate participates in the profit and bears a loss in proportion to the financial value represented by his certificate.

In practice Ijarah Sukuk are structured as a sales and leaseback transaction, whereby originator creates an SPV to work as issuer of Sukuk and trustee on behalf of investors and sells asset to SPV, which sells the asset to investors in the form of Sukuk certificates and proceeds is used to pay price of assets to originator. After selling the assets to SPV originator lease back the assets under Ijarah agreement.

Figure 1- Ijarah Sukuk Process Illustrated



[WWW. http://www.cliffordchance.com accessed on 07/11/2013]

Figure 1 depicts sale and lease back Ijarah Sukuk structure. The originator is the person having ownership in assets requires cash. In order to sell assets to many investors, he divides the total value of assets into smaller denominations represented by Sukuk. To formalize the process a Special purpose vehicle [SPV] is created who act as an issuer as well as a trustee on behalf of Sukuk holders.

1. Issuer SPV issues Sukuk, which represents an undivided ownership interest in an underlying asset or transaction. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.

2. The Investors subscribe for Sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any assets acquired using the proceeds – see paragraph 3 below) and thereby acts as Trustee on behalf of the Investors.

3. Originator enters into a sale and purchase arrangement with Trustee, pursuant to which Originator agrees to sell, and Trustee agrees to purchase, certain assets (the "Assets") from Originator.

4. Trustee pays the purchase price to Originator as consideration for its purchase of the Assets in an amount equal to the Principal Amount.

5. Trustee leases the Assets back to Originator under a lease arrangement (Ijarah) for a term that reflects the maturity of the Sukuk.

6. Originator (as Lessee) makes Rental payments at regular intervals to Trustee (as Lessor). The amount of each Rental is equal to the Periodic Distribution Amount payable under the Sukuk at that time. This amount may be calculated by reference to a fixed rate or variable rate (e.g. LIBOR or EIBOR) depending on the denomination of Sukuk issued and subject to mutual agreement of the parties in advance.

7. Trustee and Originator will enter into a service agency agreement whereby Trustee will appoint 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. To the extent that Originator (as Servicing Agent) claims any costs and expenses for performing these obligations (the "Servicing Costs") the Rental for the subsequent lease period under the lease arrangement will be increased by an equivalent amount (a "Supplemental Rental"). This Sup-

Similarities and Differences B/W Sukuk and Bonds

1. Bonds are interest based while Sukuk are profit based
2. Sukuk are backed by real assets which is not the case with bonds
3. Sukuk and bonds are providing almost same return based on IBOR
4. Bonds are debt based securities while Sukuk are equity based
5. Normally Bonds and Sukuk both are rated by a rating agency
6. In addition to other legal requirements Sukuk needs Shari'a compliance while bonds do not
7. Both Sukuk and Bonds can be listed or unlisted
8. Sukuk can be issued for a Halal business only which is not the case for Bonds
9. For issue of Sukuk an SPV is required while no such demand for Bond issue
10. Both Sukuk and Bonds can be issued by public as well as private sector

plemental Rental due from Originator (as Lessee) will be set off against the obligation of Trustee to pay the Servicing Costs.
8. Issuer SPV pays each Periodic Distribution Amount to the Investors using the Rental it has received from Originator.
9. Upon: (i). an event of default or at maturity (at the option of Trustee under the Purchase Undertaking); or (ii). the exercise of an optional call (if applicable to the Sukuk) or the occurrence of a tax event (both at the option of Originator under the Sale Undertaking), Trustee will sell, and Originator will buy-back, the 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.
10. Payment of Exercise Price by Originator (as Obligor).
11. Issuer SPV pays the Dissolution Amount to the Investors using the Exercise Price it has received from Originator.
The government of Pakistan issued Motorway Sukuk of US $ 600 million in 2005. Citigroup and HSBC acted as lead managers while Meezan bank was a local advisor. Sukuk was listed on Luxumberg stock exchange. According to the prospectus, it was designed as sale and lease back Ijarah Sukuk. Motorway M-2 was sold by National Highway Authority to a Special Purpose Vehicle [SPV] Pakistan International Sukuk Company Ltd [PISCL] created for the issue of Sukuk to act as trustee on behalf of Sukuk holders, which sold the M-2 to Sukuk holders. An investor with a minimum of US $ 100,000 could purchase a block of Sukuk with a subsequent certificate of US $ 1,000 each. After sale, M-2 was taken by the government of Pakistan on lease for five years on an agreed rental of LIBOR plus 2.20% of the sale value of asset [US $ 600 million]. The government made payment of rentals on semiannual basis to Stakeholders through SPV. After passing five years [Jan 2005-Jan 2010] M-2 purchased back from SPV [Sukukholders] by government of Pakistan at an exercise price of US $ 600 million and transaction stand closed.

Sukuk Al-Ijarah, Pakistan

Issuer	Pakistan International Sukuk company Limited
Lead Manager	Citigroup & HSBC
Assets	Motorway M-2, Islamabad to Lahore
Status	Senior/ Unsubordinated
Structure	Sukuk Al-Ijarah
Seller of Highway Assets	National Highway Authority
Lessee	Government of Pakistan
Listed	Luxemburg Stock Exchange
Size of Issue	US $ 600,000,000
Issue Date	Jan 27, 2005
Maturity	Jan 27, 2010
Profit Rate	LIBOR + 2.20 % per annum
Profit Payment	Semiannually
Minimum Holding Amount per investor	US $ 100,000
Registrar	Citigroup global marketsTadawul
Payment Administrator	Citibank
Local Advisor	Meezan Bank Ltd

11.4.1. Key Features of Skuk Al-Ijarah

In this structure two concepts [Sales and Ijarah] of Islamic finance are being used, hence principles of sale and Ijarah applies as follow:-

1. Asset(s) are in the ownership of originator and sales should be unconditional. It must not include a clause as SPV [Sukukholders] shall lease back the asset to originator. Assets must carry value and normal usage is for Halal purposes. Assets must be identified and price must be agreed. Also ownership of assets must be transferred to SPV [Sukukholders].

2. Ending Ijarah contract in transfer of ownership of asset at completion of term of lease is allowed, however through a separate contract, for a consideration or without it. If an asset is under sale and lease back then a reasonable period of time between lease and re-sale must have expired. Both contract of lease and sale [effective at a future date] cannot be executed at the same time. Skuk Al-Ijarah is

a contract of Ijarah Muntahia Bittamleek [Promise (by SPV {Sukukholders}) to sell for a price][26] So an offer of Sukuk where originator enters into a sales contract with SPV [Sukukholders] effective on redemption date would be a void contract.

3. Mustager (Lessee)/Originator of Sukuk issue is permitted to sublease whole or any part of asset to a third party (except owner of asset/SPV-Sukukholders) for any agreed amount of rent, unless the owner [SPV-Sukukholders] stipulates in Ijarah contract, binding lessee from subletting. Sharing of usufruct by more than one person is permitted.

4. Ijarah (lease) contract is binding contract which neither party [SPV-Sukukholders & Originator] may terminate or alter without the consent of other except following:-

a. Mujeer (lesser)/SPV-Sukukholders sell the asset to a third party (lessee's/originator's consent is not required on sale of asset however it must be known to the purchaser that asset is under lease).

b. In case of total destruction of leased asset.

c. If asset(s) is partially damaged leading to an impairment of expected benefits to lessee/originator, he can terminate the lease contract.

d. Any of the parties [SPV-Sukukholders & Originator] hold option to terminate contract as per lease agreement.

e. Force majeure (intervening contingencies)

f. Lesser/SPV-Sukukholders stipulates in the contract of lease that lease shall come to an end if lessee defaults in payment of rent.

g. In case of death of lessee/Originator[27] and if heirs can prove that the contract of lease has become, after death of legator, too onerous for their resources and in excess of their needs.

5. Subject matter (asset) of lease must be capable of being used while preserving the asset (consumables cannot be leased), and benefits from Ijarah must be lawful in Shari'a. Ijarah contract can be executed with a non-Muslim subject to; the use

[26] Under Sukuk structure normally this promise to purchase is made by originator

[27] In case of Sukuk a case of insolvency of originator [Government/Corporation] may end contract

of asset must not be for Haram (unlawful) purposes. In case of damage to asset during lease tenure following rule applies.

a. Damage is caused due to negligence of lessee, he is responsible to repair and also pay the rentals for a period asset is not used and remained under repair.

b. Damage caused without negligence of lessee, lesser is responsible for repair and no rent shall be charged for the period during which asset was not useable.

6. Leased asset is the responsibility of the lesser throughout the duration of Ijarah. He is responsible for major repairs and maintenance. Permissible insurance is the responsibility of lesser. (However, he can delegate the tasks of insurance and maintenance to lessee on lesser's expenses). Sukuk issue where total maintenance is the responsibility of originator is questionable as risk of ownership is transferred from lessor to lessee which is against the Ijarah principles.

7. Lease rentals may be in cash or kind (goods) or benefit (service) and must be specified as lump sum or installments, fixed or variable based on a designated method by mutual agreement of parties. Lease rentals are due from the period lessee starts using asset or asset made available for use to him. If rentals are variable, it is necessary to fix the rent for first period and then tie up with a bench mark (e.g. inflation index, interbank offered rate etc.). Such a bench mark must be based on a clear formula subject to floor and ceiling. Rentals of any future period can be fixed (changed) with mutual agreement, however, unpaid rentals for the past cannot be increased being receivables from the lessee. If the lessee stops using the asset or returns it to the owner without owner's consent the rent will continue to be due for remaining period of Ijarah subject to the condition that lesser keeps the asset available to the current lessee.

8. All permissible securities including guarantees to secure the rights of lesser/Sukukholders against the negligence of lessee/originator, default in payments etc. are allowed. Penalty on default by lessee/originator can be stipulated in the contract of Ijarah, however, it cannot form part of the income of lesser and must be used for charitable purposes.

11.5. Sukuk Al-Musharaka

Sukuk Al-Musharaka provides an opportunity for investment by general investors. An issuer is a person (firm) inviting to partnership in project or activity, and subscribers are partners while realized funds are contributions in Musharaka capital. Sukukholders own the equity stake in Musharaka and share profits and losses. Musharaka Sukuk can be issued by opting any of the following modes:-

11.5.1. Sukuk Al-Shirka

Sukuk Al-Shirka are the certificates issued by a business/person to invite investors to be partners in an existing business, asset(s) or an intended business, purchase of asset(s), project(s) and business plan. Accordingly Sukukholders shall become partners in the business and subscription money is the capital of company/business. Every Sukuk holder is entitled to actual profit earned according to agreed ratio and liable to any actual loss occurred during the term of Sukuk. It is a partnership between issuer and Sukukholders and partnership laws of Shari'a applies [Shari'a Standard 12].

Musharaka Sukuk, Dubai, UAE

Abstract From Prospectus of

JAFZ Sukuk Limited

Term: 5Years Value AED 7.5 Billion

Parties

Issuer JAFZ Sukuk Limited, a limited liability company, incorporated on 23 May 2007 in accordance with the laws of the Cayman Islands (the ''**Issuer**'').

Ownership of the Issuer 250 of the Issuer's shares have been issued and are held by Maples Finance Limited on trust for charitable purposes.

Company Jebel Ali Free Zone FZE, a Jebel Ali Free Zone Establishment established on 5 March 2006 in the Jebel Ali Free Zone under Implementing Regulations No. 1/92 issued pursuant to Law No. 9 of 1992 (the ''**Company**'').

Trustee The Issuer will act as trustee in respect of the Trust Assets (as defined below) (the ''**Trustee**'') for the benefit of Certificateholders in accordance with the Declaration of Trust (as defined below) and the Conditions.

Musharaka Partners The Company and the Trustee.

Managing Partner The Company (in such capacity, the ''**Managing Partner**'').

Obligor The Company (in such capacity, the ''**Obligor**'').

Joint Lead Managers Barclays Bank PLC, Deutsche Bank AG, London Branch, Dubai Islamic Bank PJSC and Lehman Brothers International (Europe) (together the ''**Joint Lead Managers**'').

Musharaka Profit Distribution The objective of the Musharaka, pursuant to the Business Plan, is to generate profit by utilising the Musharaka Assets in accordance with the Business Plan. The Musharaka is expected to yield, net of Taxes, a minimum profit of EIBOR plus 1.31 per cent. per annum on the capital of the Musharaka. The profit generated by the Musharaka shall be distributed by the Managing Partner two Business Days prior to each Periodic Distribution Date. Such profit will be distributed in accordance with the following proportions: Trustee: 99% Company: 1% If the profit payable to the Trustee is greater than the relevant Periodic Distribution Amount, any surplus profit distributable to the Trustee over the Periodic Distribution Amount will be recorded by the Managing Partner in the
Musharaka Accounts as a credit to the line item entitled ''**Musharaka Profit Reserve Amount**''. Any amount standing to the credit of the Musharaka Profit Reserve Amount column in the Musharaka Accounts on the Musharaka End Date will, subject to the terms of the Musharaka Agreement, will be paid to the Company as an incentive fee for acting as Managing Partner. The Managing Partner may, however, prior to the Scheduled Redemption Date use the amounts standing to the credit of the Musharaka Profit Reserve Amount (an ''**Advance Incentive Fee**'') so long as any amounts deducted from the Musharaka Profit Reserve Amount prior to the Scheduled Redemption Date are recredited in the event that on a Periodic Distribution Date the aggregate of (i) the funds available to the Musharaka for distribution to the Musharaka Partners on that date, plus (ii) the amounts then standing to the credit of the Musharaka Profit Reserve Amount, is less than the relevant Periodic Distribution Amount. If such profit is less than the relevant Periodic Distribution Amount or if for any other reason the funds available in the Transaction Account on the Periodic Distribution Date are not sufficient to enable the Trustee to pay the relevant Periodic Distribution Amount due on the relevant date, in full for any reason, the Managing Partner will deduct such shortfall from the Musharaka Profit Reserve Amount. If the amounts standing to the credit of the Musharaka Profit Reserve Amount are insufficient (after the Managing Partner has re-credited any Advance Incentive Fee), the Managing Partner shall meet the shortfall through the provision of Shari'a compliant financing and in the event this is not possible it will provide an interest free loan to the Trustee which shall be repayable solely from profits of the Musharaka.

Management Agreement The Musharaka Partners will each appoint the Company as Managing Partner of the Musharaka under a management agreement (the ''**Management Agreement**''). The management responsibilities of the Managing Partner will be set out in the Management Agreement and will entitle the Managing Partner to take all necessary or desirable action on behalf of the Musharaka to achieve the Musharaka's objectives.

Purchase Undertaking The Company (acting in its capacity as Obligor and not as Managing Partner) will execute the Purchase Undertaking dated on or about the Closing Date in favour of the Trustee. Under the Purchase Undertaking, the Obligor will undertake that upon the Trustee exercising its right to oblige the Obligor to purchase all (or, as the case may be, a pro rata part) of the

Trustee's Units, the Obligor shall purchase the same on the relevant Exercise Date following the delivery of an exercise notice (an ''**Exercise Notice**'') by the Trustee under the Purchase Undertaking, in the form prescribed by the terms of the Purchase Undertaking.

Summary of the Certificates

Certificates AED 7,500,000,000 Trust Certificates (*Sukuk Al-Musharaka*) due 2012 (the ''**Certificates**'').

Closing Date 27 November 2007.

Scheduled Redemption Date 27 November 2012.

Issue Price 100 per cent. of the aggregate principal amount of the Certificates.

Status Each Certificate will evidence an undivided beneficial ownership interest in the Trust Assets and will rank *pari passu*, without any preference, with the other Certificates. **The Certificates will be limited recourse obligations of the Issuer as described below.**

Periodic Distribution Dates 27 May 2008 (the ''**First Periodic Distribution Date**'') and each 27 November and 27 May thereafter up to and including the Periodic Distribution Date falling on 27 November 2012.

Periodic Distributions On each Periodic Distribution Date, Certificateholders will be entitled to receive the Periodic Distribution Amount (as defined in Condition 5.1) from moneys received in respect of the Trust Assets (representing a defined share of the profit in respect of the Trust derived from payments made to the Trustee under the Management Agreement).

Scheduled Dissolution Unless previously redeemed, the Certificates shall be redeemed in full by the Trustee on the Scheduled Redemption Date at an amount equal to the Dissolution Distribution Amount (as defined below) as of such date and the Trust shall be dissolved following such payment in full.

Dissolution Distribution Amount means as of any Redemption Date (other than the Change of Control Put
Date), the aggregate principal amount of the Certificates outstanding plus the aggregate of all accrued and unpaid
Periodic Distribution Amounts as of such date and, in the case of the Change of Control Put Date, the aggregate
principal amount of the Certificates to be redeemed plus the aggregate of all accrued and unpaid Periodic Distribution
Amounts, in respect of the Certificates to be redeemed, as of such date.

Use of Proceeds The proceeds of the sale of the Certificates will be applied as the Trustee's Cash Contribution to the Musharaka. See ''*Musharaka Agreement*''.

Listing Applications have been made for the Certificates to be listed on the primary exchange of the Dubai International Financial Exchange and the Official List of the UK Listing Authority and to be admitted to trading on the London Stock Exchange's Gilt-Edged and Fixed Interest Market.

Ratings The Certificates have been rated ''A+'' by Standard & Poor's and ''A1'' by Moody's. A rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, reduction or withdrawal at any time by the assigning rating agency.

Clearance and Settlement Holders of the Certificates must hold their interest in the Global Certificate in book entry form through Clearstream, Luxembourg. Transfers within Clearstream, Luxembourg will be in accordance with its usual rules and operating procedures. See ''*Clearance and Settlement*''.

Denominations The Certificates will be issued in minimum denominations of AED 500,000 and integral multiples of AED 100,000 in excess thereof.

11.5.2. Sukuk Al-Mudaraba

Mudaraba Sukuk offers an opportunity to general investors to invest in a business or project whereby issuer will act as manager to manage the business established by using funds of Sukuk holders. The issuer is Mudarib [Manager] and subscribers are Rab-ul-Mal [Investors] while realized funds are the capital of the entity. Sukukholders share profits according to agreed ratio and bear all losses [shared among Sukukholders as per equity stake]. A reward of the issuer would be in the form actual profit sharing.

11.5.3. Sukuk Al-Wakala

Wakala Sukuk offers an opportunity to general investors to invest in a business or project whereby issuer will act as manager to manage the business/portfolio/project established by using the funds of Sukuk holders. The issuer is Wakil/Agent/Manager and subscribers are Rab-ul-Mal [Investors] while realized funds are the capital of the entity. Sukukholders share profits according to agreed ratio and bear all losses [shared among Sukukholders as per equity stake]. The reward for management services would be in the form of Payment to Wakeel.

Mudaraba Sukuk issued by SHB, KSA in 2009

Issuer	Saudi Hollandi Bank
Lead Manager	Saudi Hollandi Capital - Riyad Capital
Status	Senior/ Unsubordinated, Unsecured
Structure	Mudaraba Sukuk
Size of Issue	725,000,000
Issue Date	2009-12-30
Maturity	Dec 31, 2019 (call option in 2014)
Profit Rate	SIBOR + Margin (190 bps)
Profit Payment	Six monthly
Collateral	None
Minimum Holding Amount	SAR 500,000
Register	Tadawul
Payment Administrator	Saudi Hollandi Capital
Holders' Agent	Saudi Hollandi Capital

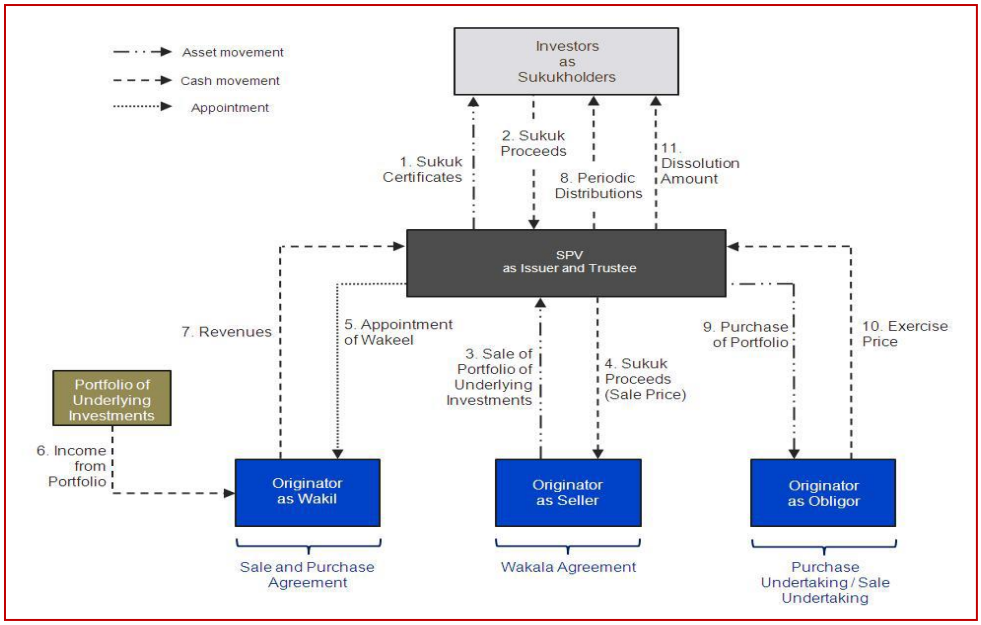
Figure 2 presents wakala Sukuk structure explained as under [DIFC Sukuk Guide].

1. Issuer SPV issues the Sukuk, which represents an undivided ownership interest in, inter alia, the wakala assets. They also represent a right of the investors against the Issuer SPV to payments of the Periodic Distribution Amounts and Dissolution Amounts.
2. The Investors subscribe for the Sukuk in return for a fixed principal amount (the Sukuk proceeds) payable to the Issuer SPV.
3. The Issuer SPV, in its capacity as principal, enters into a wakala agreement with the wakeel pursuant to which the wakeel agrees to invest the Sukuk proceeds, on behalf of the Issuer SPV, in a pool or portfolio of investments (the wakala assets), selected by the wakeel, in accordance with specified criteria.
4. The Sukuk proceeds will be used by the wakeel to purchase the selected wakala assets from one or more sellers.
5. The wakala assets will be held and managed by the wakeel, on behalf of the Issuer SPV, for the duration of the Sukuk in order to generate an expected profit to be agreed upon by the principal. The wakala assets will constitute part of the

trust assets held by the Issuer SPV (in its capacity as trustee) on behalf of the investors.

6. The wakala assets will generate a profit return, which will be held by the wakeel on behalf of the Issuer SPV.

Figure 2-. Wakala Sukuk transaction illustrated



WWW. http://www.cliffordchance.com accessed on 07/11/2013

7. The profit return will be used to fund the Periodic Distribution Amounts payable by the Issuer SPV to the Investors. Any profit in excess of the Periodic Distribution Amounts will be paid to the wakeel as an incentive fee. It is possible that the wakala assets may generate a return that is less than the Periodic Distribution Amounts. One possible mechanism used in the past, to ensure that there are sufficient funds to make

up any shortfall between the income generated by the wakala assets and the Periodic, Distribution Amounts due to Investors, is for the Obligor to agree (under the purchase undertaking) to purchase a certain portion of the wakala assets at regular intervals for an Exercise Price equal to the Periodic Distribution

Amounts. However, following the AAOIFI Statement, the general view amongst Shari'a scholars is that it is not permissible for an Obligor to agree to purchase wakala assets for fixed or variable amounts (calculated by reference to a formula), as this would be akin to a guarantee of profit. This mechanism would only be acceptable under AAOIFI standards if the Seller and the Obligor were different entities

Sukuk-Al-Istithmar [Investment], KSA

Issuer	Saudi Electricity Company
Lead Manager	Samba Capital & Investment Management Company and HSBC Saudi Arabia Limited
Status	Senior/ Unsubordinated, Unsecured
Structure	Sukuk Al-Istithmar
Size of Issue	7,000,000,000
Issue Date	2010-05-10
Maturity	Expires on 10/05/2030 with Purchase Undertaking option on 2017 / 2020 / 2025
Profit Rate	SIBOR + 0.95 %
Profit Payment	Quarterly
Minimum Holding Amount per inverstor	SAR 10,000
Register	Tadawul
Payment Administrator	Samba Financial Group
Holders' Agent	SABB Securities

8. The Periodic Distribution Amounts will be paid to the investors on the relevant periodic distribution dates. The Periodic Distribution Amounts will either be a fixed or variable amount calculated in accordance with a fixed formula (e.g., based on LIBOR).

9. Upon: (i). the maturity date or upon the occurrence of an event of default, the Issuer SPV, in its capacity as trustee will exercise its option under the Purchase Undertaking to require the Obligor to purchase the wakala assets at an Exercise Price that is equal to the Dissolution Amount payable to investors together with any accrued but unpaid Periodic
Distribution Amounts.

(ii). the exercise of an optional call (if applicable) or the occurrence of a tax event, the Obligor will exercise its option under the Sale Undertaking to buy the wakala assets from the Issuer SPV, in its capacity as Trustee, at an Exercise Price that is equal to the Dissolution Amount payable to investors together with any accrued but unpaid Periodic Distribution Amounts.

10-11 . Upon the occurrence of one of the events described in (9) above, Obliger will pay cash to the trustee and the Issuer SPV, in its capacity as Trustee, will pay the Dissolution Amount to investors using the Exercise Price received from investors and redeem the Sukuk, upon which the trust will be dissolved.

Sukuk Al-Istithmar: The term "Istithmar" is broadly understood to mean an "investment". Under a Sukuk al-Istithmar structure it is possible for Ijarah contracts (and the relevant underlying assets), Murabaha receivables, and/or Istisna'a receivables (each generated by the originator), as well as shares and/or Sukuk certificates to be packaged together and sold as an investment. The income generated by such investment can then be used to make payments to the investors under the Sukuk.

Combination of Al-Istisna'a and Al-Ijarah, KSA

Issuer	Sadara Basic Services Company
Lead Manager	AlBilad Investment Company, Alinma Investment Company, Deutsche Securities Saudi Arabia L.L.C., Riyad Capital
Status	The Certificates constitute undivided beneficial ownership in the Sukuk Assets and represent direct, secured, unconditional and, subject to the conditions, unsubordinated obligations of the Issuer, ranking equal without any preference or priority among themselves
Structure	The Shariah structure of the sukuk is essentially a combination of Istisna and Ijara with a Musharaka contractual overlay interposed between the two
Size of Issue	7,500,000,000
Issue Date	2013-04-02
Maturity	Scheduled to be on the Periodic Distribution Date immediately following the Final Distribution Date (being no Later than December 15, 2028). The issuer also has the option to redeem the Certificates in full on any Periodic Distribution Date after the fifth anniversary of the Closing Date in accordance with the Conditions.

Profit Rate	6 months SAIBOR plus 0.95 percent
Profit Payment	Semi-Annually
Collateral	Pursuant to the Issuer Security Document, the Issuer will grant security over the Sukuk Assets to the Onshore Issuer Security Agent and Offshore Issuer Security Agent (as the case may be), each of whom will hold such security for the benefit of, inter alias, the Certificate holders
Minimum Holding Amount per inverstor	SAR 1,000,000 for a period of 6 months from the closing date, and thereafter SAR 50,000
Register	Saudi Stock Exchange (Tadawul)
Payment Administrator	HSBC Saudi Arabia Limited
Holders' Agent	HSBC Saudi Arabia Limited

Istisna'a Sukuk: The issuer is the manufacturer (supplier/seller), the subscribers are buyers of the intended product(s) while the funds mobilized through subscription are the cost of the product(s). The Sukuk holders own the product and are entitled to the sale price of the certificates or the sale price of the product(s) sold on the basis of parallel Istisna'a or disposed of otherwise.

Salam Sukuk: Issuer of the Sukuk is a seller of the goods of Salam and Sukuk holders are buyers of the goods while funds realized are Salam capital. The Sukuk holders are owners of the Salam goods and are entitled to the sale price of the certificates or the sale price of the Salam goods through a parallel Salam or sales revenue at maturity of Salam contract.

Murabaha Sukuk: The issuer is a seller of commodity and subscribers are buyers and realized funds are the cost of the underlying commodity. Sukuk holders are entitled to the sales revenue of Murabaha sales.

Dubai Used Sukuk to finance infrastructure projects during the first decade 2001-10

11.6. Questions

1. Briefly, discuss concept and application of Sukuk.
2. What is the difference between conventional bonds and Sukuk?
3. Explain the structure of sale and lease back Sukuk Al-Ijarah?
4. What are the salient features of Sukuk Al-Wakala?
5. Explain various types of Sukuk Al-Musharaka?

True/False

1. Prospectus of Sukuk must include all contractual conditions, information about participants in the issue along with their rights and obligations; including issue agent, issue manager, originator, investment trustee, guarantor (of capital, returns), payment agent and any other related party along with conditions of appointment and dismissal.

2. Prospectus of Sukuk must include the identification of the contract, on the basis of which Sukuk are launched i.e. Ijarah, Murabaha, Salam etc.

3. Prospectus of Sukuk must clearly mention the Shari'a compliance of issue duly certified by Shari'a board.

4. Prospectus of Sukuk must clearly state that investment of realized funds will be taken through Shari'a compliant modes of investment.

5. Prospectus of Sukuk should state that each owner of a certificate participates in profits and losses.

6. Prospectus of Sukuk must not include the guarantee of capital or return by the issuer to Sukuk holders except in cases of negligence. However, it is allowed to an independent third party to provide guarantee free of charge.

7. Underwriting of Sukuk is allowed without any charge.

8. Trading in Sukuk and redemption on profit/loss is allowed after closing subscription, allotment of Sukuk and commencement of the activity.

9. Redemption of Sukuk by the issuer at market price or an agreed price at the time of redemption is allowed, however, it is not allowed to stipulate in the prospectus by the issuer as of redemption at nominal value.

10. It is permitted, immediately upon the issue and up to the date of maturity, but after the passing of ownership of the asset(s) to the Sukukholders, to trade in Sukuk that represent ownership of existing leased assets or assets to be leased on the promise.

Suggested Readings

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Chapter 12

Islamic Insurance

Insurance is a source of spreading/distributing risks

Insurance is a type of business which spread the risk of an individual over a group of participants. The insurance business is very helpful in reducing many risks of individuals and businesses including injury and destruction of assets. Insurance provides financial support to the family in case of loss of life. Conventional insurance is not matching with the principles of Islamic financial system due to Gharar in its operations, hence, the concept of Islamic insurance was introduced based on mutual cooperation among the members.

Learning Objectives

After studying this chapter one should be able to understand and interpret the following:

Why had Islamic Insurance?

What is the underlying principle in Islamic Insurance?

How Islamic insurance is different from conventional insurance?

What are Shari'a rulings about managing an Islamic insurance?

What is the role of an Islamic insurance company?

What is the process of an Islamic insurance operation?

12.1. Introduction

Insurance is a business activity engaged in diversification (spread) of risks of a person among all participants. Traditionally insurance companies are providing indemnity against a certain type(s) of risks for a premium. Businesses are subject to many risks including fire, theft and accidents etc and insurance companies are sources of risk mitigation. The concept behind the organization and management of insurance business is working on the principle of cooperation. In its simplest form it is a fund created by a number (e.g. 100) of persons having the same type of asset (e.g. cars) to compensate the one(s) who suffered loss due to destruction or theft of said asset (car). Everyone is contributing to the fund a specific amount known as premium (e.g. 5000) to be indemnified by an amount equal to the loss of asset subject to a maximum limit (e.g. 150,000). The insurance business is also covering disability and or death of participants, known as life insurance.

Under both types of insurance, premium is charged, compensation is paid, indemnity against probable loss is provided, however conventional insurance involves Gharar which makes it prohibited.

Practically this concept of insurance is changed to commercialization in the modern framework of business, where a company guarantees the making loss of policyholders good, by charging a premium, based on the length of the period, the probability of occurring loss and amount of compensation to be paid. Furthermore, there are re-insurance companies providing an opportunity to the insurance company to share the risk; as well as loss/compensation by sharing the amount of premium.

From Islamic finance perspective sharing of risk among the participants is permitted, however, the present practices of insurance sector are not matching with the spirit of cooperation, encouraged by Islam. Following are the prime reasons against conventional insurance which justify the creation and management of Islamic insurance [SS # 26].

1. The conventional insurance contract is a financial *mu'awadha* (exchange contract) that aims at making a profit out of the insurance operations. Insurance company buys the risk of a customer for a premium leading to Gharar. Shari'a prohibits a transaction of *Gharar*[28] in business.

Mr. A entered into an insurance contract for his new car costing PKR 1,000,000, with Bolan Insurance Company by making a contribution of PKR 40,000 as premium per annum. As per agreement company undertakes to make the loss good up to the value of the car, irrespective whether such amount is available in insurance fund or not. This transaction involves Gharar as the outcome is not clear. The loss may or may not happen. In the case of the loss company will lose the money and in the case of no loss company will gain.

2. Under conventional insurance framework, the insurance company is a party that signs the contract in its own name to indemnify against a probable loss while under Islamic insurance framework insurance company assumes the role of an agent to the participants to

1. Conventional insurance is based upon buying the risk of customer by insurance company for premium, while Islamic insurance is a cooperative arrangement spreading the risk over a group of participants.

2. Under conventional insurance, company takes the responsibility to compensate the policy-holder, while under Islamic Insurance framework, loss is compensated from Insurance fund (Waqaf fund) and no such liability lies upon Islamic insurance company

3. Insurance fund is a Waqaf [trust fund] under Islamic insurance, while no such concept in conventional insurance.

4. At the time of liquidation, any surplus in the insurance fund is the wealth of shareholders under conventional, however it goes into charity under Islamic insurance framework.

[28] According to SS # 26 Gharar is what one cannot predict its unrevealed/unknown consequences. Something that may occur/materialize or may not.

manage insurance fund contributed by members.

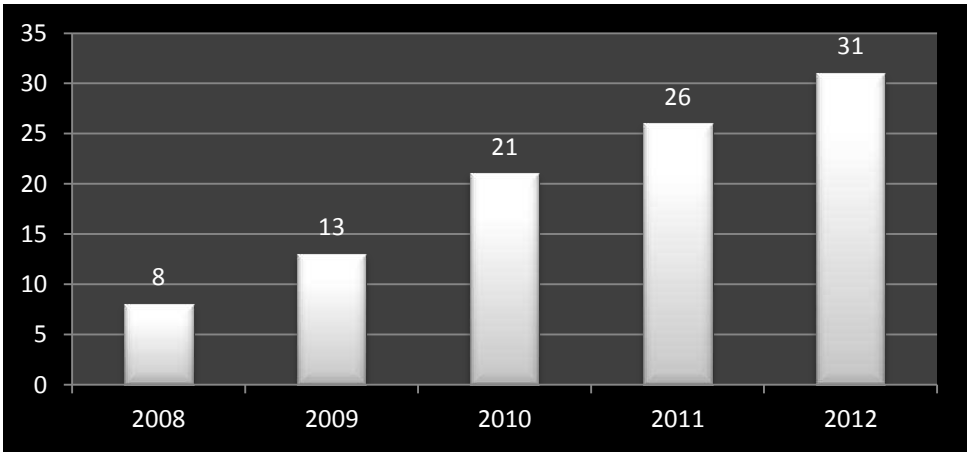
3. Under conventional insurance framework, insurance company owns the premium paid by policyholders against its commitment to pay the compensation in case of loss while under Islamic insurance contribution belongs to insurance fund and compensation is paid out of insurance fund.

4. After meeting liability for compensation and operating expenses whatever left is the profit of the insurance company under conventional insurance framework, while under Islamic insurance surplus belongs to policyholders and not the insurance company. The insurance company is an agent entitled to agreed fee or commission. When liability for compensation exceeds the available amount in the insurance fund, the insurance company is not required to pay from his own assets under Islamic insurance framework.

5. Under Islamic insurance framework, any return on investment of insurance fund generated in the process belongs to policyholders after deducting Mudrib's share for an insurance company, while under conventional insurance framework all returns belong to insurance company against the commitment of making loss good of policyholders.

6. Commercial insurance is a profit-oriented activity while Islamic insurance aims at achieving cooperation among the members of the society.

Global Volume of Assets under Islamic Insurance US $ Billion



Source: IFSL 2013

7. Under Islamic insurance framework the insurance company earns profit as under:

- As an investor of its own funds
- As an agent to insurance fund, fee is earned
- As Mudarib for managing investment of insurance funds

While under conventional insurance revenues of insurance company consist of premiums as well as total return on investments.

8. Under conventional insurance framework, Insurance Company is the insurer, giving commitment to compensate in case of loss, and the policyholder is being insured against a probable loss while under Islamic insurance participant is insurer as well as insured and the role of the company is only a facilitator through a Wakala/agency contract.

9. Conventional insurance framework is a creation of local business laws and no religious supervision is required while under Islamic insurance framework an insurance company is bound to adhere the rulings of Shari'a supervisory board in addition to local business laws.

10. At the time of liquidation, the surplus in insurance fund is required to be spent for charitable purposes under Islamic insurance framework, while under conventional framework surplus belongs to shareholders of the insurance company.

A, B, C, D, E, F, G, H, I, & J owners of cars entered into an insurance agreement by making contributions of PKR 40,000 each for a compensation of actual loss incurred subject to a maximum of PKR 200,000 per person the year 2013. During the year C and D claimed compensation of PKR 20,000 and 60,000 respectively based upon actually verified loss of cars. Furthermore, the collected amount earned PKR 50,000 as return on investments.

Under conventional insurance company would make a gross profit of PKR 370,000 (450,000-80,000) while under Islamic insurance, company would earn only PKR 70,000 as under.

- Fee for managing insurance operations @ 10% of contributions PKR 40,000

- Share from return on investments as Mudarib @ 60% of earnings PKR 30,000

Insurance account is a Waqf/trust account and the balance shall remain in it for future claims of participants. At the completion of the year 2013, there is a balance of PKR 300,000 (450,000-150,000) in insurance account. Under conventional framework, this surplus belongs to the insurance company while under Islamic insurance, surplus belongs to participants as long as the company is working. In the case of dissolution, surplus shall be spent on charity.

12.2. Islamic Insurance

During the second half of twentieth-century liberation of the Muslim world from colonial powers completed (almost) and Muslim societies started looking critically, at prevailing socio-economic system around them, through Islamic lenses. A mass movement of Islamisation of societies started across the Muslim world [e.g. Brotherhood movement and Jamaat e Islami]. As a part of reforms, the financial sector was selected to eliminate Riba (interest) from the economy. The conference of OIC foreign ministers (1973) in Jeddah was a big milestone where decision to establish Islamic development bank was taken place. Report of Council of Islamic Ideology-Pakistan (1980), Tabung Haji program of Malaysia, Egypt's Mitghamer bank (1963), Iranian revolution (1979), economy-wide interest free banking in Pakistan and Sudan, research contributions of IIUI and IPS, Federal Shari'a court decision (1991) and finally Supreme court decision (1999) against riba, Raja Zafar-ul-Haq commission report and contributions by Justice-rtd-Taqi Usmani-Pakistan, establishment of Islamic banks in Malaysia, UAE, Bahrain, Qatar, Iran, KSA, Sudan and Pakistan, establishment of AAOFIF (1991) and Islamic Fiqh Academy (IFA) Jeddah, paved way for modern Islamic financial industry. As an extension to banking, Islamic finance rules were developed for capital market and insurance.

Conventional insurance is prohibited because it involves Gharar (uncertainty). According to a Hadith, reported by Abu Huraira (RA), "The Prophet (PBUH) prohibited sales which involve Gharar" [Muslim, Abu Dawood, Tirmizi, Al

Mowata, Ahmad]. Islamic insurance framework is based on the principle of mutual cooperation among the participants. Practically an insurance company is set up to execute and facilitate the operations of insurance, as an agent to policyholders, although participants can manage the operation by themselves. Under Islamic insurance framework participants are contributing through premium (donation) in an insurance fund, to be used to compensate losses of participants, as per agreed terms and conditions.

According to AAOIFI, SS # 26, Islamic insurance 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 thus initiated involves payment of contributions as donations, and leads 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 an 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.

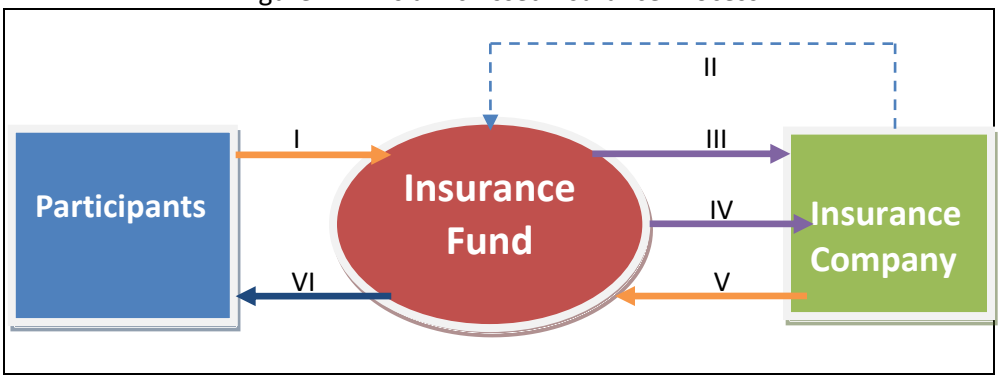
The insurance company is a central entity in both frameworks i.e. Conventional and Islamic insurance. The status of an insurance company is entirely different under both framework. Under conventional insurance regime, the insurance company is responsible for compensating losses of participants, as agreed upon. As a reward for purchasing risks of others (policyholders), insurance company receives premiums from policyholders which form part of the income of the company after deduction of expenses and liability for compensations.

Under Islamic insurance framework, the insurance company is not responsible for making the losses of participants good, out of its own wealth. The role of an insurance company is to work as custodian of assets of insurance fund on behalf of participants for an agreed fee; hence, insurance company is an agent (Wakala contract) to the insurance fund. In insurance fund donations are contributed by participants and losses of participants are compensated out of insurance fund. Also, insurance company assumes another role of partner (Mudaraba contract)

with participants by investing their contributions to earn returns. A specific share of profit is allocated to the insurance company as Mudarib for its services.

Like conventional insurance, Islamic insurance companies offer two types of policies including life insurance (Takaful) and asset insurance. For asset insurance premiums are collected from participants and after deduction of the fee, balance is contributed in the insurance fund. The insurance fund is invested in Shari'a compliant securities including equities and Sukuk. Return on investments is shared between insurance fund and insurance company being a manager (Mudarib) of investments. Any claim arises due to loss of a participant; compensation is paid out of insurance fund as per agreed set of rules. Any surplus arises after meeting expenses and liability for compensation that can be shared among participants. Donations made by participants belong to trust (insurance fund), hence, nobody shall claim its assets including an insurance company. During the life of insurance company, insurance fund is used for meeting claims, however in the case of a liquidation; balance in insurance fund is spent for charitable purposes only.

Figure 12.1. Islamic Asset Insurance Process



According to figure 12.1, following are steps in asset insurance process under Islamic financial system:

I & II. The customer enters into an insurance agreement by making payment of premium which is a contribution in the insurance fund and signs the standard

contract designed by the insurance company. [Cheque by customer; and signing of agreement with the company]

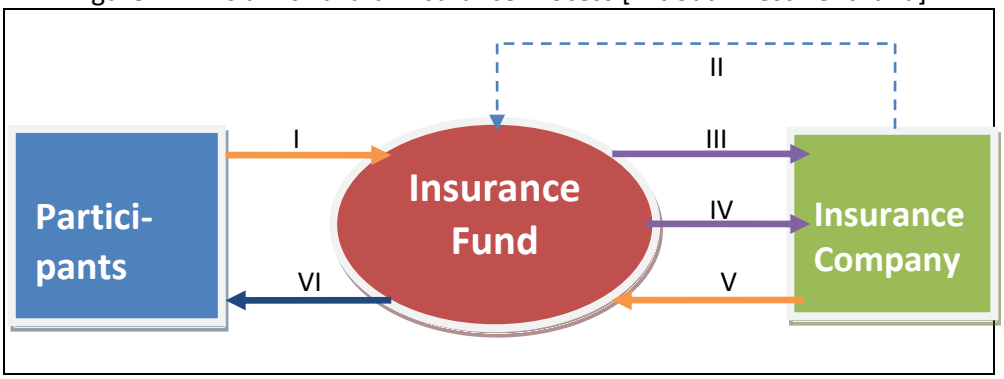
III. The amount of fee is deducted by the insurance company for services to be rendered for the management of insurance operations.

IV. Amounts of insurance funds are invested by the insurance company in Shari'a compliant securities.

V. Return on investment, as well as original amount of investment, refunded to the insurance fund.

VI. Payment of any claims arises out of insurance fund [Cheque by Insurance Company].

Figure 12.2. Islamic Takaful Insurance Process [wit out investment fund]



Under Takaful (life insurance), there are two schemes in practice. One is participant opts for protection against disability and/or death. Under this scheme premium paid by policyholder is contributed in Waqaf (insurance fund) after deduction of Wakala fee. If any claim arises that is paid out of insurance fund. Furthermore, insurance fund is invested in Shari'a compliant securities and return on investment is shared by the insurance company and insurance fund according to a pre-agreed ratio. During the working of insurance company claims are met out of insurance fund and in the case of liquidation, balance in insurance fund is to be used for charitable purposes and will not be treated as wealth of shareholders of the insurance company. In the case of termination/maturity of the policy, participants will get nothing under this scheme, whatever he contributed is a do-

nation and if he could never receive a claim (not emerged), the benefit of his contribution shall be taken by someone else (whenever a claim emerges).

According to figure 13.2, following are steps in Takaful [without investment fund] insurance process under Islamic financial system:

I & II. The customer enters into in an insurance agreement by making payment of premium which is a contribution in the insurance fund and signs the standard contract designed by the insurance company. [Cheque by customer and signing of agreement with the company]

III. The amount of fee is deducted by the insurance company for services to be rendered for the management of insurance operations.

IV. Amounts of insurance funds are invested by the insurance company in Shari'a compliant securities.

V. Return on investment, as well as original amount of investment, refunded to the insurance fund.

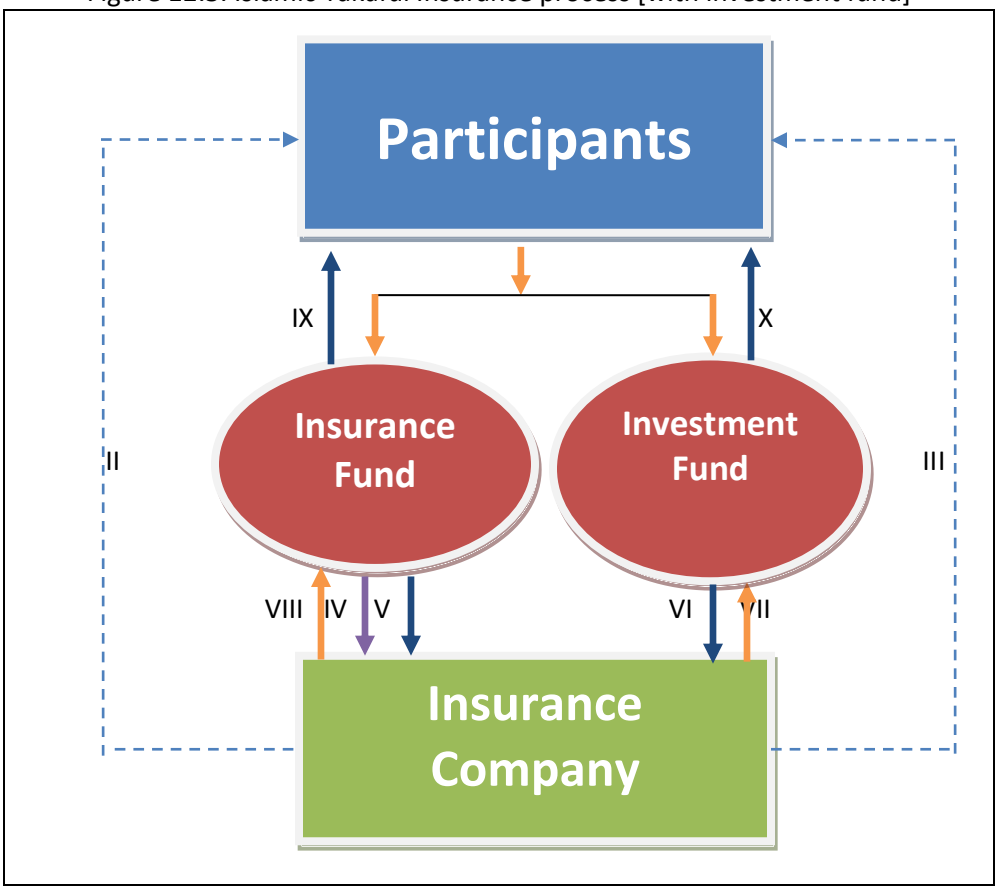
VI. Payment of any claims arises out of insurance fund [Cheque by Insurance Company].

The second scheme of Takaful (life insurance) is a mixture of investment and protection against disability and/or death. Under this scheme whenever a premium is received, it is divided into two parts (as per terms and conditions); a part is contributed in Waqaf (insurance fund) after deduction of management fee by the insurance company, and second part is mixed with an investment fund. Participant is insured against risks of injury and/or death; as well as entitled to receive the market value of his share in investment fund at the time of termination/maturity of insurance policy. Whenever a claim emerges, it is paid out of insurance fund. The insurance company is responsible to invest and manage both investment fund and insurance fund as manager (either Mudarib or agent).

In the case of Mudarib (Mudaraba Model), the insurance company is entitled to a portion of actual profit earned on investments, while in the case of investment agency (Wakala Model), the insurance company shall receive a management fee for its services.

According to figure 13.3, following are steps in Takaful [with investment fund] insurance process under Islamic financial system:

Figure 12.3. Islamic Takaful Insurance process [with investment fund]



I. The customer enters into in an insurance agreement by making payment of premium; a portion is a contribution in insurance fund and remaining in investment fund [Cheque by Customer].

II &III. Two contracts are signed by customer and insurance company; first is for appointing insurance company as agent/trustee to manage the operations of the insurance fund, and the second contract is either appointing insurance company as agent [Wakala Model] to manage investments or Mudarib/partner [Mudaraba Model]. In the case of agency insurance company shall charge fixed

fee for services while in the case of Mudaraba, it will work as a partner for a portion of actual profit earned on investments. [Signing of standard agreement by customer with company]

IV. The amount of fee is deducted by the insurance company for services to be rendered for the management of insurance operations.

V & VI. Amounts of insurance funds, as well as investment funds, are invested by the insurance company in Shari'a compliant securities.

VII & VIII. Return on investment, as well as original amount of investment, refunded to insurance fund and investment fund.

IX. Payment of any claims arises out of insurance fund [Cheque by Insurance Company].

X. Payment of investment balance in the account of the customer is made on termination/maturity of an insurance policy, as per a set of rules agreed upon [Cheque by Insurance Company].

There are two suggested models of insurance, known as Wakala Model and Mudaraba model. Wakala model suggests that being a trustee of insurance fund as well as manager of investments, compensation of the insurance company should be given as a fixed predetermined fee for its services. Hence, under this model insurance company shall receive two types of fee including a fee for management of insurance fund and another amount of fee for managing the investment operations of insurance fund as well as investment fund of policyholders (if any). While under Mudaraba model reward of an insurance company is a combination of fee for managing insurance fund and share in actual profit from return on investment.

It is interesting to note that under conventional insurance, the company is purchasing the risks of others for a premium. In the case of claims, company is required to compensate even if insurance fund (created through premiums) does not carry sufficient amount. Additional amount required to meet the liability of policyholders is taken from the wealth of shareholders. Likewise, if there is surplus, it is included in the wealth of shareholders. In the case of liquidation, any deficit or surplus belongs to the shareholders. It is a gamble which involves Gharar, hence prohibited under Islamic insurance framework. While under Islamic

insurance framework, the job of an insurance company is to work as custodian/agent (Wakeel) for the management of insurance fund on behalf of participants for a fixed fee. Furthermore to act as investment agency either for a fixed fee or a share in actual profit earned on investments. Whatever deficit or surplus arises on insurance fund is neither deducted nor added to the wealth of shareholders. Also at the time of liquidation, if any surplus arises that is spent for charitable purposes. It is a business plan without Gharar, hence allowed under Islamic financial system.

There can be a situation under Islamic insurance framework when a claim arises, but insurance fund is not able to meet fully. In this case, following options are available to an Islamic insurance company to manage the shortage:

- Make payment to policyholder equal to amount available in insurance fund; however this will affect business of Islamic insurance negatively, especially given the competition from conventional insurance industry
- Make partial payment in cash and promise to pay the balance once further premiums are deposited in the insurance fund.
- Make full payment of a claim by obtaining interest-free loans (Qard-e-Hasan), if available.

Option three is being practiced by Islamic insurance companies by providing interest-free loans from the wealth of shareholders in order to keep on the smooth running of insurance operations, as it guarantees the successful running of the insurance business. Successful running of the business of insurance is in the benefit of an insurance company; hence, it is a win-win situation.

12.3. Summary of Shari'a Rulings

In this section, a summary of Shari'a rules, taken from Shari'a Standard 26, issued by AAOIFI, is presented.

1. The managing company is entitled to its own capital and returns on capital, the agency fee, and its specific share of the actual profits earned by investing the insurance assets through Mudaraba or investment agency. The company also bears

all the expenses of its operations including those relating to its task for investing the insurance assets.

2. The insurance fund is entitled to the contributions and the returns thereon, the provisions and reserves relating to the insurance business, and the insurance surplus. The fund bears all direct expenses pertaining to the management of insurance operations.

3. The relationship among participants is Musharaka; between participants and company is Wakala, and Mudaraba or investment agency; and the relationship between insurance fund and participants is donation commitment (at the stage of making contributions) and of indemnification commitment (at the stage of compensation).

4. Donation commitment; and compensation commitment; and participants may undertake to bear any deficit that may occur, as per regulations.

5. The insurance company should maintain two accounts separately; one for its own rights and liabilities and other for the rights and liabilities of policyholders.

6. The role of the company is of an agent in managing the insurance account; is of Mudarib [Mudaraba Model] or an agent [Wakala Model] in investing the insurance assets.

7. The Insurance account is entitled to the insurance assets and returns on investments and bears liabilities relating to these assets.

8. The adopted rules may comprise disposal of the surplus in a way that serves the cause of common interest of the participants (including accumulation of reserves, reduction of the contributions, charitable donations and distribution among participants). However, the insurance company is not entitled to any share of the surplus.

9. In the case of liquidation of the insurance company, all provisions and accumulated reserves pertaining to insurance should be spent on charitable purposes.

10. Preference should be given to policyholders to participate in management of the insurance operations [e.g. representation on the board of directors]

11. The insurance company is required to adhere to the principles and rules of Islamic Shari'a in all its activities.

12. A Shari'a supervisory board should be established; as well as an internal unit for Shari'a monitoring and auditing should also be established.

13. For a policyholder, the amount of contribution, as well as benefit payable, should be specified.

14. In the case of death of a policyholder, Takaful entitlements should be distributed among the deserving persons, parties or purposes as indicated in the documents. However if deceased was entitled to some investment balances, then the same should be distributed among the inheritors according to the Islamic rules of inheritance.
[Mr. Habib entered into Takaful insurance contract with XYZ Company and nominated his wife as beneficiary. On his death insurance claim amounting to PKR 4,000,000 is paid to his wife. At the same time, he has investment balance of PKR 2,000,000 with the insurance company, which is distributed among his legal heirs including a widow, a son and two daughters. The share of Widow is (12.5% of total) PKR 250,000; Son is (50% after deducting share of widow) PKR 875,000; each daughter (25% after deduction of widow's share) PKR 437,500] According to Islamic law share of widow is $1/8^{th}$ and of son is double than daughter].

15. In the case of the death benefit, it should be clearly stipulated that if death is taken place by murder the beneficiary cannot be a person involved in the murder.

[Mr. Khan entered into a Takaful insurance contract with a local Islamic insurance company. Death benefit was agreed PKR 3,000,000. Mr. Khan nominated his wife for insurance benefit. The death of Mr. Khan taken place by poison and police investigation revealed that his widow was involved in his death. His nominee, in this case, cannot be the beneficiary of insurance compensation].

16. Non-Muslims can participate in various types of Islamic Insurance with Muslims.

17. The contribution may be determined according to the actuarial principles based on statistical techniques.

18. The risk that constitutes the subject matter of insurance should be one that could probably occur. It should not be something that relates to the absolute will of the participant, and should not encounter any Shari'a prohibition.

19. Submission of accurate information by policyholder about the risk insured is required. Also, he should inform the company about any new circumstances that may contribute to increasing the risk. In the case of fraud, deceit, and false information, he may be deprived of partial or full indemnity. In the case of unintentional misrepresentation by the policyholder, the indemnity shall become proportionate to the accurate information he presented.

20. Payment of contribution on time is required. In the case of delay, company has the right to terminate the contract or pursue legal enforcement.

21. The participant shall receive equal to either the actual loss suffered or the insurance amount, whichever is less. The participant should not receive both the indemnity and the compensation from other parties for injury caused to him.
[Alam Zeb entered into an insurance contract for his car. At the time of insurance, it was decided that maximum cover would be PKR 1,000,000 for a contribution of PKR 30,000. During the year car met an accident and repair

charged amounted to PKR 200,000. Alam Zeb can claim only actual loss suffered i.e. PKR 200,000 in this case].

[Shah Zaman entered into an insurance contract for his machine and compensation amount determined PKR 1,500,000 for a contribution of PKR 45,000 for one year. During the year, a fire took place in THE factory and burned the machine as well. Actual loss suffered by Shah Zaman was PKR 2,000,000, however, insurance company would pay up to maximum limit of loss covered i.e. PKR 1,500,000 in this case]

[Arshad Khan entered into an insurance contract for his car and compensation amount (cover) agreed was PKR 1,000,000 maximum for a premium of PKR 32,000 for one year. During the year collusion took place with another car of Mr. Zahoor, and repair charges amounted to PKR 50,000, which were paid by Mr. Zahoor as settled after analysis of the accident. Mr. Arshad Khan cannot claim compensation from insurance company].

22. Insurance policy expires as under:

- Completion of agreed period
- Termination by company or participant, if it is stipulated
- Complete damage of insured property
- Death of the insured person

[Alam khan entered into Takaful insurance, covering disability and death benefit only, by making an annual contribution of PKR 25,000 up to 60 years of age. Death benefit agreed (cover) starting from PKR 4,000,000 and reducing with the passage of time to PKR 300,000 up to 67 years of age. Mr. Alam turned to 67 years and insurance cover ended, hence insurance contract ended].

[Alam khan entered into Takaful insurance, covering disability and death benefit only, by making an annual contribution of PKR 25,000 up to 60 years of age. Death benefit agreed (cover) starting from PKR 4,000,000 and reducing with the passage of time to PKR 300,000 up to 67 years of age. At the age of 55 years Mr. Alam stopped making further contributions, hence insurance cover ended as per rules of the company].

[Ali entered into an insurance contract with a local Islamic insurance company for his house by making a contribution of PKR 50,000 for an insurance cover of PKR 4,000,000. During the earthquake, house destroyed completely, hence insurance contract ended by making payment of compensation PKR 4,000,000 by the insurance company].

[Mr. EZ Khan entered into a Takaful insurance contract with a local Islamic insurance company for a cover starting from PKR 4,000,000 and reducing with the passage of time to PKR 300,000 till the age of 60 years for an annual contribution PKR 25,000 per annum. Mr. EZ died at the age of 50 years and insurance contract ended by making payment of PKR 3,000,000 by insurance company].

12.4. Role of Insurance Company

Although in principle it is agreed as well as preferred to have a council of participants to monitor the operations of Islamic insurance given the cooperative nature of activity, however in practice it is managed by a joint stock company having professional skills and expertise for a fixed sum of fee out of contributions. Hence, role of an insurance company is very vital in managing the affairs of an Islamic insurance system. It is the insurance company who is responsible for all types of documentations, management of insurance operations and investments. In practice, an insurance company is registered with the local regulator (SECP in Pakistan) to execute the operations of insurance. A set of rules relating to insurance policies is written in articles of association. After registration, a standard agreement is prepared by the insurance company and got signed from participants in the shape of an account opening form. Account opening form contains terms and conditions of insurance policy including the amount of premium as well as compensation. After account opening customer is notified the dates of payments and duration. It can be a single payment for a year or quarterly/monthly as agreed upon. Out of the premium, a portion is deducted as management fee and rest goes into an insurance fund, if it is asset insurance or Takaful covering the risk of injury and death. However, there is another scheme under Takaful where contribution amount is divided into three parts. A part is

managing fee, another part is a contribution in insurance fund and the third part is included in an investment fund. The insurance company takes the responsibility to manage insurance fund as well as invest insurance assets. Also, it invests the amounts deposited in the investment funds. Under Takaful with investment fund, a customer is entitled to physical and or death compensation as well as investment balance accumulated in his/r account. The insurance company is entitled to a fee for its services to manage the insurance operation as well as a reward for managing the investment portfolio of insurance and investment fund- if any. The reward for managing investments of insurance funds and investment funds can be settled as either share in actual profit (Mudaraba Model) or a fixed fee (Wakala Model). It is preferred to have Mudaraba model than Wakala because it motivates the insurance company to work with dedication given its share in return is linked with performance. It is the responsibility of the insurance company to ensure Shari'a compliance in all of its operations including management of insurance activities and investments. AAOIFI SS # 26 has suggested following roles for an Islamic insurance company.

1. Preparation of documents, insurance policies, collection of contributions, payment of indemnities and all other technical tasks necessary to execute insurance operations smoothly.
2. The company is entrusted with the duty of achieving common interest while undertaking the management of the insurance operations. However it should not guarantee the insurance assets except in the case of misconduct, negligence or breach of contractual obligations.
3. The company shall bear its pre-operating expenses as well as all other expenses that relate to conducting its own business or the investments of its own funds.
4. The statutory reserve of the joint stock company is deducted from its share capital and becomes part of its shareholders equity, a case that also holds true for all other capital related deductions. No deduction shall be made from the policyholders fund or profits for the benefit of the shareholders of the joint stock company.
5. 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 allocation pertaining to the

insurance fund. Such deductions, however, should by no means belong to the shareholders of the joint stock company. The accumulated balance of the insurance account shall be spent on charity purposes in case of liquidation.

6. The company represents the participants and disposes of all tasks relating to insurance account including lawsuits etc.

7. Mudarib expenses are the responsibility of insurance company relating to the investment of funds under Mudaraba.

8. In the case of a deficit in one period, that can be compensated by surplus of another period. The company can manage through charity loans (Qard e Hasan). Also, if it is stipulated, the deficit can be compensated by policyholders.

9. Expenses relating to insurance activities shall be charged to insurance account.

10. There is no restriction on reconciliation between the company and the party who causes the injury subject to confirmation with relevant Shari'a rulings and not against the interest of the participants.

12.5. Concept Building

Following insurance transactions completed during the year 2013.

1. Alam got an insurance policy for his car by making a contribution of PKR 40,000 for an insurance cover of PKR 1,000,000. During the year, an accident damaged the car and repair charges amounted to PKR 20,000.
2. Khan entered into an insurance policy by making payment as the contribution of PKR 25,000 on his house for a cover of PKR 2,500,000. During the year, nothing is claimed by him.
3. Rashid entered into an insurance policy for his factory by contributing PKR 100,000 for a cover of PKR 4,000,000. During the year, nothing claimed by him.
4. Zahoor entered into Takaful insurance covering life and disability compensation amounting to PKR 4,000,000 by contributing PKR 25,000. During the year he claimed nothing.

5. Margalla Refrigerators Ltd. entered into an insurance contract by making payment of PKR 200,000 for a cover of 5,000,000 on its factory. During the year she claimed nothing.
6. Miscellaneous contributions on other contracts were PKR 4,000,000 and insurance claims filed were PKR 3,600,000.

Assuming, (1) Returns on investments of insurance assets generated during the year were amounting to PKR 700,000 (2) Management fee of Islamic insurance company is 10% of contributions collected (3) The share of Mudarib in investment is 60% of actual returns on investments.

Required:

a. Gross Profit made by an Islamic insurance company
b. Gross Profit made by a conventional insurance company
c. Balance in insurance account under Islamic insurance framework

Solution

1. Following is the gross profit/return of an Islamic Insurance Company.

Descriptions	**Amount in PKR**
Revenue:	
Alam	40,000
Khan	25,000
Rashid	100,000
Zahoor	25,000
Margalla Refrigerators	200,000
Miscellaneous contributions	4,000,000
Total revenue through contribution	**4,390,000**
Return on investment	700,000
Total revenue	**5,090,000**
Share in contributions @ 10%	439,000
Share in returns on investment @ 60%	420,000
Gross profit of Islamic Insurance Company	**859,000**

2. Following is the gross profit/return of a Conventional Insurance Company.

Descriptions	**Amount in PKR**
Revenue:	
Alam	40,000
Khan	25,000
Rashid	100,000
Zahoor	25,000
Margalla Refrigerators	200,000
Miscellaneous contributions	4,000,000
Total revenue through contribution	**4,390,000**
Return on investment	700,000
Total revenue	**5,090,000**
Less claims made and approved	3,620,000
Gross profit of a Conventional Insurance Company	**1,470,000**

3. Following is the balance in insurance fund under Islamic insurance framework.

Descriptions	**Amount in PKR**
Revenue:	
Alam	40,000
Khan	25,000
Rashid	100,000
Zahoor	25,000
Margalla Refrigerators	200,000
Miscellaneous contributions	4,000,000
Total revenue through contribution	**4,390,000**
Return on investment	700,000
Total revenue	**5,090,000**
Less claims made and approved	
3,620,000	4,479,000
Less insurance company's share	**611,000**
859,000	
Balance in Insurance fund	

12.6. Questions

1. What is the underlying principle of Islamic insurance? Explain Islamic insurance process.
2. What are similarities and differences between conventional and Islamic Insurance?
3. Explain the Shari'a rulings relevant to Islamic insurance?
4. Explain the role of Islamic insurance company in the management of insurance process.

True/False

1. The managing company is entitled to its own capital and returns on capital as well as surplus on insurance account.
2. The insurance fund is entitled to the contributions and the returns thereon as well as management fee earned by the insurance company.
3. The relationship among participants and insurance company is of Musharaka.
4. Participants may undertake to bear any deficit that may occur, as per regulations.
5. The insurance company should maintain a single account for its own rights and liabilities and the rights and liabilities of policyholders.
6. The role of the company is of a Mudaraba in managing the insurance account.
7. The Insurance account is entitled to the insurance assets and returns on investments and does not bear liabilities relating to these assets.
8. The adopted rules may comprise disposal of the surplus in a way that serves the cause of common interest of the participants and the company.
9. In the case of liquidation of the insurance company, all provisions and accumulated reserves pertaining to insurance should be added to the wealth of shareholders of the insurance company.
10. Preference should be given to policyholders to participate in management of the insurance operations [e.g. representation on the board of directors]
11. The insurance company is required to adhere to the principles and rules of Islamic Shari'a in all of its activities.

12. A Shari'a supervisory board should be established; as well as an internal unit for Shari'a monitoring and auditing should also be established.
13. For a policyholder, the amount of contribution should be specified, however benefits payable should be specified at the time of death.
14. In the case of death of a policyholder, Takaful entitlements should be distributed among the deserving persons, parties or purposes as indicated in the documents.
15. In the case of death benefit, it should be clearly stipulated that if death is taken place by murder the beneficiary can be a person involved in the murder.
16. Non-Muslims cannot participate in various types of Islamic Insurance with Muslims.
17. The contribution must not be determined according to the actuarial principles based on statistical techniques; rather it should be determined on the basis of income of a policyholder.
18. The risk that constitutes the subject matter of insurance should be one that could not probably occur. It should be something that relates to the absolute will of the participant.
19. Submission of accurate information by policyholder about the risk insured is not required.
20. Payment of contribution on time is required. In the case of delay, company has the right to terminate the contract or pursue legal enforcement.
21. The participant shall receive equal to either the actual loss suffered or the insurance amount, whichever is higher.
22. Insurance policy expires by completion of agreed period.
23. Insurance policy expires by termination by company or participant, if it is stipulated.
24. Insurance policy expires by complete damage of insured property.
25. Insurance policy expires by death of the insured person
26. The relationship between participants and company is of Wakala for the management of insurance account.
27. The relationship between participants and company is of Mudaraba or investment agency for investing insurance assets

28. Reserves accumulation is not allowed out of surplus on insurance fund.
29. The surplus on an insurance account of one period cannot be used to make payment of compensation for another period.
30. The insurance company is also entitled to any surplus arises on insurance account.
31. If the deceased participant was entitled to some investment balances, then the same should be distributed among the inheritors according to the Islamic rules of inheritance.
32. A participant should inform the insurance company about any new circumstances that may contribute to increasing the risk.
33. In the case of fraud, deceit, and false information, a participant may be deprived from partial or full indemnity.
34. In the case of unintentional misrepresentation by a policyholder, the indemnity shall become proportionate to the accurate information he presented.

12.7. Exercises

Ex.1. Faraz khan at the age of 30 years, entered into a Takaful insurance, covering disability and death benefit only, by making an annual contribution of PKR 25,000 up to 60 years of age. Death benefit agreed (cover) starting from PKR 4,000,000 and reducing with the passage of time to PKR 1000,000 up to 60 years of age. Mr. Khan died at the age of 53 years. What would be the amount of compensation?

Ex.2. Alam khan at the age of 42, entered into a Takaful insurance contract, covering disability and death benefit as well as investment balance, by making an annual contribution of PKR 25,000 for risk coverage and 25,000 for investment up to 60 years of age. Death benefit agreed (cover) starting from PKR 4,000,000 and reducing with the passage of time to PKR 400,000 up to 60 years of age. At the age of 55 years, Mr. Alam died. What is the amount of contribution? What is the amount of investment balance assuming 12% return p.a?

Ex.3. Ali Rashid entered into an insurance contract with a local Islamic insurance company for his house by making a contribution of PKR 40,000 for an insurance cover of PKR 4,000,000. During the earthquake, house damaged partially and repair charge amounted to PKR 500,000. What would be the amount of compensation in this case?

Ex.4. Mr. EZK entered into a Takaful insurance contract, for the cover of disability and loss of life, with a local Islamic insurance company for a cover starting from PKR 5,000,000 and reducing with the passage of time to PKR 300,000 till the age of 60 years for an annual contribution PKR 25,000 per annum. Mr. EZK stopped making payment of installments at the age of 50 years. What would be the amount of claim?

Ex.5. Zeb entered into an insurance contract for his car with a local Islamic Insurance company. At the time of insurance, it was decided that maximum cover would be PKR 1,000,000 for a contribution of PKR 30,000. During the year car met an accident and repair charges amounted to PKR 100,000. What is the value of claim?

Ex.6. Shah Khan entered into an insurance contract with Arooj Insurance company for his machine and compensation amount determined/fixed PKR 1,500,000 for a contribution of PKR 45,000 for one year. During the year, a fire took place in the premises and burned the machine as well. The actual loss suffered by Shah Khan was PKR 1,800,000. What would be the amount of claim in this case?

Ex.7. Arshad Malik entered into an insurance contract with Mehran Insurance company for his car and compensation amount (cover) agreed was PKR 1,000,000 maximum for a premium of PKR 32,000 for one year. During the year, his car was stolen and police traced the culprit, who paid an amount equal to the value of the car. Mr. Arshad Malik filed a claim of PKR 1,000,000 with the insurance company. What would be the amount of claim to be paid to policy-holder?

Ex.8. Mr. Halim at the age of 40 years entered into a Takaful insurance contract with ABC Company and nominated his daughter as beneficiary. As per agreement, he would pay an amount of PKR 40,000 as annual contribution out of which 50% shall go to an investment fund and balance in insurance account. Compensation for disability would start from 2,000,000 and reduce with the passage of time to zero at the age of 60 years. Death benefit would start from PKR 4,000,000 and reduce with the passage of time to zero at the age of 60 years. He died at the age of 55 years and six months and left a widow, one daughter and one son as inheritors.

- What would be the amount of claim?
- Who will receive the death benefit?
- If his investment grown @ 15% p.a. with the insurance company what is amount of investment balance
- What would be a share of the widow in the amount paid by Insurance Company?
- What would be a share of each son in the amount paid by Insurance Company?
- What would be a share of Daughter in the amount paid by Insurance Company?

Ex.9. K, L,M,N,O,P,Q,R,S,T,U,V,W,X,Y,Z owners of tractors entered into an insurance agreement with an insurance company by making contributions of PKR 30,000 each for a compensation of actual loss incurred subject to a maximum of PKR 200,000 per person for the year 2013. During the year M, P and Z claimed compensation of PKR 20,000, 40,000 and 60,000 respectively based upon actually verified loss of assets. Furthermore, the collected amount earned PKR 150,000 as return on investments.

Assuming:

- Managing fee@ 15% for an Islamic insurance company
- Mudarib's share is 70% in returns on investments of insurance assets

Required:

a. What is the amount of gross profit for an Islamic insurance company?
b. What is the amount of gross profit for a Conventional insurance company?
c. What is insurance account balance under Islamic insurance framework?

Chapter 13

Challenges

Provision of cash for operating expenses of customers is a challenge for Islamic finance industry

Islamic Banking has shown tremendous growth in the first decade of twenty-first century. In order to avoid interest charging Islamic banks transact business through sale/purchase (Murabaha, Muajjal, Salam, Istisna'a), Leasing (Ijarah) and profit and loss sharing (Musharaka, Mudaraba, PTC, TFC, Sukuk). Cash loan facility is not available in the present framework of Islamic banking. In this chapter I have elaborated five options including Time Multiple Counter Loans (TMLC), Normal Rate of Return (NRR), Inflation Based Loan Indexation (IBLI), Overhead charges on loans and educational loans to present a workable solution for cash financing by Islamic banks. Furthermore, an account of the economic substance of prevailing contracts of Islamic finance is presented.

Learning Objectives

After studying this chapter reader should be able to understand and interpret:

Why is cash financing essential requirement?

What are issues in cash financing and how these can be solved?

What are PTCs and TFCs?

What are TMCLs and how they work?

What is Normal Rate of Return and how it works?

What is Inflation based loan indexation?

Whether prevailing contracts of Islamic finance create an economic substance different from conventional finance?

13.1. Introduction

Islamic financial system is based on *Shari'a* (Islamic law) whereby interest charging in a loan transaction is *Haram* (unlawful). In order to adhere this Shari'a constraint Islamic Financial Institutions (IFIs) do not provide finance in cash for a charge rather transact business by using trading, rental and equity-based modes of financing. Trading and rental modes of financing are used excessively by IFIs in the provision of financing as compared to equity financing due to lesser/zero uncertainty about the outcome of the investment, however, deposit collection is fully based on equity modes of financing. Generally Islamic banks provide financing through *Murabaha* (deferred sale of a commodity for profit), *Salam* (spot payment with deferred delivery of subject matter), *Istisna'a* (order to manufacture a product, payment may or may not made on spot), *Ijarah* (leasing or renting an asset for use ending in transfer of ownership), *Musharaka* (participation in profit and loss of a project or a business for a particular period), *Diminishing Musharaka* (a mortgage transaction whereby stake of bank decreases and that of customer increases over the period ending in transfer of ownership to the customer) and *Mudaraba* (partnership of skill and capital). Three of the modes are based on sale/purchase of an asset, one on renting an asset, two on partnership and one is a mixture of partnership and leasing. Any customer who needs a bank loan for any of its need can opt one or other mode of financing to transact business with Islamic banks. Deposits are collected under any of three schemes including current (free of charge loan), *Musharaka* and *Mudaraba*. In this chapter an account of the economic substance of these modes is presented.

There are certain customer needs including payment of operating expenses, an urgent payment to a vendor, long distance travels and tours, children education, marriage expenses, health expenses and credit card facility etc. which cannot be fulfilled through any of above-listed modes of financing, hence, require cash loans. However in the present practice of Islamic banks, one cannot get a loan in cash except Qarz e Hasna (charity loan). Qarz e Hasna is not a business model in itself. Islamic banks are not charitable institutions rather commercial houses. In fact, Islamic banks or any other business can survive only through earning profit

which does not exist in the transaction of Qarz e Hasna. It is appreciable that Islamic banks must reserve a certain amount for Qarz e Hasna; however that can only be done in a prosperous Islamic bank.

Another questionable practice in current Islamic finance industry is the use of Inter Bank Offered Rate (IBOR) as a benchmark for pricing products, which although makes the operation competitive with conventional banking, however, reduces the gap between conventional and Islamic banking as for economic substance is concerned. This practice has further contributed to negative perception among masses and many people find it as a mere copy of conventional products. Linkage of pricing with IBOR, further contributes in matching return on deposits with the conventional finance industry, although deposits of Islamic finance are accepted on the basis of profit and loss. So what is the way out? Should there be a national rate or not for pricing? Ideally, there should not be a single national rate on capital. It should base upon regional activity plus sector specific. For example housing rate in Islamabad should base on two factors including expected return in the housing sector and that expected return should be region based and not economy based. As we know return depends upon riskiness of an investment and all investments do not carry the same risk, hence, rate on mortgages in Islamabad city should not be same as for car Ijarah. At present Islamic finance industry charges the same IBOR plus for every transaction, which is although allowed, but the economic substance is not very much different from conventional finance.

Earlier advocates of Islamic finance (Modoodi, Usmani, Chapra, Siddiqi etc) have tried to justify this stream of banking to eliminate unfair practices including circulation of wealth among wealthy people. What progress industry made so far on this front would be an interesting study; however apparently it looks Islamic finance could not realize this objective. There are certain fixed parameters, set by conventional finance industry to extend loans and Islamic finance is also following that criterion. It makes sense as for business model is concerned, however Islamic banks cannot justify their existence merely on the basis of successful economic performance alone. It is worth mentioning that in many markets including Pakistan, Sukuk market is of Billions of US dollars without retail Sukuk

operations. A common man with meager income is not allowed to purchase Sukuk and only institutional investors can reap the dividend of Sukuk. Consequently, depositors are forced to invest in profit and loss sharing deposits with Islamic banks to ensure spread earnings for the bank. If the return on Sukuk is 12% that is not available to a depositor and only 5 to 7% is reached to depositor given the spread is for an Islamic bank. Also, there are multi-billion US dollars in current accounts of Islamic banks which are being used by banks to earn a return, but same cannot be shared with depositors, given the nature of contract used in current deposits. There should be a mechanism at a regulator (central bank) level to ensure at least 50% of the average balance of the current account may be used for community services including health, education, and small business startups through Qarz e Hasan (charity loans).

The trained human resource is a must for make or break of any system and Islamic finance has no exception. We can categories present human resource of Islamic finance industry into two groups, objectively, including bankers with professional (conventional finance) knowledge without any exposure to Islamic financial studies and Shari'a scholars with no background understanding of banking. Decisions are taken at joint meetings, however, the essence of viewpoint given by each group in a meeting is not fully understood by another group. As we know when we talk about banking in a gathering, we speak a specific language (banking language, not mere English language words) and to get the message fully transposed, expertise of audience in that language is required, which is absent in case of Muftis (Jurists in Islamic law); and same is true when Shari'a scholars speak at the same meeting; hence without doubting the intentions, it is concluded that this system of corporate governance is ok to start with, however not ideal. Ideally, it is required that both groups speak and understand the same language when they sit to gather in a meeting. It is recommended, initially, that regulator makes it compulsory for both groups (bankers as well as Shari'a scholars) to have an elementary understanding of the areas of another group. Short courses of three to six months would be sufficient for both groups to have an elementary understanding of the expertise of another group. There should be short courses of accounting and finance for Shari'a scholars and Shari'a courses for bankers. In

the long run qualifications such MBA, MSc in the area of Islamic finance would meet the needs. In the long run same qualification (MBA, MSc) should be compulsory for both groups. Having said that, still traditional qualification of Mufti would be must to work as Shari'a advisor or Shari'a member of the board.

Information technology plays very vital role in corporate governance of modern organizations. Under Islamic financial system, more disclosure is required to ensure transparency. Also, AAOIFI standards demand different types of financial reports from a Shari'a compliant business. At present in majority cases, information gathering software including accounting information are either the same as for conventional banking industry or copied on those lines. Consequently financial section of annual reports of Islamic finance industry is not very different from conventional industry's financial reports. Islamic financial industry needs to develop different information system based upon AAOIFI framework and computer software play a vital role in recording transactions and generation of reports. Available software are based upon requirements of conventional finance and lacks many things to depict the required information for Islamic finance industry. For example, there is no such built-in option in any available accounting software to check the Shari'a compliant status of a transaction or investment. Also available software ensures calculations based upon time value of money, which is not appreciated for Islamic finance. This is one of the challenges for practitioners of Islamic finance to ensure the building of required software in order to achieve the objective of more transparency and Shari'a compliance.

Profit and loss sharing is the essence of Islamic financial system. An independent evaluation of industry practices suggests that although much progress has been achieved on this front also, in spite of non-conduciveness of existing business framework and financial industry norms. Deposit side of balance sheets of Islamic financial industry is fully operated on Musharaka/Mudaraba principles. Also, equity funds are profit and loss sharing-based businesses. House financing is provided through application of diminishing Musharaka contract in many economies. Furthermore, Sukuk carries the profit and loss sharing contracts among Sukuk-holders. Although certain question marks are there (elaborated in relevant sections), however basically these are profit and loss sharing contracts. The other

side of the balance sheet (asset side) of IFIs working globally is full of Murabaha, Ijarah, and mortgages. Extension of financing facility based upon true Musharaka and Mudaraba is missing from investment portfolios of IFIs. Undoubtedly practicing of profit and loss sharing is difficult (as elaborated in Musharaka financing), however, IFIs must go for profit and loss sharing through innovation and financial engineering in order to address the negative perception among masses.

Dealing with the default at due date by a customer is a serious problem for both conventional as well as Islamic finance industry. At present, there is a reasonably high number of non-performing loans. Under conventional finance loan is rescheduled by charging additional interest which is not allowed under Islamic financial system. Given the inefficient (lengthy procedures) judicial system and norms of the financial industry, usually, banks do not prefer litigation. At present Islamic banks charge a penalty for default, which is although spent on charity, however, it makes transaction similar to conventional banking as for customer is concerned. Also, the nature of charity suggests that it is a contribution to charity by defaulter. It is generally said as why a person should contribute to charity who is unable to make payment in time. IFIs should think seriously as how to ensure prompt payment without using charity contract. There should be a collective effort and mechanism at regulator level to deal with default cases.

As we know Islamic finance is asset based financing and use either trading modes or rental models. Although minimum criteria of ownership risk is met through purchase and then either sale or Ijarah. However, this is more of risk transferring exercise than of risk sharing. If Islamic banks are dealers of goods then why not to have an inventory of goods kept for sale or lease. This will benefit both customer as well as banker and will send a very positive message in the market. The bulk purchase would enable Islamic finance industry to pass on a discount to customers as well as maintain prices. Imagine if the major portion of agricultural products is purchased and stored by Islamic finance industry, the problem of hoarding and overcharging would be minimized.

Regulation is another aspect of Islamic finance industry to be addressed. Except few countries, in the majority of societies, Islamic finance is regulated through

conventional laws, which is against the spirit of the industry. Consequently, AAOIFI standards are not applied in financial reporting and one would not find much difference in financial reports of both streams of banking. It is suggested that a central law should be prepared, ideally by AAOIFI and efforts should be made for implementation of that law globally with a cushion for certain extremely required changes by local society.

In the following sections, some of the challenges are elaborated in detail to assist the industry in further understanding as well as to move for solutions.

13.2. Cash Finance Options

In following paragraphs certain frameworks for the provision of interest-free loans (not Qarz e Hasna) are elaborated.

13.2.1. Time Multiple Counter Loans

Time Multiple Counter Loan (TMCL) is a concept suggested by Council of Islamic Ideology (CII), Pakistan in its first report on "elimination of Riba from the economy" in 1980. As per this concept a needy customer can get cash loan without paying any interest from the bank, however, a small amount of counter loan/deposit (free of charge) for a longer period is to be provided to the bank. Under this mode of financing, a larger amount of cash loan with shorter maturity issued by a bank is compensated through a smaller amount of loan/deposit for a larger period by the customer. Bank can earn a higher rate of profit by investing this shorter amount of cash in a long-term project. The following example would make the concept clear.

A person needs an amount of loan in cash amounting to Rs; 500,000 for three months and request to financier by offering Rs; 50,000 for a longer period which equate the daily product of both loans. Daily product of Rs; 500,000 for three months become Rs; 45,000,000 (500,000*90). In order to equate daily product of both amounts, deposit (loan) by the customer must remain in the bank for a peri-

od of 900 days or 2 years and six months (45,000,000/50,000). If a customer negotiates a loan with bank amounting to Rs; 500,000 payable after three months and opens fixed deposit account amounting to Rs; 50,000 for 2 years and six months transaction can be carried out. For bank incentive is very high. Let us assume KIBOR of 10% and further assume expected return on a long-term project is 15%. Return on Rs 500,000 for three months become 12,500 while return on long-term market-based investment is Rs 18,750.

Let us see this practice in totality and form a hypothetical portfolio of assets and liabilities of an Islamic bank. Following is hypothetical balance sheet (table 1) of an Islamic bank on year zero.

Table-1. Balance Sheet

Liabilities	**Amount**	**Assets**	**Amount**
Equity	1,000,000,000	Cash	5,500,000,000
Deposits	5,000,000,000	Other Assets	500,000,000
Total	**6,000,000,000**	**Total**	**6,000,000,000**

Assuming 10% of deposits submitted to SBP. Cash left with bank amounting to Rs 5,000,000,000. Further assume 20% of deposits is used for TMCL at 25% rate. It means the bank has lent interest-free loans amounting to Rs 1 Billion for one year for an interest-free deposit of Rs; 250 million for 4 years. Out of this 10% further is to be deposited with SBP (cost of conversion of short-term deposit in the long term). An infrastructure project of four years with Rs; 225 million costs is at hand with the market price of Rs; 450 at completion. Bank will earn equal to Rs; 225 million in four years (22.5% per annum on deposit of Rs; 250 million) and accrued profit of Rs 56.25 million in the first year. Let us assume the first year circumstances repeated for next five years. Realized (accrued) profit in five years is amounting to Rs 787.5 million which is 16% per annum and until completion of tenure Rs; 1,125 million (787.5+337.5) which are 22.5%. Detailed working is presented in following analytical table (Table-2).

Table-2. Analytical table of Time Multiple Counter Loan for five years
(Rs in millions)

Deposit	**loan**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
250	1,000	56.2	56.2	56.2	56.2				
250	1,000		56.2	56.2	56.2	56.2			
250	1,000			56.25	56.25	56.2	56.2		
250	1,000				56.2	56.2	56.2	56.25	
250	1,000					56.2	56.2	56.2	56.2
Y.profit		**56.2**	**112.5**	**168.7**	**225.0**	**225.0**	**168.7**	**112.5**	**56.2**
T.profit						**787.5**			**337.5**

After making payment of 10% of deposits to SBP and lending 1 billion under TMCL bank left with cash of Rs; 4.225 billion (5.5-1-.5+.225) which can be invested prudently in Murabaha, Ijarah, Salam, Istisna'a and diminishing Musharaka. Let us further assume bank invested in following ratio (table-3). After one-year following would be earning and financial position. Interest-free loan amounting to 1 billion returned. The first installment (25%) of selling price Rs; 112.5 million received. Receivables of Murabaha amounting to Rs 1,400 million received. Marketable securities realized amounting to Rs; 1,500 million. The first installment of diminishing Musharaka received amounting to 192 million (80+112). The first year Ijarah received amounting to Rs; 80 million. It all accumulated cash balance to a figure of 4,784.5 million (500+1000+112.5+1400+1500+192+80). Earnings of the bank amount to Rs; 600 million approximately, (56.5+150+ 250+112+30). If we reserve 10% for variations still Rs; 540 million is earnings.

Table-3 Investment Portfolio

Description	Rs in Millions
cash in hand	500
Reserve with SBP	525
Interest-free loan	1,000
25% Infrastructure (4 years)	225
Marketable Securities (18% average return)	1,250
12% Murabaha one year	1,250
14% Diminishing Musharaka 10 years	800
15% Ijarah 4 years	200
Other assets	500
Total	**6,250**

Assuming 8% deposit service which becomes Rs; 320 million (4,000,000,000 *8%, assuming average deposit for a year) and left with the bank is Rs; 120 million to meet the cost and earn residual as income. If 60 million is cost then 60 million is net earnings for the bank which is 6% of equity, however, profit of Rs 168.5 million (225-56.5) shall be received in next three years without any investment. If we include that amount then it becomes 228.5 million which is 23% approximately.

13.2.2. Normal Rate of Return

Financing based on the normal rate of return (NRR) was also suggested by CII in its report in 1980. According to this mode of financing, cash loans should be provided to entrepreneurs based on a normal rate of return as determined by an independent specialized agency. Any excess earning than normal rate of return should also be shared with IFI by entrepreneur voluntarily. It will provide an assurance to IFI about the minimum return. However in the case of lesser actual profit than normal rate of return or loss, the entrepreneur will have to prove the same to the satisfaction of the independent specialized agency who determined

the normal rate. Upon satisfaction of the third party bank will accept lesser profit and/or share loss as the case may be.

NRR is to be decided for each sector based on overall economic situation in the economy by an independent specialized agency (like a central bank or rating agencies). NRR may not be equal for all sectors of the economy like interbank offered rate (IBOR) of interest. In fact mechanism working behind the two rates (NRR, IBOR) is different. IBOR is determined based on demand and supply of capital while NRR is determined based on the economic outlook of a sector of the economy e.g. housing, textile etc. This scheme has the potential to reduce chances of fraud as well as concealment of the actual outcome by an entrepreneur as equity-based financing is discouraged due to lack of trust and transparency. This scheme is also very helpful in financing cottage industry and small businesses where the establishment of the accounting system and auditing is not feasible due to cost reasons.

CII has further shown its concern about the possibility of misapplication of NRR in all banking transactions leading to the opening backdoor for interest hence suggested the careful use of NRR and practically restricted to financing operations of small scale businesses as well as continuous monitoring and updating of the rate by the independent specialized agency entrusted with the job.

13.2.3. Inflation Based Loan Indexation

In current regime of paper currency inflation reduces the purchasing power of currency resulting in loss of wealth. In certain countries (including Muslim countries) double digit inflation has made the lives of masses miserable. Certainly wealth kept in currency is lost due to a decrease in purchasing power. As Interest-free loans carry no return for a provider of capital and original amount is returned, consequently, wealth of loan giver is lost due to inflation. It is a serious problem in prevailing Islamic financial system working in paper currency regime having built-in inflation.

As per objectives of Shari'a protection of faith (Eeman), life (Jaan), wealth (Maal), next generation/lineage (Nasal), liberty (Aqal) and honor (Izzat) of citi-

zens should be guaranteed by Islamic society. It is the duty of the government to protect wealth, faith, honor, life, liberty and children of the citizens. The protection provided by governments to their citizens in Muslim world varies from country to country and from class to class within a country. An analysis of protections available to citizens in the Muslim world is beyond the scope of this study; hence, I am restricted to the topic.

Inflation is caused due to the gap in demand and supply of a commodity. It is the duty of regulator to ensure uninterrupted demand and supply of commodities. Hoarding, gambling, storage, futures, forwards, mixing, cartels, monopoly etc. are the factors which interrupt supply and must be checked through enforcement of law. Inflation is also caused due to deficit financing and financial indiscipline by the government. In some of the Muslim societies, both causes of undue inflation prevail resulting in the suffering of citizens and needed to be addressed. Even after addressing undue inflation mild inflation shall prevail under paper currency regime resulting in loss of wealth. In order to ensure capital maintenance indexation of loans based on increase/decrease in the general price level is justified and Islamic Fiqh Academy (IFA), Jeddah should look into the pending matter.

There are several inflation indicators in an economy including consumer price index (CPI), wholesale price index (WPI), sensitive price index (SPI), oil price index (OPI), exchange rate price index (EPI) and sectoral price indexes etc. Which of the inflation indexes is appropriate for a loan transaction indexing under Islamic financial system? The answer would be different for different economies and a specialized public agency should be entrusted with the job to decide. An appropriate proxy for inflation could be gold price, a basket of commodities as well as a basket of currencies. Again inflation charge may not be termed as rental of money as it is required to maintain the purchasing power of the currency. If indexation gets approval from Shari'a experts then it could be used in personal loans, credit card transactions and working capital requirements of businesses where any of the existing modes of IFIs (trading, sharing, rental based) could not be applied.

13.2.4. Overhead Charge on Loan

At present IFIs are working as institutions and spend millions of rupees as overhead. A charge for overhead expenses estimated reliably could be justified in a loan transaction of cash. It could be in the form of fixed-fee on the issue of a credit card with a certain limit to the customer in order to facilitate, although debit card of IFIs have successfully replaced the need of credit card as for use of the card is concerned, however credit needs can be fulfilled by charging overhead expenses. Practically these charges would be a very small fraction of the total loan amount and ceiling should be fixed by the central bank.

13.2.5. Educational Loans

IFIs should develop a scheme of merit-based educational loans for needy students out of current deposits. Furthermore, IFIs can motivate some of its customers through a scheme of no return deposits from customers interested in helping needy students. Late payment charges form a reasonable amount with IFIs which are used as charity, could also be used for educational loans.

The above schemes carry certain merits for Islamic financial system in practice including following:-

1. Provision of cash loan facility to customers which does not exist in present framework. It is important to have built-in cash loan facility to customers otherwise, this system would not be able to meet entire financing needs of an economy hence, failure in replacing the conventional financial system.
2. It facilitates the provision of cash loans for commercial purposes and reduces the only option of Qarz e Hasna under Islamic financial system which is not a business model rather a charity and Islamic banks are not charitable institutions rather they are commercial houses and can survive only through earning profit.
3. It helps in meeting the needs of customers which cannot be fulfilled through any of prevailing financing mode.
4. It will open doors for credit card facility to customers which have become prime need keeping in view the facilities attached to it.
5. It will boost the limited access of Islamic banks to a larger community desiring finance in hard cash form.
6. It will make Islamic banks competitive to their conventional counterparts.

7. It will help Islamic banks to finance government needs of funding, consequently Islamic financial industry will get support from regulators as well as it will serve as a motivational tool to enhance political will of Muslim countries' governments to replace the conventional banking with Islamic banking.
8. It will assist in the promotion of research and education vital for the uplift of Muslim societies.

13.3. Substance or Form

In this section, an account of the economic substance of five most widely used contracts under Islamic financial system including Murabaha, Ijarah, diminishing Musharaka, deposits, and Sukuk is presented.

13.3.1. Sukuk

An important observation about Sukuk issued so for is the redemption of certificates at issue price and payment of returns as IBOR plus certain basis points. Ideally, returns on Sukuk should be provided on the basis of actual returns generated from the business. An Ijarah Sukuk should provide the return to holders on the basis of actual rent of assets and Musharaka Sukuk should distribute profit on the basis of actual profit earned instead of IBOR plus certain basis points. Likewise, redemption price of Sukuk should be decided on the basis of the actual market value of assets, instead of redeeming at par. If the value of assets against which Sukuk were issued has been decreased (usually in the case of Ijarah Sukuk) or increased (usually in the case of Musharaka Sukuk) then redemption at par value must be discouraged. It is a very valid view that return on Sukuk should be at least at par with conventional bonds; however, the objective can be achieved through higher rentals in case of Ijarah Sukuk. In the case of Musharaka Sukuk, these are equity units and should be served on the basis of actual results. The market itself will decide the intrinsic value of securities and should be called

for redemption on market price in order to promote the real essence of Islamic finance i.e. sharing of risk and reward.

Sukuk market has got momentum under Shari'a compliant financial system. According to ISI Emerging Markets[29], approximately 2000 issues of Sukuk were held with the Global volume of around US $200 Billion by the end of June 2010. In addition to corporate Sukuk, Sovereign Sukuk are also issued by the governments including Pakistan, Jordan, UAE, Thailand, Malaysia, Turkey, Indonesia, Bahrain, Qatar, Cayman Islands, Singapore, Germany, Brunei, Gambia, and Kuwait. The concept of Sukuk is initially developed to replace the conventional bonds having features of fixed return, money back security/guarantee and ready market for liquidation. However under Islamic financial system, even Sukuk cannot guarantee of all the features of conventional bonds listed above. Different types of Sukuk are offering varying degree of feature(s) of conventional bonds. Objective classification of Sukuk places them into either fixed return Sukuk or variable return Sukuk. Variable return Sukuk are very much similar to equity securities rather than conventional bonds, however, fixed return Sukuk are having some of the features of conventional bonds.

Following observations came to our knowledge during study process of Sukuk, which are being presented for the attention of experts.

1. An important observation about Sukuk issued so for is the redemption of certificates at issue price. Sukuk are certificates of ownership in an asset(s) or an organization and should be redeemed at a market price of asset(s) or organization. The announcement of the redeemable price at the time of issue is not appropriate. If Ijarah Sukuk (somehow dominating) are issued, under most of the cases value of assets gone down by the time of redemption, hence redeeming at par value takes away the economic substance of transaction under Islamic financial system. While in the case of Musharaka Sukuk redemption value could be more as well as less than par value depending upon the performance of the underlying entity.

[29] www.123 accessed on 5th July, 2010.

This practice is pushing the economic substance of transaction very near to conventional banking, although partial risk sharing is present.

2. Second is offering return based on KIBOR plus a certain percentage of profit? Islamic financial system encourages sharing of the actual outcome, which can be more as well as less than KIBOR. In the case of Musharaka Sukuk, nothing is known with certainty, but still return is offered based on KIBOR plus (e.g. JAFZA Sukuk), while in the case of Ijarah Sukuk rent of the underlying asset(s) prevailing in the market is different from KIBOR plus. This practice takes away the economic substance of transaction as should be under Islamic financial system and bring it very near to conventional banking, although partial risk sharing is still there.
3. Third is the independent guarantee of return by the third party under Sukuk agreements. Due to this guarantee of the independent third party without consideration, the whole philosophy of Islamic financial system is being compromised. For investors return is certain, then where is the difference between conventional and Islamic financial system.

Very interesting to note that as for legal form is concerned nothing is ed.[30]One can sell his/r equity holdings at any price (including par value) as agreed between buyer and seller (Shari'a standard 17). As well as one can charge whatever rent s/he thinks appropriate on his assets. Also, one can decide any distribution of profit linked with any benchmark (including IBOR) and reserve the balance or give to managing partner or company as an incentive payment. Finally, any independent third party without having consideration can guarantee a return to any of the partners (Sukuk holders) [Shari'a standard 17]. However economic substance of transaction (as claimed by Islamic financial system) is compromised through fixing IBOR plus returns, redemption at par value and also by providing a guarantee.

[30] An interesting case of Enron (USA) is recommended to readers to study for understanding of "Form over Substance"

Ideally, returns on Sukuk should be provided on the basis of actual returns generated from the business. An Ijarah Sukuk should provide the return to holders on the basis of actual rent of assets and Musharaka Sukuk should distribute profit on the basis of actual profit earned instead of IBOR plus certain basis points. Likewise, redemption price of Sukuk should be decided on the basis of the actual market value of assets, instead of redeeming at par. If the value of assets against which Sukuk were issued has been decreased (usually in the case of Ijarah Sukuk) or increased (usually in the case of Musharaka Sukuk) then redemption at par value must be discouraged. It is a very valid view that return on Sukuk should be at least at par with conventional bonds; however, the objective can be achieved through higher rentals in case of Ijarah Sukuk. In the case of Musharaka Sukuk, these are equity units and should be served on the basis of actual results. The market itself will decide the intrinsic value of securities and should be called for redemption on market price in order to promote the real essence of Islamic finance i.e. sharing of risk and reward.

13.3.2. Diminishing Musharaka

The literal meaning of Musharaka is sharing. Its root in the Arabic language "Shirka" means being a partner. Musharaka means a joint enterprise formed conducting some business in which all partners share the profit according to pre-agreed ratio while the loss is to be shared according to the ratio of contribution (Usmani, 2002). For a valid Musharaka fulfillment of certain conditions required. First is there must be an agreement written (verbal) among the partners stating clearly the terms and conditions including management, capital contributions, profit and loss sharing among the partners. Second capital can be contributed in cash as well as in assets. However once an asset is contributed as capital that belongs to firm and contributing partner is relieved from the bar of risks and returns attached to ownership of that asset. Third profit is distributed according to the agreement of partnership, however, sleeping partner cannot claim a share in profit more than his proportionate share in equity and also loss is to be shared according to an equity stake. None of the partners can guarantee the capital or profit share to any other partner (Shari'a standard 12).

Diminishing Musharaka is a form of declining partnership between IFI and client generally used to finance real estates. When a customer requests to IFI for financing to purchase an asset, IFI participates in the ownership of the asset by contributing required finance. A Certain portion (e.g.20%) must be contributed by the customer. Total equity of bank is divided into units of smaller amounts which are purchased by the client in installments. Under this mode of financing, one of the partners (client) promises to buy the equity share of the other partner (IFI) gradually, until the title to the equity is completely transferred to him. Buying and selling of equity units must be independent of partnership contract and must not be stipulated in partnership contract. Generally, IFI rent out his share to the client and earns rentals. Any profit accruing on the property is distributed among the co-owners according to agreed ratio however losses must be shared in the proportion of equity (Shari'a standard 12).

Again theoretically, it is the purchase of a house under joint ownership and, later on, rent of the property is shared by partners. Practically bank rent out its share to the customer and receives rentals proportionally. At the same time, total interest in property of bank is divided into smaller units of equal value depending upon the nature of rentals. Customers pay the installments which constitute a portion of rent and another portion for the purchase of units. The following example would clarify the concept. Mr. ABC went for Islamic house financing to acquire the house in Islamabad. The cost of the house is Rs; 5000,000.

Table 7-5. KIBOR and Inflation Rates

End of Years	KIBOR	Inflation
00	-0-	-0-
01	09%	07%
02	10%	07%
03	10%	08%
04	11%	09%
05	10%	10%

As per terms of contract, 20% is to be paid by customer and balance by an Islamic bank. KIBOR is 9% and bank charges to this customer KIBOR plus 1%. The term of the contract is 5 years. Let us further assume following (table 7-5) KIBOR and property inflation rates for 5 years. It is further assumed that at beginning average rent of property in that area is Rs; 240,000 per year. As per prevailing practice following table 7-6 analyzes the five yearly payments. Rent is charged as a percentage (return/Interest) on balance payable and shares are sold at par.

Table 7-6.Analytical table under prevailing Method

End of years	Installments	Rent	Principal	Balance
0	1,000,000	-	1,000,000	4,000,000
1	1,200,000	400,000	800,000	3,200,000
2	1,152,000	352,000	800,000	2,400,000
3	1,064,000	264,000	800,000	1,600,000
4	992,000	192,000	800,000	800,000
5	888,000	88,000	800,000	-
Total	6,296,000	1,296,000	5,000,000	

Following observations are worth mentioning and demand immediate attention of leaders in Islamic financial system

1. Rent is charged on the basis of KIBOR plus a certain percentage and not on the basis of rent prevailing in the market. KIBOR is a return on capital and not rent of the property. Property rent is determined independently based on demand and supply of houses in a region and also it varies from region to region. In the case of Pakistan, property rents are much lesser than KIBOR rate[31].

[31] In Islamabad average rent of a house is about Rs. 60,000 with market value of Rs. 20 million, resulting in 3.6% return while KIBOR is about 12%. Also rent of a same house in Islamabad is much different from Rawalpindi city.

2. Sale of units at par value is also not in line with the essence of Islamic financial system. It should be based on market value, which creates the real difference in the Islamic and conventional system. If it is Musharaka as it is claimed then no question of guaranteed return to any of partners. Under present system return is guaranteed to a banker in the form of rent as well as the purchase of equity share at par value. This practice takes away the economic substance of Islamic financial system and matches transaction with conventional banking as for economic substance is concerned.

By looking at the legal form of contract one can conclude as nothing is against Shari'a law. One can charge rent of house as per his own calculations based on any benchmark including KIBOR rate. Also, one can sell his equity share at any price as agreed between seller and buyer (Shari'a standard 12). However, the unique thinking of Islamic financial system of variable return does not exist in the transaction. The mentality of fixed and certain returns for banks prevails in the transaction. With this practice Islamic financial system cannot be accepted as superior particularly in avoiding real estate crisis as occurred in the United States in 2007-08. If rent is to be charged on KIBOR and equity shares are to be sold at par then such crisis cannot be avoided, however if rent is to be charged based on the market rent of property and equity units are to be sold based on market value then it is guaranteed that such crisis could not happen.

Although legal requirements are fulfilled, however substance of the transaction is not matching with theory. Theory suggests earning rent of property and not of money, as well as no question of selling shares at par value while market value is different from par. Following table 7-7 shows calculations in line with theory. The difference in two tables is clear. In second case units are sold on the basis of market value as well as rent is charged on the basis of rents prevailing in the market which links financial sector to real sector. In first table rent is charged on the basis of KIBOR which is not preferable under Islamic financial system. The calculation in the second table is in line with the theory where rent of property (and not of capital) is charged as well as units are sold on market value (and not return of principal). Under prevailing practices (where economic substances of

Islamic housing is matching with conventional), one cannot claim superiority of Islamic financial system over conventional mortgages.

Table 7-7. Analytical table under proposed method

End of Year	Property Value	Rentals	Share of Bank	Share in Rent	Unit Price	Installment
0	5,000,000			-	1,000,00	1,000,000
1	5,350,000	240,000	0.80	192,000	800,000	992,000
2	5,724,500	256,800	0.64	164,352	856,000	1,020,352
3	6,182,460	274,776	0.48	131,892	915,920	1,047,812
4	6,738,881	296,758	0.32	94,963	989,194	1,084,156
5	7,412,770	323,466	0.16	51,755	1,078,22	1,129,976
Total	36,408,611	1,391,800	-	634,962	5,639,33	6,274,296

The overall difference in total charge is just Rs. 21,704/- in five years. It could be more or less depending upon market conditions; however there is a major difference in the rental as well as selling price of equity shares by the bank to the customer. In fact, there is a difference of Rs. 661,038/- in rentals and of Rs. 639,335/- in selling price of equity units. These differences of calculation clearly change economic substance of transaction under both systems. Under conventional mortgage return is fixed while under Islamic return is variable depending upon market conditions, hence, second method, in the opinion of the author is more in line with the essence of Islamic financial system.

13.3.3. Murabaha Financing

Mudaraba is the chief tool of deposits collection for Islamic financial institutions. Current deposits are accepted as loans from depositors which can be withdrawn

on demand by depositors. Some of the Islamic banks are accepting these deposits as Amanah. Amanah deposits cannot be utilized by the bank in its operations. If Amanah deposits are lost without negligence of bank, making the loss of depositors good is not the responsibility of the bank, hence, Amanah deposits are not recommended to safeguard the interest of both bank and customers. Under loan current deposit scheme bank has the flexibility to use the funds and the customer is protected from loss of amount in case of any miss-happening (burglary, fire, theft etc.) in any branch of the bank. Saving deposits are accepted under profit and loss sharing schemes hence Shari'a rulings of Musharaka and Mudaraba apply as the case may be. Generally, banks are accepting deposits under Mudaraba then mix the funds of the bank and create a joint pool for investment. Out of this pool after meeting the statutory reserve requirements investment portfolio is created and managed by IFIs. Any profit generated by investment portfolio is shared by bank and depositors. As deposits are not fixed hence depositors are free to deposit and withdraw which had created a problem in profit distribution. IFIs came up with a solution of profit distribution on daily product basis. The third category of deposits is time deposits under profit and loss sharing system. Under this scheme deposits are accepted for a fixed period which provide opportunity to IFI to invest in more profitable long term projects hence depositors of this scheme are getting higher profit in comparison of the second scheme discussed above. Longer the period, higher the rate of return is earned. Higher return to longer period deposits is justified because it provides an opportunity to IFI to invest the funds in long-term projects, generally giving a higher return, without the fear of returning to depositors on demand.

As for legal matters are concerned, every scheme is duly certified by Shari'a experts. In every Islamic bank, Shari'a advisor, as well as supervisory board, is present. However following observations demand due care from experts in the field. It is practice (knowingly & willfully) of Islamic financial industry to serve the depositors, at least, equal to conventional banking in order to retain deposits. As for investment of funds by Islamic banks is concerned, resulting return may or may not be sufficient to service depositors at par.

1. In the case of actual return to depositor is more than conventional banking, Islamic banks are happy, however if an actual return to depositors is less than return offered by conventional banks, usually, IFIs sacrifice their share in profit to compensate the deficit of depositors. At the legal front, there is no issue and any of the partners can sacrifice his share in favor of another partner, however, this practice takes away the economic substance of transaction under Islamic financial system and match with conventional banking.
2. Another issue is sharing of gross profit with depositors; hence, in certain instances (especially in initial years of an IFI) even if banks suffer a net loss, depositors are gaining a return on their savings. In addition to compromising on economic substance under this scheme, doubts in the minds of masses are also created as where is the difference between conventional and Islamic banking.

As for the legal form of contract is concerned, there is nothing against Shari'a, and one can negotiate a contract of Mudaraba to share gross profit instead of net profit. Also, there is no bar in sacrificing share of profit by one partner(s) in favor of others without prior agreement, at the time of profit distribution, however in the presence of such practices economic substance of transaction shifts from Islamic financial system to conventional banking, leading to doubts in the minds of masses, consequently jeopardizing future of Islamic financial industry.

13.3.4. Ijarah Financing

In this section, I have analyzed the existing practice in the light of desired principles. Ijarah is a reward for a service. Ijarah (Leasing) is a rental contract whereby IFIs lease an asset for a specific rent and period to the client. Ownership risks of the asset are borne by IFI while expenses relating to use the asset are the responsibility of the client. The difference between Ijarah and sale is that ownership in Ijarah remains with lesser while in the case of sales it is transferred to the purchaser. Ending Ijarah in the sale of the asset is allowed by Islamic Fiqh Acad-

emy (IFA) through a separate contract at the completion of the term of the lease. The contract can be executed prior to purchase and possession of the asset. Consumables cannot be leased out. Right of lessee to use the asset is restricted to lease agreement or/and as per normal course of business. Lessee is liable for any harm to the asset caused by any misuse or negligence on his part. Rentals of joint property are shared according to equity. A joint owner can rent his share only to the co-partner. Inter Bank Rate can be used as a benchmark for the amount of rentals. At the completion of Ijarah term either asset is returned to IFI or purchased by the client (Shari'a standard 9).

Although in theory, Ijarah is a rental contract whereby rent of the asset should be determined on the basis of aggregate demand and supply of assets [of that class]. Also, ownership risks are required to be borne by lesser. At the completion of lease tenure either asset may be taken back or sold to the lessee. However in practice except the legal form of the contract all calculations are deto copy of conventional leasing. Islamic banks determine rentals on the basis of KIBOR whereby principal amount as well as required return is ensured. Furthermore principal amount is also recovered along with rentals (Hanif, 2011).

Suppose, on January 01, 2006, ABC Company contacted the Gujranwala branch of the bank to provide a car costing Rs; 1,500,000, on lease for five years, payable in five equal annual installments at the beginning of the year. Bank promised to gift the asset after five years subject to prompt payment of lease rentals. Bank wants to earn 10% per annum on this deal. Two of the calculation methods are explained here. First is traditional method of installment calculation by applying following formula:

$$P = R[1 - \frac{(1+i/m)^{-nm}}{i/m}](1 + \mathrm{i})$$

Where *P* is the amount spent on the purchase of an asset, *R* is the installment, *I* is the rate of return, *n* is the number of years and *m* is a number of compounding in a year. This formula is based on the concept of time value of money hence not recommended for use in Islamic modes of financing. As per this formula if we calculate five equal annual installments compounded annually amount of each installment becomes approximately Rs; 359,700 rounded to 100.

Table I- Breakup of Returns and Principal

End of years	Installment	Interest	Principal	Balance
0	359,700	-	359,700	1,140,300
1	359,700	114,030	245,670	894,630
2	359,700	89,463	270,237	624,393
3	359,700	62,439	297,261	327,132
4	359,700	32,568	327,132	0
Total	1,798,500	298,500	1,500,000	

In present practice following observations demand attention of experts in the field of Islamic financial system

1. First is the charging of rent based on KIBOR plus a certain percentage. KIBOR is the cost of capital and not the rent of an asset. KIBOR is determined through demand and supply of capital, if the free market is in operation, or based on return offered by the government for its borrowing. While asset rent is determined based on total demand and supply of a particular asset class on rent. Rent of assets is determined independently (e.g. rent of vehicles is higher than KIBOR and rent of houses is lesser than KIBOR in Pakistan). Consequently, when rent is charged on the basis of KIBOR, economic substance of transaction disappears under Islamic financial system, however, matches with conventional banking.
2. The second is the recovery of the price of the asset through sale at the end of Ijarah term. At present asset is sold at par value which makes the transaction competitive with conventional banking. Practically certain assets lose their value and should be sold at less than par (e.g. Cars, Machines etc.), while others appreciate in their value (e.g. houses). Islamic financial system dictates to sell an asset at market value in its essence, while under present practice, the real economic substance of transaction based on risk and return is compromised.

It is interesting to note as for legal form is concerned, nothing is being violated. In both cases listed above nothing is against Shari'a law; one can charge any rent for his asset and one can sell at any price as agreed between the parties (Shari'a standard 9), however, the difference which Islamic financial system wants to create is absent.

Here we are suggesting an alternative calculation method under Ijarah. This method suggests calculation of rent on the basis of rentals of underlying asset prevailing in the market. Suppose rental of this type of car is Rs; 216,000 [18,000 per month] in the market but without transfer of ownership. It is assumed impact of any inflation on rentals shall be equally offset by the depreciation in value of car, hence, no increase in rentals. Suppose further after five years, estimated residual value of car is Rs; 875,000. As bank has promised to gift the car at the end without any consideration so the capital and return must be recovered through installments. To accelerate the payments, residual value is included in the amounts of installments hence amount of each installment becomes 391,000 [175,000+216,000]. Bank shall receive Rs; 391,000 of investment immediately hence no return for this amount. So actually investment is Rs; 1,109,000 and bank receives extra for four years amounting to Rs; 455,000 [(391,000 X 4) – 1,109,000] which is 41% of original investment and average annual return is 10.3%. Instead of receiving residual value in installments, through a changed contract asset can be sold for this price at the end of lease term.

Table II- Breakup of Rentals and Principal

End of years	Installment	Rentals	Principal	Balance
0	391,000	216,000	175,000	1,325,000
1	391,000	216,000	175,000	1,150,000
2	391,000	216,000	175,000	975,000
3	391,000	216,000	175,000	800,000
4	391,000	216,000	175,000	625,000
Total	1,955,000	1,080,000	875,000	4,875,000

Certainly amount is higher from conventional banking; actually customer is required to pay an additional amount of Rs; 156,500 (in present value terms 130,500) rounded to 100 during the lease term. Is it a cost of being Muslim as some quarters claim; and following Islamic financial system? The answer is no! a strong No! Look at the nature of contract under both systems. First is the bearing of risk level by the investor; and demanding a higher return for higher risk is well established and accepted principle of finance. IFI is bearing the total risk of ownership during the lease term and mitigates through the permissible mode of insurance on its own expenses while under the conventional leasing system risks are transferred to the customer. Second if asset demands certain overhauling IFI do not receive the rentals while under conventional system installments are required irrespective whether the asset is in repair or usage phase. IFIs should promote this philosophy among their customers that investor deserves higher return keeping in view the bearing of more risk as compared to conventional leasing. Finally monthly rental of 18,000 can be reduced to 15,400 to be competitive with conventional banking. I recommend the second method to be used in the calculation of rentals, under Ijarah, by IFIs.

13.3.5. Murabaha Financing

Murabaha is a sales contract whereby the cost of goods sold is disclosed to the buyer. In its original form as a contract of sales, it has nothing to do with credit provision or financing facilitation. However given the matching feature of Murabaha with conventional banking, its application is largest in the financing and investment portfolios of IFIs working in Pakistan. In fact during Sept. 2006 to Sept. 2010, the share of Murabaha financing was slightly above 40% in financing and investment portfolios of Islamic banking industry in Pakistan (Hanif, 2011). Any customer comes for any business need; preference is given to Murabaha contract if applicable. The procedure is very simple and makes the job of bankers easier. Whatever price of a product exists in the market, Islamic banks are adding the KIBOR rate as profit margin based on the length of credit. To make the concept clear following example would be helpful. A person needs a Laptop for his

son studying at a local University. Market price is Rs; 50,000/- and KIBOR rate is 10%. Customer needs financing for 1 year. Working is presented as under. If customer pays in single installment at completion of one year then his financial liability is amounting to Rs; 55,000/- if he pays in two semiannual installments he is required to pay two installments of Rs; 26,890/- with a total financial obligation of Rs; 53,780/- which is less than yearly payment equal to Rs; 1,220/- Likewise if he makes payment in four quarterly installments then amount of each installment becomes Rs;13,291/- with total financial obligation of Rs; 53,164/- which is lesser in amount under annual and semiannual payment plan equal to Rs;1,836/- and Rs; 617/- respectively. If customer opts for monthly installment then amount of an installment becomes Rs; 4,396/- with total financial obligation of contract amounting to Rs; 52,750/- which is less than annual, semiannual and quarterly installment equal to Rs; 2,250/-; Rs; 1,031/- and Rs; 414/- respectively.

Shari'a risk in such a contract is indulging in the time value of money. As per Murabaha sale, one can charge any profit rate as agreed with buyer including KIBOR and KIBOR plus. Likewise, one can agree to any payment plan including spot, credit, single payment, semi-annual plan, quarterly plan, monthly plan or any other. However, one cannot increase or decrease amount receivable on the basis of early or delayed payment which is being violated in practice. At ten percent profit rate price of the computer becomes Rs; 55,000 irrespective of any payment plan. However as we saw price varies according to receivable schedule. For single payment at the end it is Rs; 55,000/- for semiannual installments it is Rs; 53,780/- for quarterly installments it is Rs; 53,164/- and finally under monthly payment plan it is Rs; 52,750/-. What is a justification for four different amounts to be recovered from customer except time value of money? Under this principle of determination of financial rights and obligations if payment plan extends to more than a year then price would be higher than Rs; 55,000/-

As for legal status of contract is concerned, nothing wrong with it and IFIs have the right to negotiate any price (Ayub, 2007, p.218, Shari'a standard 8), however, economic substance is suffered. Under sales contract essence is to charge profit irrespective of payment plan. Islamic finance discourages time value of money while charging different profit based on a payment plan and length of the period,

brings back time value in the transaction resulting in matching economic substance with conventional banking.

What is the way out? As a matter of principle time value should be given up, however, this will turn operations uncompetitive with conventional banks. The important question is the decision-making process of customers of IFIs. In-depth studies are required to answer the question. Very limited studies available so far on the subject, have concluded that customers of IFIs are doing business with these banks assuming Shari'a compliance in their operations. A chief motivating factor to choose an Islamic bank is the avoidance of interest and Shari'a compliance. [Bley, et. al. 2004; Haque, et.al. 2009; Hanif, et. al. 2012]. If this is true then leaving time value concept should not be difficult for Islamic financing industry. IFIs should charge a single price irrespective of payment plan. E.g single price should be negotiated with the customer for one year credit and the customer should be given the flexibility to discharge obligation within one year as per his/r convenience.

13.4. Conclusion

Islamic Banking has shown tremendous growth in last ten years in global as well as in the local market. It is the result of a dream to replace conventional banking based on interest prohibited in all known revealed religions including Judaism, Christianity and Islam. In order to avoid interest charging Islamic banks transact business through sale/purchase (Murabaha, Muajjal, Salam, Istisna'a), Leasing (Ijarah) and profit and loss sharing (Musharaka, Mudaraba, PTC, TFC, Sukuk). Cash loan facility is not available in the present framework of Islamic banking. This chapter has elaborated five options including Time Multiple Counter Loans (TMLC), Normal Rate of Return (NRR), Inflation Based Loan Indexation (IBLI), Overhead charges on loans and educational loans to present a workable solution for cash financing by Islamic banks.

Although these cash loans modes of financing are feasible in operations of IFIs [subject to approval of IFA, Jeddah, and Shari'a Board of practicing IFIs] but should be used in special circumstances where none of the trading, rental and

equity-based modes of financing is applicable and should not be misapplied to open back door for interest. Cash loan facility is essential to cater for total needs of an economy if Islamic financial system is aimed at replacing and complete elimination of interest based conventional banking from an economy. Application of cash loan financing will help in meeting financial needs of working capital of firms, cash needs of nonprofit organizations, personal cash needs of individuals for education, travel, health and social ceremonies. It is expected that issue of cash loans shall receive due consideration from Shari'a experts, IFA- Jeddah, regulators, Standard setting bodies and Shari'a boards of IFIs.

As for economic substance is concerned that is although different from conventional finance being asset based financing, however, linkage of cost and revenue with conventional financial industry (instead of market returns of each sector) has minimized the gap between conventional and Islamic financial systems. It is recommended that Islamic finance industry should move towards market returns of every sector. In order to achieve this Islamic finance industry collectively develop a framework to determine different profit rates based on the market for different investments including housing, leasing and trade. This will although make the operations noncompetitive with conventional finance; however this will help is generating positive perception in the market.

Issues are very tough and demand extraordinary wisdom and skill from academia as well as industry to come up with solutions through innovation and financial engineering. One can expect a shift towards market-based returns (instead of interbank offered rate) by Islamic finance industry with the passage of time and increased share in assets of the underlying market.

13.5. Questions

1. Explain the importance of cash financing in modern business settings
2. What are disadvantages to Islamic Banking for not having cash financing facilities?
3. What is time multiple counter loan [TMCL]? Explain in detail, how it works?

4. Explain NRR based loan scheme and overhead based loan scheme. How they are different from each other?

5. Mr. Alam khan is a local textile owner engaged in the production of bed sheets exported to the Far East and Europe. At present facing liquidity crisis due to delay in payments by purchasers abroad and needs cash financing of 20 million immediately. It is expected liquidity of business would be normal within next Six months after payment of the loan. Mr. Khan has nothing to deposit as counter loan and entered into a contract of TMLC with a local Islamic bank. Whatever is to be deposited with the bank under TMLC, is required to be included in loan amount as an addition to 20 million.

- What would be loan amount sanctioned if the customer is required to deposit 2 million for required period computed on Dailey product basis?
- What would be the amount of counter loan if the equating term is 10 years?
- What would be the equating term if the counter loan is 5 million?
- If KIBOR is 10% and it is expected to increase by 50 BPs every year for next ten years and IFI has an opportunity to invest in Sukuk Al-Ijarah for 10 years at a stable rate of 15% per annum, what is profit position of IFI, assuming loan issued to customer is 25 million for six months and counter loan/deposit is of 5 million for required period based upon daily product?
- Keeping in view the information in the previous requirement, calculate NPV assuming discount rate of 7%

Suggested Readings

- CII-1980. Council of Islamic Ideology (Pakistan) Report on “Elimination of Riba from the economy and Islamic modes of financing”
- SBP-State Bank of Pakistan. Islamic Banking Bulletins 2007-2013.

Glossary

Bai Muajjal: Sale on credit
Balance sheet: A statement showing financial position at a particular point in time
Cash flow statement: A statement disclosing cumulative cash inflows and outflows for a particular period
Dailey product: A mechanism where two different amounts with different duration can be equated on daily basis
Diminishing Musharaka: Diminishing Musharaka is a form of declining partnership between IFI and client generally used to finance real estates.
Hadith: Saying and/or action of Prophet Muhammad (PBUH).
Income statement: A statement showing result of business for a particular period
Ijarah: Ijarah (Leasing) is a rental contract whereby IFI leases an asset for a specific rent and period to the client. Ownership risks of the asset are borne by IFI
Ijarah wa Iqtana: Ending Ijarah contract in the transfer of ownership of asset at the completion of the lease term.
Ijma'a'a: Consensus opinion of jurists in Islamic law
Istisna'a: Istisna'a is a sale agreement whereby buyer places an order with the manufacturer to manufacture specified commodities for a price agreed within specified period of time.
Muajjal: Literal meaning of Bai Muajjal is deferred / credit sales.
Mudaraba: Mudaraba is a type of partnership whereby skill and money brought together to conduct business.
Murabaha: Murabaha is a cost-plus profit sale contract whereby disclosure of cost to the buyer is necessary.
Musharaka: Musharaka means a joint enterprise formed to conduct a business in which all partners share the profit according to pre-agreed ratio while the loss is shared according to the ratio of contribution.

Qiyas: Individual opinion of a jurist
Qura'n: Revealed book of Islam
Riba: Interest and usury; any predetermined increase in a transaction of loan.
Salam: Bai Salam is a form of sale contract whereby IFIs purchase goods for spot payment with deferred delivery.
Shirka: Partnership
Shirkat ul Aqad: Partnership by contract
Shirkat ul Milk: Partnership in ownership
Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets.
TMLC: Time multiple counter loans whereby one can get a larger amount for a short period in exchange for shorter amount for the large period.

Appendixes

1. **Establishment of an Islamic Bank**
2. **Establishment of standalone branches**
3. **Establishment of subsidiary by a conventional bank**
4. **Shari'a Advisor**

Appendix.1.

Establishment of an Islamic Bank

Annexure-I to IBD Circular No. 02 of 2004

DETAILED CRITERIA FOR SETTING UP OF SCHEDULED ISLAMIC COMMERCIAL BANK
BASED ON PRINCIPLES OF SHARI'A IN THE PRIVATE SECTOR

The State Bank of Pakistan has issued detailed criteria for the setting of Scheduled Islamic Commercial Bank for conducting business based on the principles of Shari'a in the private sector. Those interested in establishing the Scheduled Islamic Commercial Bank have been asked to apply to the Director, Islamic Banking Department, State Bank of Pakistan, P.O. Box No. 4456, I.I. Chundrigar Road, Karachi. Applications may be made giving details with supporting documents, forms for which can be obtained from the State Bank. Applications, which are not complete in all respects, shall not be considered. The following will be the broad criteria for consideration of setting up of the Scheduled Islamic Commercial Bank:-

i) The proposed bank would be a Public Limited Company and would be listed on the Stock Exchange. A minimum of 50% of shares shall be offered to the general public.

ii) All financial transactions will be in accordance with the injunctions of "SHARI'A".

iii) The application shall indicate the modes of finance proposed to be used for raising resources and extending financial assistance.

iv) The applicant will also indicate expertise and other facilities available to them for ensuring compliance of their banking business with Shari'a.

v) To be able to commence business the bank shall have a minimum paid-up capital of Rs 1000 million and also shall at all times maintain minimum capital adequacy Ratio of 8% based on risk-weighted assets.

vi) At least 15% of the total paid up capital shall be subscribed personally by the Sponsor Directors. The number of Sponsor Directors shall not be less than seven. The amount proposed to be subscribed by each sponsor Director is required to be indicated.

vii) Sponsor Directors should have to declare personal Net Worth, which should not be less than the amount to be subscribed by them personally. The Net Worth of each sponsor Director is required to be indicated and supported by a duly authenticated copy of the latest Wealth Statement filed with the taxation Department. In the case of sponsor Directors resident in countries where filing of Wealth statement is not a requirement of law, a certificate of personal Net Worth and general reputation issued by an international bank of repute would be acceptable. This facility would also be available to applicants
who have recently returned to Pakistan.

viii) Sponsor Director(s) subscribing more than 5% of the total paid up capital shall clearly indicate their request separately. However such request should commensurate with his net worth.

ix) Sponsor Directors shall not dispose of their shares in any manner whatsoever for a minimum period of 3 years and thereafter only with the specific written approval of the State Bank.

x) Foreign investment by sponsor Directors shall be permissible only on the basis of capital being non-repatriable, but dividends will be remittable abroad.

xi) Application shall stand disqualified if any of the sponsors and/or Directors their spouses or firms:-

a) has been convicted by a Court of law in Pakistan or abroad for a criminal offence.

b) has been associated with any illegal activity especially banking business, deposit taking, financial dealings and other business;

c) has failed to meet his or her obligations to banks and other financial institutions. They shall furnish names of the banks/DFIs alongwith the names of the branches with which they have had dealings. Bank reports are also required to be submitted;

d) has defaulted in payment of taxes. They shall indicate their National Tax Numbers;

e) is or has been associated as Director/Chief Executive with the Corporate Bodies whose corporate and tax record including customs duties, central excise and sales tax has been unsatisfactory. They shall name the corporate bodies, their bankers and disclose their tax numbers and dividend record. Those not so associated with Corporate Bodies would be required to indicate their occupation/profession/trade and highlight their achievements;

f) in the opinion of the sanctioning authority enjoys adverse reputation regarding integrity and performance.

xii) Neither one person can be a Director in more than one financial institution nor one group should have more than one bank.

xiii) Not more than 25% of the sponsor Directors shall be from the same family as defined in Section 5(ff) of the Banking Companies Ordinance.

xiv) The Chief Executive would be a professional with no adverse information regarding his integrity and performance and shall require prior clearance of State Bank of Pakistan.

2. The applicant will also submit the following documents along with the request:-

i) Feasibility Study for setting up of Bank including Organization structure and the name of the proposed Chief Executive.

ii) Short Term and Long term Business Plan.

iii) Risk management guidelines, Plans for Internal control system and scale of authority

iv) Working system and procedures for business operations

v) List of companies / firms and their bankers in which sponsor directors and their family members as defined in Section 5(ff) of Banking Companies Ordinance, are interested as Directors, Chief Executive, Partner, Proprietor, or major shareholders holding 5% or more shares

vi) Certificate that a Shari'ah Advisor has been appointed in the light of SBP Shari'ah Board's "Fit and Proper Criteria" and the approval of SBP. However,

Islamic Banks are free to appoint a Shari'ah Committee at their own discretion and not as part of SBP regulation.

3. The bank which may be permitted to be established, shall be subject to the prevalent banking and other laws, rules and directives issued by SBP from time to time.

4. The Bank must commence operation within six months of the grant of permission. They must open at least five branches within a period of twelve months from the date of permission.

5. The applicant shall deposit Rs 4,000,000/- (Rupees four million) along with the application as processing fee. The fee so deposited shall be non-refundable.

6. Incomplete application shall be returned and processing fee retained. Re-submission would attract fresh fee.

Appendix.2.

Establishment of Standalone Islamic Banking Branches

Annexure-III to IBD Circular No. 02 of 2004
GUIDELINES FOR OPENING OF STAND ALONE BRANCHES
FOR ISLAMIC BANKING BY EXISTING BANKS

With the objective of promoting Islamic banking in Pakistan, the following Guidelines for opening of Stand-alone branches for Islamic Banking by existing commercial banks have been prepared by State Bank of Pakistan. The banks desirous of offering Shari'ah compliant products and services are required to apply to the State Bank for issuance of a license under these Guidelines.

1. Definitions

The following terms, as used in these Guidelines, shall have the following meanings:-

i) "banks" means commercial banks, including branches of foreign banks operating in Pakistan**,** which desire to offer Shari'ah compliant products and services;

ii) "IBB" or "branch" means the Islamic Banking Branches of commercial banks, which offer the Shari'ah compliant products and services only;

iii) "Shari'ah compliant products and services" means banking products and services offered by banks to their clients duly approved by their Shari'ah adviser/Shari'ah Supervisory Committee;

iv) "IBF" means the Islamic Banking Fund set up by the banks to fund the operations of their Islamic Banking Branches;

v) "IBD" means the Islamic Banking Division set up at the head office of the banks/ country offices in Pakistan to administer, supervise and regulate all matters pertaining to IBB**.**

vi) "deposit" means deposits mobilized under section 26A of the Banking Companies Ordinance, 1962.

LICENSING REQUIREMENTS FOR ISLAMIC BANKING BRANCH(ES)

2. Eligibility Criteria

The eligibility of a bank to open Islamic banking branch(es) shall be considered by the State Bank keeping in view, among others, the financial strength of the bank as evident from its capital base(net capital free of actual and potential losses), adequacy of its capital structure, record of earning capabilities, future earning prospects of the bank, managerial capabilities, bank's liquidity position, track record of the bank's adherence to prudential regulations, credit discipline, quality of customer services and the convenience and the needs of the population of the area to be served by the proposed branch. In addition, the following considerations will also be taken in the grant of the license:-

(i) Banks having CAMELS rating of 1, 2 and 3 in the last ON-SITE inspection shall be eligible for opening Islamic Banking Branches.

(ii) There should not be major adverse inspection findings against the bank.

(iii) The bank shall identify experienced and trained key staff to handle the IBB operations.

3. Working Paper/Proposal

The applying bank is required to submit a proposal to the Islamic Banking Department of the State Bank of Pakistan, outlining the following details:-

i) Number of branches alongwith name of city where the IBB is to be offered within the next financial year.

ii) Products and services to be offered by the IBB including deposits, financing, investment, etc.

iii) Method of segregating the funds of IBB from the funds of commercial banking of the applying bank.

iv) Infrastructure and logistic requirements, including manpower and training programs.

v) The name, qualification and experience of Shari'ah Adviser(s).

vi) Accounting aspects, such as accounting policies to be followed, profit and loss sharing mechanism, etc.

The banks will be required to submit such further information as required by State Bank while processing the case.

4. Issuance of License

i) State Bank will evaluate the proposal of the bank keeping in view merits of the case and upon its satisfaction, will grant an approval in principle to the bank for opening of branch(es) upon such terms and conditions as it deems fit. However, license for individual branch opening shall be issued on receipt of formal application on prescribed format under the provisions of Section 28 of the Banking Companies Ordinance, 1962 (Application Form). This will be issued when requirements of para 5 hereof are complied with and evidence is provided that adequate security arrangements have been provided at the proposed place of business and the Town Planning Regulations are not violated.

ii) In subsequent years, if the bank wishes to open more branches, the bank shall submit to State Bank of Pakistan for approval, an Annual Islamic Banking Branch Expansion Plan (the Plan) at least 30 days before the commencement of each calendar year (January-December) during which it plans to open branches. The plan would, inter alia, indicate the number of the new branches proposed to be opened in urban and rural areas, location of each of the proposed branch and the area which it would serve, branches proposed to be closed (if any), the number of existing branches incurring losses consecutively for the last three years, arrangements for managerial and other staff members and information technology access and linkage for the proposed branches and arrangements for housing each of the proposed branch. State Bank will consider the Plan for new branches keeping in view the need of the system and grant approval in principle for number of new branch(es) that bank will be allowed to open during the given calendar year within 30 days from the date of receipt of the Plan complete in all respect. The approval in principle granted under a particular Plan shall lapse in case bank fails to submit a formal application for issuance of

license at least 30 days before the expiry of that particular year. Similarly license issued under the respective Plan shall expire where a bank fails to open the branch before 31st December of that year.

iii) Request for a new branch in Azad Kashmir will have to be supported by the AJ&K Government.

iv) The branch(es) shall be subject to the prevalent banking and other laws, rules and directives issued by SBP from time to time.

v) Banks will be free to shift or reallocate their branches within the same city/town/village without prior approval of State Bank. Intimation of shifting of a branch will be sent by the bank concerned to the State Bank within 15 days from the date of its shifting on prescribed performa (Annexure 'A').

vi) The license may be revoked in case it subsequently transpires that the bank had made material misrepresentation of facts or concealment of material information and the responsible official(s) shall personally be liable for action under the relevant laws.

5. Commencement of Business

Before commencement of business, the bank will ensure that all the Documents and agreements pertaining to each type of products and services alongwith Risk management guidelines, Plans for Internal control and Information Technology systems are in place. All relevant documents/agreements and guidelines should be duly certified by their Shari'ah Adviser/Committee and a certificate in this regard will be submitted to the State Bank alongwith the Application Form. All these documents should be made readily available to the SBP Inspection Team during inspection of the bank.

6. Islamic Banking Division

(i) The bank will be required to set up an Islamic Banking Division ("IBD") at the Head Office/Country Office in Pakistan.

(ii) The bank will submit the organizational structure of the IBD alongwith details of key persons of the division (qualification and years and type of experience) to Islamic Banking Department of the State Bank of Pakistan alongwith the Application Form.

(iii) The responsibilities of the IBD shall be as follows:-

(a) To manage and be responsible for the operations of IBB(s), including policy and procedural matters;
(b) To liaise with other departments in the bank and Shari'ah Adviser/Committee to ensure smooth operations of IBB(s);
(c) To ensure that all funds pooled into the IBF are channeled into Shari'ah compliant financing and investment activities;
(d) To arrange training of staff on Islamic banking;
(e) To arrange for compilation and submission of such returns, as may be required to be submitted to State Bank from time to time;
(f) To ensure that all directives and guidelines, particularly those applicable to Islamic banking, issued by State Bank are strictly complied with;
(g) To maintain the Statutory Cash Reserve and Liquidity Requirement with State Bank as prescribed by State Bank from time to time.
(h) Other roles and responsibilities as determined by the bank or State Bank form time to time.
(iv) The IBD shall be headed by a senior and experienced officer directly reporting to the Chief Executive (in case of foreign banks, the Country Manager) and manned by qualified staff.

7. Islamic Banking Fund

(i) The bank shall be required to maintain a minimum fund of Rs 50 million or 8% of the risk weighted assets of IBB(s), whichever is higher.
(ii) The IBF shall be funded by way of an allocation by the head office of the bank or in case of foreign bank, its country office.
(iii) The IBF shall be placed under the control of IBD to fund the operations of the IBB(s).

8. Physical set-up

Every licensed branch of a bank shall carry a name, and shall invariably be required to prominently display the name of the branch as stipulated in the license.

9. Shari'ah Compliance

A Shari'ah Advisor has to be appointed in the light of SBP Shari'ah Board's "Fit and Proper Criteria" and the approval of SBP. However, Banks are free to appoint a Shari'ah Committee at their own discretion and not as part of SBP regulation.

10. Systems and Control

The bank shall ensure that proper systems and controls are in place in order to ensure segregation of funds and protect the interest of depositors, including but not limited to the followings:-

i) The bank shall be required to prepare procedure manuals for the IBD and IBB operations duly approved by their Shari'ah Adviser/Shari'ah Supervisory Committee as well as the Board of Directors or in case of branches of foreign banks operating in Pakistan, by their Head Office.

ii) The bank shall prepare a full set of documents pertaining to the deposit, investment and financing products pertaining to IBB operations.

iii) The full set of the documents duly vetted by their Shari'ah Adviser/Shari'ah Supervisory Committee shall be maintained by the IBD. Similarly, all documents in respect of new schemes offered by IBB(s) shall also be prepared and maintained by IBD before launching of the scheme.

iv) All documents (including ledgers, registers, pay-in-slips, cheques, receipts, passbooks, etc.) used in the IBD and IBB(s) shall be appropriately marked, so as to easily distinguish them from the documents pertaining to commercial banking.

v) In order to efficiently utilize the existing branch network, the bank may authorize some of its branches to sell the Islamic banking deposit schemes. However, in such cases proper systems and control should be in place to ensure that the fund transfer takes place on the same day to/from the IBB. The authorized branches shall not, in any manner whatsoever, receive/pay interest on such services. The authorized branches may charge a reasonable fee/commission on sale of such deposit schemes under a policy to be approved by the Board of Directors or in case of branches of foreign banks, their Head Office. Proper training in Is-

lamic banking should also be provided to the staff of authorized branches dealing with such deposit schemes.

vi) The bank shall be required to undertake comprehensive internal audit including internal Shari'ah Review on the operations of the IBB(s) and IBF at least once in a year.

11. Accounting Records and Disclosure

(i) The banks shall keep separate book of accounts in respect of Islamic banking operations and ensure proper maintenance of records for all transactions for segregation of funds.

(ii) The banks shall prepare a separate daily trial balance of the operations arising from the IBB(s).

(iii) Based on the balances of all the items (assets, liabilities, expenses and income) relating to the operations of the IBD/IBB(s), the bank shall prepare and submit separate annual as well as quarterly financial statements for its IBB operations alongwith its periodical financial statements on the format prescribed by State Bank from time to time.

12. Statutory Liquidity and Cash Reserve Requirements

In order to maintain the Statutory Cash Reserve and Liquidity requirement in respect of IBB operations, the IBD will open a separate current account with State Bank. In this account, IBD will maintain the Cash Reserve with State Bank in the manner prescribed for commercial banks (at present @ 5% of time and demand liabilities). For Statutory Liquidity Requirement (SLR), till the development of Shari'ah compliant approved securities, they will for the present, maintain an additional cash amount equivalent to 6% of their TDL in the same current account with State Bank in lieu of SLR (i.e., 40% of 15% SLR at present). Therefore, in all, IBD will maintain 11% of time and demand liabilities (TDL) of the Islamic banking branches in this current account with State Bank on weekly average basis and 10% of TDL on daily basis in lieu of CRR and SLR for IBB operations of the bank.

13. Reporting to State Bank

i) In the Weekly Statement of Position submitted to the State Bank, the banks shall submit separately the position of IBB operations.

ii) The banks shall also be required to submit such other statements regarding their Islamic banking operations as prescribed from time to time.

14. Processing Fee

A processing fee @ Rs. 25,000/- per branch applied in the Proposal/Plan has been fixed. The banks while submitting the Proposal/Plan shall invariably enclose a cheque in the name of State Bank of Pakistan as processing fee. The Proposal/Plan without the amount of processing fee shall not be entertained. The processing fee will be non-refundable.

ANNEXURE-A

PARTICULARS OF THE ISLAMIC BANKING BRANCH SHIFTED

1. Name of the Bank _____
2. Name of the Branch shifted _____
3. Licence No._____ Dated_____
4. Premises from which shifted_____
5. Exact location of the premises to which shifted_____
6. Distance between the old and new branch/booth premises _____
7. Date of shifting_____
8. Reasons necessitating the shifting (in detail)

_____

_____

_____

9. Working results of the branch/booth at the old place, i.e. deposits advances and profit & loss accounts or the last three financial years
10. No of Accounts (category-wise) as at the end of last financial year and on the date of shifting.

11. Distance (in meters/kilo meters) of the old premises with nearest branches of other banks. S. No. Name of Bank Name of Branch Distance

12. Distance (in meters/kilo meters) of the new premises from the nearest branches of other banks. S. No. Name of Bank Name of Branch Distance

12. Certified that location of new premises does not violate the Town Planning Regulations of the concerned authority.

13. Certificate from the **competent authorities** that both the existing and proposed premises are: (a) within the same locality (in case of branches at banked places including big cities); (b) within the same territorial limits of the same village (in case of branches at un-banked places).

_____ _____

(Signature of Officer Incharge of the Branch with date)

(Counter Signature of an Officer not below the rank of
Sr. Vice President of the Head Office or equivalent with date)

Appendix.3.

Establishment of Islamic Banking Subsidiary by conventional Banks

Annexure-II to IBD Circular No. 02 of 2004

DETAILED CRITERIA FOR SETTING UP OF ISLAMIC BANKING SUBSIDIARIES BY EXISTING COMMERCIAL BANKS

In order to promote Islamic banking in Pakistan, inter alia, a new clause (aa) has been now inserted in sub-section (1) of section 23 of the Banking Companies Ordinance, 1962, in terms of Banking Companies (Amendment) Ordinance, 2002 notified in the Gazette of Pakistan dated November 4, 2002, as follows:

"(aa) the carrying on of banking business strictly in conformity with the Injunctions of Islam as laid down in the Holy Quran and Sunnah".

2. The existing scheduled commercial banks are therefore now also allowed to open subsidiaries for Islamic Banking operations. The banks interested in establishing a subsidiary for Islamic banking ("subsidiary") may apply to the Director, Islamic Banking Department, State Bank of Pakistan, Post Box No. 4456, I.I. Chundrigar Road, Karachi. Applications may be made giving details with supporting documents, forms for which can be obtained from the State Bank. Applications, which are not complete in all respects, shall not be considered.

3. The following shall be the broad criteria for setting up of a subsidiary, of the existing scheduled commercial banks, for Islamic banking:-

i) The proposed subsidiary would be a Public Limited Company and would be listed on the Stock Exchange. A maximum of 49% of shares shall be offered to the general public.

ii) The subsidiary may be granted a license under section 27 of the Banking Companies Ordinance, 1962 to conduct the banking business strictly in accordance with Shari'a and would be considered as a Scheduled Islamic Commercial Bank.

iii) All financial transactions of the subsidiary will be in accordance with the injunctions of "SHARI'A".
iv) The application shall indicate the modes of finance proposed to be used for raising resources and extending financial facilities.
v) The applicant(s) will also indicate expertise and other facilities available with them for ensuring compliance of their banking business with Shari'a.
vi) To be able to commence business, the subsidiary shall have a minimum paid up capital of Rs 1,000 million and also shall at all times maintain minimum capital adequacy Ratio of 8% based on risk weighted assets.
vii) At least 51% of the total paid up capital shall be subscribed by the banking company(ies).
viii) Banks meeting the Capital Adequacy guidelines issued by State Bank and having CAMELS rating of 1, 2 and 3 during the last three years ON-SITE inspection shall be eligible for opening the subsidiary.
ix) Banking company(ies) shall not dispose of their shares in any manner whatsoever for a minimum period of 3 years and thereafter only with the specific written approval of the State Bank.
x) Application shall stand disqualified if any of the sponsors and/or Directors, their spouses or firms:-
a) has been convicted by a Court of law in Pakistan or abroad for a criminal offence.
b) has been associated with any illegal activity especially banking business, deposit taking, financial dealings and other business;
c) has failed to meet his or her obligations to banks and other financial institutions. They shall furnish names of the banks/DFIs alongwith the names of the branches with which they have had dealings. Bank reports are also required to be submitted;
d) has defaulted in payment of taxes. They shall indicate their National Tax Numbers;
e) is or has been associated as Director/Chief Executive with the Corporate Bodies whose corporate and tax record including customs duties, central excise and sales tax has been unsatisfactory. They shall name the corporate bodies, their

bankers and disclose their tax numbers and dividend record. Those not so associated with Corporate Bodies would be required to indicate their occupation/profession/trade and highlight their achievements;

f) in the opinion of the sanctioning authority enjoys adverse reputation regarding integrity and performance.

xi) Every Director of the subsidiary shall meet the Fit and Proper Test prescribed by SBP and would require prior clearance from State Bank of Pakistan.

xii) One person cannot be a Director in more than one bank/financial institution.

xiii) Not more than 25% of the Directors shall be from the same family as defined in Section 5(ff) of the Banking Companies Ordinance.

xiv) The Chief Executive would be a professional fulfilling the conditions stipulated in the Fit and Proper Test issued by State Bank and shall require prior clearance of State Bank of Pakistan.

4. The applicant(s) will also submit the following documents along with the request:-

i) Feasibility Study for setting up of Subsidiary including Organization structure and the name of the proposed Chief Executive.

ii) Short Term and Long term Business Plan.

iii) Risk management guidelines, plans for Internal control system and delegated approval authorities

iv) Working system and procedures for business operations

v) List of companies / firms and their bankers in which the banking company(ies), sponsor directors and their family members as defined in Section 5(ff) of Banking Companies Ordinance, are interested as Directors, Chief Executive, Partner, Proprietor, or major shareholders holding 5% or more shares

vi) Certificate that a Shari'ah Advisor has been appointed in the light of SBP Shari'ah Board's "Fit and Proper Criteria" and the approval of SBP. However, Islamic Banking Subsidiaries are free to appoint a Shari'ah Committee at their own discretion and not as part of SBP regulation.

5. The subsidiary, which may be permitted to be established, shall be subject to the prevalent banking and other laws, rules and directives issued by SBP from time to time.

6. The subsidiary must commence operation within six months of the grant of permission.
7. The applicant(s) shall deposit Rs. 1 million (Rupees One million only) along with the application as processing fee. The fee so deposited shall be non-refundable.
8. Incomplete application shall be returned and processing fee retained. Re-submission would attract fresh fee.

Appendix.4

Shari'a Advisor

Annexure-IV to IBD Circular No. 02 of 2004
ISLAMIC BANKING DEPARTMENT
STATE BANK OF PAKISTAN
FIT & PROPER CRITERIA FOR APPOINTMENT OF SHARI'AH ADVISORS

1. MINIMUM QUALIFICATION AND EXPERIENCE

a. The Shari'ah Advisor must have an experience of at least 5 years giving religious rulings.

b. He should have knowledge of or at-least be familiar with the banking industry.

c. Minimum qualification is Dars-e-Nizami. Higher education like M.A. Islamiat, economics or in the discipline of banking and finance may be an added qualification.

d. Relaxation in number of years of experience may be considered in case of experience as teacher of Islamic Fiqh in a reputable institution other than banking institutions, for a period of not less than three years with a proven track record.

2. TRACK RECORD

a. The Shari'ah Advisor must have an impeccable track record in the companies he/she has served either in the capacity of an employee or director/chief executive or as chairman.

b. Has not been terminated or dismissed in the capacity of employee, director/chairman of a company.

3. SOLVENCY & FINANCIAL INTEGRITY

a. Has not been associated with any illegal activity especially relating to banking business.

b. Has not been in default of payment of dues owed to any financial institution and/or default in payment of any taxes individual capacity or as proprietary concern or any partnership firm or in any private unlisted and listed company.
c. Has sufficient means to discharge his/her financial obligations.

4. INTEGRITY, HONESTY AND REPUTATION

a. Has not been convicted in any criminal offence, involved in any fraud/forgery, financial crime etc.
b. Has not been subject to any adverse findings or any settlement in civil/criminal proceedings particularly with regard to investments, financial/business, misconduct, fraud, formation or management of a corporate body etc.
c. Has not contravened any of the requirements and standards of regulatory system or the equivalent standards of requirements of other regulatory authorities.
d. Has not been involved with a company or firm or other organization that has been refused registration/licence to carry out trade, business etc.
e. Has not been involved with a company/firm whose registration/license has been revoked or cancelled or gone into liquidation.
f. Has not been debarred for giving religious rulings by any religious institution/body.

5. CONFLICT OF INTEREST

a. Is not a Shari'ah Advisor of any other financial institution. The term financial institution will include any bank, investment finance company, non-banking finance company, venture capital company, housing finance company, leasing company or modaraba company.
b. The conflict of interest shall not apply if a Shari'ah Advisor is nominated by the SBP in its own Shari'ah Board.

FORM-SAP

SHARI'AH ADVISORS PARTICULARS TO BE SUBMITTED BY THE BANK

PHOTO

2 x2 1/2

1. FULL NAME_____

2. FATHER'S NAME _____

3. DATE & PLACE OF BIRTH _____

4. RELIGION _____

5. N.I.C. NUMBER _____ N.T.N. _____

6. EDUCATION _____

7. PRESENT JOB/STATUS AND OFFICAL ADDRESS_____

8. TELEPHONE NUMBERS _____

9. IF SHARI'AH ADVISOR HAS CHANGED HIS NAME, STATE PREVIOUS NAME AND REASONS FOR THE CHANGE

_____

_____

10. APPOINTMENTS HELD DURING THE LAST FIVE YEARS (WITH DATES)

_____

11. NAME(S) & DESIGNATION(S) OF THE DIRECT SUPERVISOR (ONE GRADE UP) UNDER WHOM SHARI'AH ADVISOR HAS SERVED DURING THE LAST FIVE YEARS

_____

12. DATE WHEN THE SHARI'AH ADVISOR LAST FILLED IN A SECURITY VETTING FORM AND THE NAME OF THE DEPARTMENT FOR WHOM FILLED.

_____

13. PRESENT RESIDENTIAL ADDRESS IN FULL _____

14. PERMANENT RESIDENTIAL ADDRESS IN FULL_____

15. NAMES & ADDRESSES OF THREE RESPECTABLE PERSONS (NOT RELATIVES) WHO

HAVE BEEN CLOSELY ACQUAINTED WITH THE SHARI'AH ADVISOR DURING THE LAST FIVE YEARS.

_____

Signature of concerned official _____

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