YOUR BRIEF GUIDE TO

ISLAMIC FINANCE

FIRST EDITION

MUFTI ISMAIL DESAI

TAIF

TRAINING & AWARENESS OF

ISLAMIC FINANCE

بسم الله الرحمن الرحيم

Your Brief Guide to Islamic Finance

First Edition

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Forward: Respected Mufti Muhammed Sa’eed Motara (Chief Mufti and Sheikh al-Hadeeth of The Islamic University, Azaadville, South Africa)

In the Name of Allah, Most Beneficent, Most Merciful

All Praises are due to Allah alone and may Durood and Salaam descend upon the Seal of the prophets,

Nabi Muhammed sallallahu alaihi wa sallam and also upon his household and

all his noble and illustrious companions.

The duty of earning a Halaal and Islamically wholesome livelihood in accordance with the directives of Shari’ah is an integral part of every Muslim’s day to day activity. Sadly, this is a duty that is generally neglected and especially when a person is not endowed with *Taqwa* and is not conscious of the fact that Allah Ta’aala is monitoring his every activity, he relaxes in his comfort zone, remains unperturbed about how he conducts his business and does not scrutinize his methodology of earning livelihood, as long as he continues to fill his coffers and to inflate his bank balance. Rasulullah sallallahu alaihi wasallam has warned in a Hadeeth that no person will be able to move from his place on the Day of Qiyamah until he answers five pertinent questions, amongst them the question that where did he earn his income from and how did he spend it? A person will only be able to answer this question correctly if his methodology of trade and earning livelihood was in compliance with the Qur’aan and Sunnah. If his trading is done in accordance with the commands of Allah and His Rasul sallallahu alihi wasallam, then he will be recorded as an honest trader who will be blessed with amazing accolades on the Day of Qiyamah. In a Hadeeth, Rasulullah sallallahu alaihi wasallam has given glad tidings that an honest and trustworthy businessman will be resurrected on the Day of Qiyamah in the august company of the Prophets, truthful servants and martyrs. These are indeed extraordinary accolades to be bestowed with. The booklet that you, Oh reader, are holding in your hand is a work that will, Insha-Allah go a long way in guiding you to reach that sought-after goal of being honest and trustworthy in the field of Trade and Commerce.

Alhamdulillah, I had the opportunity of perusing through the manuscript of this booklet which is entitled “Your Brief Guide to Islamic Finance” penned by a budding and talented young Aalim, Mufti Ismail bin Mufti Ebrahim Desai Saheb (hafizahullah; wa- sallamahu minal aafaat wal fitan). It is really heart-warming and enlightening to notice young Ulema of this calibre doing academic research in various departments of Deen and then penning down their observations and conclusions for the benefit of the Ummah at large. The author has endeavoured to bring to the attention of the reader the different types of mechanisms that Shari'ah has set in place that can be profitable for a Muslim businessman whilst remaining within the permissible parameters of Shari'ah. He has simplified complex Islamic business terminologies by citing examples so that it becomes easier for the reader to understand the different concepts of Islamic Finance.

I feel that this booklet will be beneficial and inspirational for Muslim traders who are sincerely endeavouring to ensure that their commercial activities conform and comply with the dictates and requirements of our beautiful and sacred Deen and Shari'ah. This work will, Insha-Allah, together with other works that have been written on the subject, fill an important niche in the Muslim World of Trade and Commerce.

Due to time constraints, I did not have the good fortune of reading the entire book word for word. I have only read snippets at random from various parts of the book and therefore have to be frank and honest by stating that due to not having scrutinized every aspect of the book, my writing of this foreword should not be construed to mean that I necessarily agree with each and every observation and opinion of the author. However, I am confident that, under the supervision of the writer's esteemed and honourable father, Hadhrat Mufti Ebrahim Desai Saheb (madda-zillahu), the writer has, to the best of his ability, endeavoured to provide proper Shar'ie directives in this Brief Guide to Islamic Finance.

May Allah Ta'aala accept this noble effort and make it the means of salvation for the writer and everyone else who has been instrumental in letting this work reach fruition and come into the public domain. May Allah Ta'aala also grant barakah in the health, life and livelihood of the writer and bestow him with sincerity and true Islamic zeal so that he may, with the Will of Allah, grow from strength to strength in the academic field and in his Deeni endeavours. May Allah Ta'aala continue to rightly guide him so that he becomes a role model and a beacon of Hidayat for people from all walks of life. Ameen.

(May Allah Ta'aala forgive the writer of this foreword, a lowly servant who is always in need of the Guidance, Mercy and Grace of his Creator).

Muhammed Saeed,

Khaadim (Servant) of Madrasah Arabia Islamia,

Azaadville.

25 Zhul-Hjjah 1437 / 27 September 2016

Forward By my illustrious and beloved Father, Mufti Ebrahim Desai Saheb.

(May Allah grant him long life. Aameen)

It is the grace of Almighty Allah that I have been engaged in educating the public on Islamic Economics for a considerable period of time. Many Shariah Compliant Business Campaigns highlighting un-Islamic business practices and advising on the Shariah Compliant alternatives to such practices were conducted.

I also had the opportunity to address many national and international business campaigns and conferences to create awareness of Islamic Finance and to conduct our dealings in a divinely prescribed way. However, such initiatives are not sufficient for one to understand the details on Islamic Economics. There is a great need for literature on Islamic Economics.

In an endeavour to explain Islamic Economics in a simplified way, I have prepared an introduction to Islamic Finance which has been positively received by schools, Madrassah's and Darul Uloom's. I have received many requests to prepare a second version to that book. I could not do so due to my daily busy schedule and time constraints. My son, Mufti Ismail (Sallamahu) has been following my discourses and also advanced his studies in Islamic Economics and has gained practical experience in the field. I encouraged him to prepare the 'Brief Guide to Islamic Finance" as a follow up to my introduction to Islamic Finance.

Alhamdulillah, Allah (Ta'ala) has granted Mufti Ismail the Tawfeeq to prepare the book in your hands which covers 15 topics on Islamic Finance. The beneficial features of the book are:

1) reference for students, professionals, practitioners, schools and Madrassah's

2) comprehensive and lucid in style

3) glossary of Islamic terminologies at the end of the book.

It is my fervent Du'aa that Allah accept this book for His pleasure and make it a means of changing the mind-set of people to understand the wisdom of Islamic Economics and implement the Divine Laws in their dealings. Aameen.

Ebrahim Desai,
Darul Iftaa Mahmudiyyah

Chapter One

Islamic Finance - Introduction and Background

Early History of Islamic Finance

Muslims established a complex economic system in the early stages of Islam. Business partnerships, private equity funds, deferred trading, Islamic futures sales, leasing, agency and other advanced financial techniques formed the backbone of the Islamic financial market even then. Interest-free finance was an integral part of this system.

Early Islamic bankers - or 'sayarifa' - conducted business on a macroeconomic level. They established powerful economic markets. They financed international markets, sank large pools of liquidity into various investment funds, engaged in foreign exchange transactions, created boutique finance houses, and developed a vast array of complex and intricate banking transactions.

The public sector consisted of water resources, energy resources such as animal-driven machinery, and unexploited lands and forests. The public treasury - or Bayt al-Mal – distributed zakat - or obligatory alms - and voluntary charity to the poor and needy while paying the salaries of government workers and public servants such as the chief justice, judges, head mufti and central bank governors.

The Islamic market was regulated and monitored by a central reserve bank.

At its height, this ideal Islamic economic market stretched from Morocco and Spanish Andalusia in the west, to India and China in the east, Central Asia in the north, and Africa to the south.

The Islamic economic system was largely displaced by the medieval period due to various historical, political, social and other factors. Islamic financial institutions only re-emerged during the 1970s. The Dubai Islamic Bank in the United Arab Emirates and the Islamic Development Bank, or IDB, in Saudi Arabia both started operations in 1975.

The theory of establishing an ideal Islamic Capital Market, or ICM, was largely developed between 1955 and 1975. Since then, Islamic banking & financial institutions have expanded in both number and size around the world.

The Difference between Islamic & Conventional Finance

The fundamental difference between Islamic finance and conventional finance is that of market regulation and monetary utility.

Market Regulation

Conventional banks operate within the framework of the free market economy.

An open market economy attracts speculative behaviour, complex derivative transactions, pyramid schemes, gambling, interest, unbridled profit maximization and other unethical practices, which have severe consequences for the social, political and monetary well-being of a society.

Islamic economic activity, on the other hand, is regulated by divine injunctions prohibiting interest, speculative behaviour, obscurity, market monopolization, gambling, and trading in unlawful or prohibited commodities and services. This leads to a just and stable economic system.

Intrinsic Utility

In conventional finance, money is considered as a commodity having intrinsic utility and value. Profits are earned through interest and by dealing in money and monetary papers.

In Islamic finance, however, money is merely a medium of exchange. Financial transactions are backed by assets and services, and profit is earned by exchanging illiquid assets for money.

An asset cannot be compounded like interest-based loans. Asset financing creates assets. Illiquid assets and equities can only have one owner at any given time, unlike conventional loans, which compound into large artificial cash flows.

Interest creates artificial cash supplies with no backing in assets or services, resulting in economic volatility, inflation, and the poor getting poorer while the rich get richer.

The practices of the free market economy contribute widely towards economic injustice and financial oppression.

Sovereign Debt – Example

Many developing countries take out mega loans from banks and other financial institutions which they then repay many times over due to the compounded interest that accumulates on such loans.

How would an Islamic bank finance the needs of developing countries?

- An Islamic bank could finance the construction of infrastructure projects such as highways, schools and hospitals and deliver the completed projects to the government via an ‘istisna’ contract.
- The bank could take an equity stake in a government project and share in any profits or losses using ‘musharaka’ or ‘mudaraba’ partnership arrangements.
- It could purchase assets and lease them out with an option to buy in an ‘ijara wa iqtina’ contract.
- The bank could establish Islamic Finance Microfinance initiatives to help alleviate poverty.

John the Factory Owner –Example

John owns a factory where business is booming. He needs capital to buy the machinery and equipment that will allow him to increase production to meet the growing demand. John takes out a loan from his bank for $50,000 over a tenure of five years. He begins paying out the loan at a rate of $15,000 per year. It takes him ten years to pay off his loan and in all he pays the bank $150,000 – triple the original amount.

How would Islamic finance fulfil John’s needs?

An Islamic bank could structure a mudaraba partnership arrangement. Under this, the Islamic bank would be the investor while John would be the investment manager or working partner. The Islamic bank and John initially agree to a fixed percentage ratio on the returns of the partnership. The bank and John may then terminate their partnership arrangement with mutual agreement.

Mark the Homeowner – Example

In 2012, Mark lost his job, his house, and everything he had spent in paying off his mortgage as a result of the infamous Global Financial Crisis.

The primary causes of the crisis were imprudent lending, subprime mortgages, mezzanine financing, complex derivative schemes and unethical financial practices.

Because conventional financial institutions deal in monetary papers without backing in assets or services, they lend out money many times above their real cash reserves. This creates a false and deceptive market economy.

How can Islamic finance fulfil Mark's needs?

An Islamic bank always limits financing to actual assets and services. Therefore the bank could take direct ownership of the asset and arrange financing for the client on the basis of an ijara wa iqtina (Islamic lease with an option to buy), or draw up a normal purchase and sale agreement, or a diminishing musharaka agreement.

'Musharaka' is the Arabic term to describe a partnership. In a diminishing musharaka, the Islamic bank & Mark purchase the home on an Islamic partnership basis. The bank's equity stake diminishes throughout the financing tenure, while Mark's percentage increases until he becomes the sole owner.

The bank never charges Mark interest. The homebuyer pays for just two things:

- The equity in instalments over a fixed financing tenure
- Rental amounts paid to the bank based on ownership proportions.

What roles can Islamic Finance play?

Islamic finance is a global phenomenon. It provides answers to many of the problems created by the conventional economic system. It offers a wide variety of financial solutions with a high degree of coherence and adaptability.

Conventional financial products can be broadly divided into four categories:

1. Equity

2. Trading

3. Leasing

4. Debt

Islamic finance covers the first three forms of conventional but not debt financing, which is prohibited in Islam.

Islamic financial institutions offer the following three types of banking products and financial instruments:

1. Equity – Mudaraba (see Chapter 6)/Musharaka (see Chapter 5)

2. Trading – Murabaha (see Chapter 8), Salam (see Chapter 9)

3. Lease – Ijara (see Chapter 7)

Notes:

Chapter Two

Ethics in Islamic Finance

Islam is a complete way of life according great emphasis to ethical values and moral codes. Allah (the most high) says in the Holy Qu'ran:

"I have perfected your religion today and I have completed my bounty upon you and I am pleased with Islam as your religion".

Definition of Ethics

Ethics is defined as a set of moral principles that distinguish between right and wrong. Ethics is also used to describe morality, and codes of ethics to describe codes of morality. The word 'ethics' stems from the Greek 'ethos', or 'character'.

Definition of Business Ethics

Business ethics examines the ethical principles and rules of commercial and financial institutions. Business ethics define what is good and bad and what is just and unjust in business.

Objective of Business Ethics

The fundamental objective of business ethics is to enable individuals to make the right moral choice between different business options or to provide prescriptive advice on how to act morally in any given situation.

Basic Islamic Business Ethics

Truthfulness

Islam encourages truthfulness in all commercial activities. The last prophet of Allah (the most high) has stated that "an honest, truthful businessman will be among the prophets, sincere believers and martyrs." (hadith of al-Tirmidhi)

The prophet also said, “Indeed, the traders shall be resurrected on the day of resurrection as sinners except those who exercised religious restraint (taqwa), were pious and truthful.” (Tirmidhi)

Free Enterprise

Islam to a certain extent allows freedom of economic enterprise, profitization and private ownership. However, Islam has set certain economic restrictions and regulations that allow for distributive justice and economic equitability while preventing monopolization and other economic malpractices.

Trustworthiness

Trustworthiness is the fundamental element of business ethics. Without trust, people cannot engage in sustainable commercial ventures and partnerships. Islam promotes trust.

Allah (the most high) says:

“And do not betray those who trust you”

The prophet said:

“Discharge the trust to those who have entrusted you, and do not deceive one who has not deceived you” (Tirmidhi)

Generosity and Leniency

Generosity and leniency are the fundamental pillars of a socially and morally coherent society. They are inherent elements of good character.

Allah (the most high) says:

“And if the debtor is in difficulty then grant him respite until easier times”

The prophet said:

“Allah loves one who is lenient in selling, buying, and in requesting payment” (Tirmidhi)

The prophet also said:

“He who gives respite to the person in difficulty or wipes out the debt, Allah shall shade him under his throne on the day when there shall be no shade save His” (Tirmidhi)

Honouring Obligations

Islam accords much importance to fulfilling and honouring contracts and promises.

Allah (the most high) says:

“Oh you who believe, fulfil your obligations.”

The prophet said:

“Muslims are bound by their conditions.” (hadith of al-Bukhari)

Just and Fair Labour Relations

Governments, legislators and legal experts around the world are striving to protect the poor from financial exploitation, social degradation and other inhumane and immoral practices. Islam strongly encourages employers to fulfil their religious duty and social and moral obligations by treating employees in a fair, just and equitable manner. Islam promotes a relationship of brotherhood between the employer and employee.

The prophet said:

“I will be the disputing party with the following three persons, one of them being he who employs a person who despite having completed his tasks and duties does not give him his due wage…”(Bukhari)

The prophet said:

“Give the labourer his wages before his sweat dries”

“Look after them as you look after your own children. Feed them with whatever you personally eat”

The rights of employees are clearly elucidated in the above traditions.

Deception and Fraud

Much of the global financial crisis was caused by sometimes fraudulent misrepresentations by financial brokers which encouraged a dramatic rise in imprudent lending of financial reserves.

Islam, on the other hand, prohibits all forms of deceptive and fraudulent behaviour.

The prophet said:

“If anyone sells a defective article without drawing attention to it, he will be under Allah’s anger and the angels will continue cursing him.” (hadith of Ibn Majah)

Financial Exploitation

Financial exploitation, or fiduciary abuse, is defined as the improper use of another person’s resources for one’s personal benefit. There are many types of financial exploitation, such as trickery, intimidation, coercion and misinformation.

Islam prohibits all forms of unjust and unethical financial exploitation.

The prophet prohibited a number of methods of financial and market exploitation that had been prevalent during the pre-Islamic era such as the exploitation of rural dwellers who knew little of the more sophisticated practices of an urban market.

Price Fixing

In 2007, Tiger Brands, a South Africa-based multinational company, was fined 98.8 million rand ($7.2 million) by the South African Competition Tribunal after admitting to collusion with rival brands to bread prices. The fine represented 5.7 % of Tiger Brands’ annual bread sales.

Islam allows free trade and economic activity. Financial managers, investment firms and retail traders are allowed to set reasonable market prices. However, Islam considers the economic wellbeing of the wider population and thus regulates the market to prevent price fixing and other forms of financial manipulation. It is the duty of the central reserve bank or central monetary agency to monitor the market for such exploitative financial practices.

Conclusion

Business ethics has become an important topic of discussion among global financial institutions and regulators. Where promoted by secular and Western principles, ethical codes tend to be utilitarian, oppressive, situational and devoid of spiritual backing or power.

Islamic ethics has the solution to much of the financial, social and moral decay currently being witnessed in the world.

Notes:

Chapter Three

Principles of Islamic Finance

Every economic system is based on certain fundamental elements and founding principles.

Similarly, Islamic finance is based on a body of fundamental principles which form the backbone of any Shariah-compliant banking product. Islamic banking transactions must be interest-free, not open to dispute, be non-speculative, share profits and losses and back financing with assets and services; and be ethical:

Transactions must be interest free

Definition of Interest

'Riba' is an Arabic word meaning 'increase, extend or add'. According to Shariah law, riba, or interest, is defined as "any premium that must be paid by the debtor to the creditor with the principle amount as a condition of a loan or for an extension of its maturity."

Riba has been strictly prohibited in Islam. However, this prohibition is not only confined to Islam. The world's other major religions – Christianity, Judaism and Hinduism – also prohibit interest.

In Islam, the Qu'ran and prophetic traditions make clear the strict prohibition on interest.

Allah (the most high) says:

"Those who devour usury will not stand except as one who stands with madness. That is because they say: 'Trade is like usury.' But God has permitted trade and forbidden usury."

The prophet (may peace be upon him) cursed the receiver of interest, the payer of interest, the recorder of interest and the witness to such a transaction. (hadiths of Muslim, Tirmidhi, Ahmad ibn Hanbal)

Islamic jurists, who have particular expertise in Islamic jurisprudence and law, have classified riba into two broad categories: riba al fadl, and riba al nasi'a.

Riba al Fadl

'Fadl' is an Arabic word meaning 'excess' or 'surplus'. According to Shariah law, riba al fadl refers to a surplus in any of the two commodities of exchange: goods and currency. Riba al fadl is also known as 'riba al hadith' this form of usury has been described in the various collections of sayings and acts of the Prophet Muhammad known as the hadith.

While only six commodities are mentioned in the hadith (gold, silver, dates, wheat, salt and barley), classical jurists have made this inclusive of certain commodity transactions through the medium of 'qiyas' – or 'legal analogy' – in which they have determined a specific characteristic of each of the six commodities, or 'amwal al-ribawiya'. Each school of thought has interpreted these common characteristics differently.

Zaid the vegetable shop owner - Example

Zaid, a vegetable shop owner, wishes to exchange 1,000 bags of high-grade potatoes for Amr's 1,500 bags of low-grade potatoes. This would be an impermissible transaction since the surplus amount of goods measured by volume and weight is considered as riba and interest.

Imran the car owner – Example

Imran has just bought a brand new Mercedes Benz car. He is, however, unhappy with the purchase and wishes to exchange the Mercedes for a used BMW. This transaction is permissible as although the commodities are different, cars are measured by number rather than volume and thus the transaction is equal.

Riba al-Nasi'a

Riba al-nasi'a is also termed riba al-jahiliyya (jahiliyya refers to pre-Islamic times), or riba al-Qu'ran, as this type of riba has been specifically mentioned in the Qu'ran.

'Nasi'a' is an Arabic word meaning 'credit or delay'. Shariah scholars define riba al-nasi'a as a "loan where a specific repayment period and a premium amount in excess of the capital is pre-determined."

It makes no difference whether the premium is a fixed or variable percentage of the principle or an absolute amount to be paid in advance or on maturity.

Unopen to Dispute

Any contract which is open to future dispute is not Shariah compliant.

ABC Technologies, a professional software company – Example

ABC Technologies wishes to sell banking software to an Islamic bank, though the bank has failed to provide detailed specifications. The vagueness of the contract means the deal is not Shariah compliant.

BHM Financial Advisory – Example

BHM Financial Advisory enters into an arrangement with BPS Shariah Bank to conduct annual Shariah and financial audits. However, the tenure, audit scope, Shariah check list and other key points are not specified. This arrangement is not Shariah compliant as, again, there is the possibility of future dispute between both the contracting parties.

Non-Speculative (Gharar)

'Gharar' is an Arabic word meaning 'uncertainty' or 'vagueness". Shariah scholars broadly define gharar as future contractual uncertainty.

Gharar refers to the sale of a commodity or good which is not present at hand, of which the consequences of the sale are unknown, or which present such risk that it is impossible to determine the future existence of the commodity at all.

Where an integral element of a contract is left vague or uncertain, then such an arrangement is considered non-Shariah compliant. Contracts must have contractual certainty in order to be Shariah compliant.

Profit and Loss Sharing and Asset-Backed Financing

The profit and loss sharing, or PLS, system of Islamic banking is based on the principle: “No return without risk”.

Islamic financial institutions earn profits on direct equity positions. An Islamic bank cannot earn profit without having a direct equity stake. One of the fundamental principles of Islamic banking is: “Entitlement to returns is linked to the liability of loss.”

Islamic banks earn profits on actual equity stakes instead of merely dealing in financial papers. Islamic banks take asset or ownership risk before making an ijara wa iqtina transaction or a diminishing musharaka.

Ethical

Social morality is of pivotal and critical importance in Islam. Trading, buying and selling carrion, wine, pornography, pork and other forbidden matter is impermissible according to Shariah law.

The Prophet (may peace be upon him) said:

“Indeed Allah and his messenger have made the trade of intoxicants, carrion, pig and idols unlawful and illegal.”

Notes:

Chapter Four

Islamic Law of Contracts

An Islamic sale – or 'bay' – is defined as: "The exchange of an item of value for another item of value by mutual consent". An Islamic contract essentially refers to the exchange of items of value between the contracting parties.

Conditions of a Valid Sale

An Islamic contract of sale must have the following four elements:

- Contract (Aqd)
- Subject of Sale (Mabee)
- Price (Thaman)
- Possession (Qabd)

These are the fundamental elements of any Shariah-compliant contract of sale.

Contract (Aqd)

Offer and Acceptance

An Islamic legal contract is sealed by an offer and its acceptance. For example, Zaid proposes to sell one hundred barrels of crude oil to Amr, who in turns accepts this proposal and thus concludes the deal. This is a legally binding Islamic contract.

An offer and acceptance can be effected in the following two ways:

- Verbally
- By Implication

Contractual Capacity

According to classical Shariah law, both contracting parties must be:

- Sane
- Mature

There are certain circumstances that can affect contractual capacity:

- Insanity or Dementia
- Unconsciousness / Sleep
- Intoxication
- Serious Incompetence or Foolishness
- Insolvency
- Death or Life-Threatening Illness

Conditions of Contract

Every Islamic contract must fulfil certain conditions and legal criteria in order to be Shariah compliant. Contracts must be:

a. Non-Contingent

Contractual certainty plays a key role in determining the Shariah compliancy of a contract. Shariah scholars state that the delivery of the commodity of sale must be fixed and non-dependant on future contingencies or uncertain events. For example, Zaid sells his motor vehicle to Amr on condition that the vehicle will only be delivered if the US dollar exchange rate exceeds $1.50 to the British pound. Such a sale would not be Shariah compliant as exchange rates are subject to constant change.

b. Unconditional

Islamic contracts must be unconditional. For example, John sells two hundred travel vouchers to Mark on condition that Mark employs John's son at his travel agency. This would not be Shariah compliant.

c. Attach Reasonable Conditions

A contract can have conditions attached provided they don't go against other essential elements of the contract. For example, Muhammed sells two holiday apartments to Ahmed on condition that the holiday apartments be legally transferred to Ahmed's company.

d. Common Market Practice

Unreasonable conditions may be accepted so long as they conform to general market practice. For example, Yasir, a hardware store owner, buys a thousand bags of cement from Yusuf on condition that Yusuf delivers the bags to Yasir's international storage depot.

e. Immediately Effective

Each contract of sale must be concluded and effectuated with immediate effect. Future sales, forward cover and the like are not Shariah compliant. For example, Salih, a clothing manufacturer, requires vital cash flows to pay his suppliers in Beijing. He agrees a forward exchange contract, or FEC, with his bank. However, this transaction is not Shariah compliant as the FEC exchange contract only concludes some months later when Salih's shipments arrive.

Subject Matter of Contract (Mabee)

The subject matter of a Shariah compliant contract of sale must be:

a. Existent

The subject matter of a sale must exist at the time of the sale. A non-existent commodity cannot be sold. For example, John sells an unborn calf to Mark. This is not Shariah compliant since the subject of the sale does not yet exist.

b. Valuable

The subject matter of a sale must be regarded as an object or commodity of value. Shariah scholars use the term ‘mal mutaqawam’ to refer to any commodity having value in Islam. For example, Zaid sold a leaf to Bakr. The sale is not Shariah compliant as a leaf is not considered to be of value.

c. Legally Usable

The subject matter of a sale should be Shariah compliant and must not be ‘haram’, or prohibited in the Qu’ran – for example, wine.

d. Ownable

The subject matter of a sale should be a commodity that can be owned. For example, one cannot sell the sky as it is not a commodity that can be legally owned.

e. Deliverable

The subject matter of a sale must be something that can be possessed and delivered. For example, Zaid wishes to sell an off-plan building to Bakr. This transaction is not Shariah compliant since the building does not yet exist.

f. Specific and Quantified

The subject matter of the sale must be specifically determined and quantified, otherwise it is not Shariah compliant. For example, Zaid owns a large real estate company offering apartments of different sizes and architectural designs. Zaid wishes to sell three unspecified apartments to John. This sale is not Shariah compliant as the object of the sale is too ambiguous.

Price (Thaman)

The selling price of the sale is called the ‘thaman’, while the market value is called the ‘qima’.

The thaman must be:

a. Quantified (Maloom)

Both parties must agree on a numeraire, being one particular currency which serves as the standard of value through which the sale is executed. This is usually the local standard currency.

b. Specific (Muta’ayyan)

The price must be specific. If not, the sale is not Shariah compliant.

Possession

The subject matter must be in the physical or constructive possession of the seller at the time of the sale. This rule applies only to movable items.

Physical Possession

Physical possession is defined as having control and power over an object on one’s person or around one’s person. For example, John purchased 1,000 barrels of refined oil from TradeCor, a large Gulf oil company. John has not yet received the shipment. However, he wishes to sell the oil to Global Freight, a multinational transport company. This sale is not Shariah compliant since John does not have physical possession of the oil.

Constructive Possession

Constructive possession refers to having control, risk and the assumption of all rights and liabilities for the commodity of sale.

For example, Al-Nakheel Bank, an international Islamic financial institution, purchases ten heavy duty vehicles from Global Motors, a Japanese vehicle manufacturer. Global Motors deliver the vehicles to Al-Nakheel's central warehouse. The bank then sells the vehicles to ABS Freight Company while they sit in its warehouse. This transaction is Shariah compliant as Al-Nakheel had constructive possession of the vehicles.

Primary Islamic Contracts

Islamic Contracts are primarily categorized as follows:

Bay Sahih – Valid Sale

A valid Shariah compliant sale is deemed to have met the above stated requirements concerning contract, or aqd; subject of sale, or mabee; price, or thaman; and possession, or qabd)

Bay Batil – Void Sale

A sale becomes void if it does not meet the stated Shariah requirements. Both seller and purchaser have no legal title to the item of sale nor the purchase price in a void sale as the transaction is considered non-existent in Shariah.

Bay Fasid - Voidable Sale

A voidable sale refers to any sale containing certain non-Shariah compliant elements. If these elements are removed from the contract, the sale will become Shariah compliant. It is wajib – or obligatory – for the contracting parties in a voidable sale to cancel the sale and remove the non-compliant elements.

Bay Mawquf – Suspended Sale

'Mawquf' is an Arabic word meaning 'suspended'. Bay mawquf is a suspended sale. For example, Luke sells Mark's offshore property holdings to John without Mark's permission. This sale is suspended subject to Mark's approval.

Bay Makruh (Disliked)

Shariah accords great importance to ethical behaviour in financial dealings and economic activities. Shariah considers a sale to be 'makruh' – or 'disliked' – if it goes against ethical requirements. For example, transactions after the Friday call to prayer, false bidding, etc.

Some Common Contracts

Bay Musawama

This is a normal sale made without reference to cost price and where the mark-up is unknown. 'Musawama' means 'bargaining'.

Bay Muqayada

A barter sale or counter-exchange of goods. Currency exchange or sale does not fall under bay muqayada.

Bay Mu'ajjal

A sale on a deferred payment basis. Bay mu'ajjal is valid if the payment date is specified and fixed. Shariah scholars state that the purchase price in a bay mu'ajjal can be more than for a cash sale.

Security in Bay Mu'ajjal

Since the seller is owed the purchase price of the subject matter of the sale, he has a legal Shariah right to obtain security from the client. This security must be well defined and in accordance with Shariah guidelines on securities.

Promissory Agreement

The seller may request the purchaser to sign a promissory note stating that he shall pay the full purchase price in order to secure the seller's rights. Promissory notes cannot be sold to third parties.

Bay Ta'ati

A sale concluded by the conduct of the contracting parties, where, for example, goods are presented at a shop's till and the shopkeeper takes the money without any discussion of price having taken place or any contract being signed. The offer and purchase is implied in the conduct of the buyer and seller.

Bay al-Inah

The sale of a commodity on credit and repurchasing it for a lesser amount in cash.

For example, Zaid purchases 1,000 designer garments from his local bank for $50,000 on a deferred payment basis. Zaid immediately sells the garments back to the bank for $40,000 cash. This is clear interest, hence the transaction is not Shariah compliant.

Bay Tawlia

A sale in which there is a clear and explicit reference to the cost price between the buyer and seller.

Notes:

Chapter Five

Musharaka (Islamic Investment Partnerships)

Musharaka is an Arabic word meaning 'to share'. It is derived from the Arabic 'shirka', meaning 'partnership'. The terms 'shirka' and 'musharaka' are used interchangeably.

A musharaka is a partnership between two or more parties, usually for the purpose of conducting business or trade. Musharakas are created by an investment of capital or pooling together of expertise.

Investment partners mutually share profits based on capital investment ratios, management duties and business capacities and they share losses according to proportionate capital investment.

A musharaka can be terminated by any of the business partners provided that prior notice is given to the other partners.

Musharaka or shirka can be broadly categorized as follows:

- Shirkat al-milk
- Shirkat al-aqd

Shirkat al-Milk

Shirkat al-milk is a partnership between two or more persons in the joint ownership of assets or properties for non-commercial purposes.

Zaid the equity purchaser – Example

Zaid, a recent college graduate, wishes to purchase a home. However, like most recent graduates, he has limited financial resources. Zaid approaches Al-Nakheel Islamic Bank to finance the equity purchase. Zaid and the bank jointly purchase the home on a 20:80 acquisition ratio.

Shirkat al-milk is further divided as follows:

a. Ikhtiyari (Optional)

Two or more parties decide to pool resources to fund a joint venture. For example, Luke and David jointly purchase properties for their expanding real estate portfolio.

b. Ghair Ikhtiyari (Automatic/Non-Optional)

An automatic joint partnership without any intention or effort from the parties involved. For example, Yusuf and Bakr are the only heirs of their father. They jointly inherit their father's real estate portfolio.

Shirkat al-Aqd

Shirkat al-aqd is a partnership between two or more parties in a joint commercial enterprise on the basis of mutual agreement.

Business partners pool resources to engage in profit-seeking ventures.

Every shirkat al-aqd has shirkat al-milk embedded within it, namely the joint ownership of the assets and property.

Basic Differences between Shirkat al-Aqd and Shirkat al-Milk

Two fundamental differences between shirkat al-aqd and shirkat al-milk are:

1. Shirkat al-aqd is a direct joint commercial partnership or profit-driven contract agreement, whereas shirkat al-milk is formulated for non-commercial purposes. Shirkat al-milk is a simple partnership of ownership without the intention to profit.

2. Ownership proportions cannot be fixed in a shirkat al-milk, while they must be pre-determined and specified in a shirkat al-aqd.

Shirkat al-Aqd Categories

Shirkat amal

This is a joint partnership in providing services to clients. 'Amal' means 'services'. The fees charged by the business partners are distributed according to mutually agreed ratios.

Shirkat al Amwal what does amwaal mean?

This is the most common musharaka used by Islamic banks and financial institutions. Shirkat al amwal is a partnership between two parties who invest resources in a joint commercial enterprise. 'Amwal' means 'wealth'.

Shirkat al Wujooh

'Wujooh' is an Arabic word derived from 'wajaha', meaning 'goodwill'.

Shirkat al wujooh is a joint partnership between two or more parties who purchase commodities on credit on a basis of goodwill and mutual trust with the supplier. These commodities are then sold in the market for a profit.

Each of the above three categories fall under the following two broad classifications:

1. Shirkat al-Mufawada

'Mufawada' means 'equal'. In a shirkat al-mufawada, all business partners share equally in the fundamental aspects of capital, investment management, profit ratios and risk profiles. If any of these elements are deficient, the partnership is automatically categorized as shirkat al-inan. (Inan means 'unequal') All the partners are trustees and agents unto each other.

2. Shirkat al-Inan

In this, capital, investment management and profit-sharing ratios need not be equally shared amongst the business partners. Losses are always based on capital investment ratios and not mutually agreed ratios.

Duration of Musharaka

Permanent Musharaka

This is the most common form of musharaka. It is also referred to as an ongoing or open-ended musharaka. A permanent musharaka refers to a partnership which has no intention of terminating at any time in the future.

Partners are, however, allowed to exit the partnership at any point should they so wish provided they give sufficient notice to the other business partners. Contracts may also have a lock-in clause to prevent parties terminating their participation for a specific tenure.

The remaining partners may purchase the exiting partner's musharaka portfolio shares.

Temporary Musharaka

A partnership arrangement formulated with the intention of at some point winding up, at which point its assets are realised in cash and distributed along with any cash reserves on a pro-rata basis.

Musharaka Capital

All Shariah compliant commodities of value may be pooled in the musharaka portfolio. Debt cannot form part of the portfolio.

Shariah scholars state that the investment contribution can be in the form of liquid cash or illiquid commodities of value. For example, Zaid has a thriving business enterprise but is short of cash. He enters into a musharaka with a private equity fund. Zaid contributes his financial stocks while the private equity fund contributes much needed cash to the Musharaka portfolio.

Business evaluations of commodity contributions or contributions in kind must take place before musharaka execution.

Capital investment ratios, profit ratios, master agreements and all other partnership documentation must be well defined and determined before the musharaka is formed.

Musharaka Management

As a general principle, all business partners in a musharaka have the right to engage in the direct administration and management of the partnership. Partners may agree for practical reasons to appoint certain individuals from the investment partners to manage the financial and administrative affairs of the partnership. They may even decide to appoint an external investment or financial manager.

Partners who are not directly involved in the management and administrative affairs of the partnership are known as silent or sleeping partners. Since they do not participate in the actual business, they cannot receive a greater profit ratio than their original capital contribution ratio. Working partners can receive more than their investment capital ratios.

Working partners are tasked with running the musharaka portfolio but cannot receive a fixed remuneration for their investment management services. However, working partners may be given an increased profit ratio out of consideration for their management duties.

Working partners serve as agents on behalf of their co-investors.

An external investment manager can only receive a fixed remuneration for his services but cannot receive profit from the portfolio. External business managers do not share in profits or losses.

An external business manager may invest in the musharaka portfolio under a completely separate and independent contract and may receive profits and share losses in the capacity of investor and receive a fixed and defined remuneration for his management services in the capacity of business manager and employee of the partnership.

The Shariah supervisory board (SSB) should ensure that the sleeping partners of an Islamic bank's musharaka portfolio do not infringe on the duties of the working partners, who would generally be the bank itself. This would enhance the Shariah compliance of an Islamic bank.

Profit and Loss Sharing

According to Shariah, profits cannot be fixed, whether as a stipulated number or percentage of the invested capital or any other fixed amount.

For example, Zaid and Bakr enter into a musharaka partnership. Zaid and Bakr cannot fix $100,000 as a fixed monthly profit since the partnership has yet to declare any profits. What if the partnership runs a loss?

Neither can they fix a monthly profit of 10% of their investment amount. This would result in an absolute fixed number, which again is not Shariah compliant.

Also, if Zaid and Bakr agree on a fixed percentage of the partnership revenue, this would not be Shariah compliant as there is a fixed absolute number.

Profit in a musharaka should:

- not be guaranteed or fixed in any absolute terms
- be distributed to every partner according to pre-agreed profit ratios
- not exceed the silent partner's capital contribution ratio
- have well determined and fixed profit ratios and mechanisms
- allow for voluntary surrender of all or part of the profit share of any of the investors. This provision is strictly voluntary and should not be pre-agreed at partnership execution.

Loss in a musharaka can only be shared according to capital contribution ratios.

Profit Calculation

The musharaka portfolio cannot declare returns before the actual realization of profit. The portfolio can, however, announce expected returns and may declare returns upon actual profit realization.

Profits are only realized with the combination of surplus and principle.

Balance sheets do not represent profits.

Modern Application of Musharaka

Many Islamic businesses require cash flows to fund their operations. They cannot go to conventional banks as they charge interest on credit. An Islamic bank would offer a temporary musharaka finance facility in order to fulfil the financing needs of the business. The bank would contribute the running finance facility funds while the client contributes the business he owns. Profit-sharing mechanisms must be well defined and structured in accordance with standard profit-sharing guidelines.

A typical Shariah-compliant musharaka facility:

The Islamic bank and the client agree on financing limits, profit-sharing ratios, managerial roles and financing tenure. The bank conducts a detailed investigation into the client’s credit rating and also evaluates the client’s commodity contribution.

The bank then opens an Islamic current account to finance the client’s needs and to hold the client’s cash deposits.

The Islamic bank and client share the profits according to pre-agreed ratios. In the case of a loss, the bank and client share the loss according to capital contribution ratios.

The bank gradually sells its shares to the client upon the termination of the musharaka tenure. The bank eventually sells all its shares and exits the musharaka.

Common musharaka products include:

- Diminishing musharaka
- Project financing
- Import financing
- Inter-bank liquidity management
- Musharaka securitization
- Working capital financing

Dispute Resolution

The Master Musharaka Contract Agreement (MMCA) should have a special clause for dispute resolution stating that the parties agree to take any and all disputes to an external Shariah Review Council for adjudication. The Shariah Review Council should be completely independent of the bank and the client so as to remove all suspicions of financial prejudice. The Shariah Supervisory Board should not be allowed to adjudicate in such disputes.

Termination of Musharaka

Partners may unilaterally terminate partnership participation at any time provided that suitable prior notice is given.

If any party becomes insane, or becomes otherwise incapable of effecting business transactions, the musharaka is automatically terminated.

Actual Liquidation

If the musharaka is terminated and the assets are realized as cash, they are distributed to the partners on the basis of capital contribution ratios. Profits are distributed on pre-agreed profit-sharing ratios.

Constructive Liquidation

Illiquid assets are either distributed by granting them to the partners in lieu of the profit they have earned or liquidated in the market and the proceeds then distributed to the partners.

Partners can demand a separation of the assets instead of liquidating them. Certain assets have to be liquidated since they cannot be separated, such as machinery or houses.

Notes:

Chapter Six

Mudaraba (Financial Investment Partnership)

Mudaraba is partnership between two or more persons for investment and business purposes. One party contributes the capital while the other contributes financial management expertise.

The rab al-mal, or financier, (plural arbab al-mal) contributes the capital, while the mudarib – or investment manager, monitors and manages the invested capital while securing profitable investment portfolios.

The Arabic term for ‘investment capital’ is ‘ras al-mal’.

Mudaraba is also known as ‘qirad’ or ‘muqarada’. Mudarabas belong to the same family of musharaka partnerships.

‘MM’ is a short form used in Islamic finance for ‘musharaka and mudaraba’.

Differences between Musharaka and Mudaraba

a. The rab al-mal provides the investment capital to the mudaraba portfolio, whereas all parties must contribute capital in a musharaka. The mudarib may only contribute capital to a mudaraba portfolio with the consent of the rab al-mal.

b. Only the mudarib manages a mudaraba portfolio, while all partners have a right to manage a musharaka portfolio.

c. In a mudaraba partnership, the rab al-mal alone is responsible for any losses, while the mudarib only loses the work he put into managing the portfolio. (The mudarib would be responsible for a loss, however, if it was found he was negligent in his duties.) In a musharaka, all parties bear losses according to their capital investment ratios.

d. The mudarib does not have a share in the mudaraba portfolio; therefore the mudarib’s share of the profit does not rise if there is an increase in value of the mudaraba assets. However, all partners jointly own a musharaka portfolio, and therefore all benefit from an appreciation in value of the assets even if they did not receive any profits through trading.

e. The mudarib has no liability in a mudaraba. However, all partners have unlimited liability in a musharaka. All remaining liabilities would have to be borne by the musharaka partners in the event of a liquidation.

Similarities between Mudaraba and Musharaka

Both musharaka and mudaraba are partnership based. Each party contributes either management expertise or capital in a mudaraba, or capital only in a musharaka.

The mudarib or rab al-mal is permitted to voluntarily surrender all or part of his capital to the mudaraba portfolio. Similarly, any partner in a musharaka partnership can voluntarily surrender all or part of his capital to the musharaka portfolio or a co-investor.

Scope of the Mudaraba

Mudarabas can be restricted or unrestricted in terms of the scope of business.

Mudaraba Muqayyada (Restricted Mudaraba)

In this, the rab al-mal restricts the mudarib's investment management role to particular economic areas and financial dealings. The mudarib's role may even be restricted by geographical location.

Mudaraba Mutlaqa (Unrestricted Mudaraba)

Here, the mudarib is permitted to invest in any Shariah compliant business. However, the mudarib is not permitted to lend money to anyone without the prior consent of the rab al-mal.

Mudaraba Capital

All Shariah-compliant commodities of value may serve as the capital input in a mudaraba portfolio. The investment capital may be in cash or in kind.

Business evaluations of commodity contributions or contributions in kind must take place before mudaraba execution or at the latest before the portfolio realizes any profit.

Capital investment ratios, profit ratios, master agreements and all other partnership documentation must be well defined and determined before the mudaraba execution.

All partners must agree on one particular numeraire to serve as a standard value for the mudaraba business.

Debt cannot serve as the mudaraba capital.

Example:

Zaid and Yusuf set up a mudaraba partnership to invest in a business buying and selling cars.

Zaid, the rab al-mal, invests $50,000 in the portfolio. Zaid and Yusuf agree a profit ratio of 65% for the rab al-mal and 35% for the mudarib.

The partners agree that the common numeraire will be the US dollar.

Mudaraba Duration

Permanent Mudaraba: This is the most common form of mudaraba. It is also referred to as an ‘ongoing’ or ‘open-end’ mudaraba.

Permanent mudaraba refers to a partnership where there is no intention of terminating the joint venture at any time in the future. A partner may exit the venture at any point provided sufficient notice is given to the other partners.

Temporary Mudaraba: This a partnership formed with the intention of termination at some point in the future. The partnership is dissolved and the assets realized in cash, which are then distributed along with any other cash reserves on a pro-rata basis.

Mudaraba Management

The mudarib alone manages a mudaraba portfolio. The rab al-mal does not have any right to manage the portfolio. The mudarib's managerial responsibilities can in no way be restricted or encroached upon.

The mudarib receives a share of the profit from the mudaraba portfolio but cannot receive a fixed wage for his managerial duties.

He can, however, become an employee with a fixed remuneration provided that his role as mudarib is terminated.

The mudarib can invest in the mudaraba portfolio provided this is done under a completely separate contract agreement between the mudarib and rab al-mal or arbab al-mal. Each role must be clearly distinguished and defined.

Mudaraba Profit and Loss Sharing (PLS)

According to Shariah, profits cannot be fixed, whether as a stipulated number, a percentage of the invested capital, or any other fixed amount.

All profit-sharing ratios and mechanisms must be clearly specified by all partners before execution of a mudaraba partnership.

Any partner can voluntarily surrender all or part of his profit share to another partner on condition that this was not a pre-condition of the partnership agreement.

Partners in a mudaraba portfolio may agree on various fixed profit ratios. For example, Zaid, the rab al-mal, and Yusuf, the mudarib enter into a partnership to sell agricultural produce. They agree on the following profit-sharing ratios:

Commodity	Zaid - Yusuf
Wheat	34% - 66%
Rice	50% - 50%
Beans	25% - 75%
Cabbages	65% - 35%

Similarly, the partners can agree on profit mechanisms based on geographic location. For example, Mark, the rab al-mal, and John, the mudarib, enter into a mudaraba partnership to trade in luxury apartment suites. They agree on the following profit-sharing mechanism:

Location	Mark – John
Cape Town	50% - 50%
Dubai	60% - 40%
Berne	30% - 70%
New York	40% - 60%
Riyadh	38% - 62%

The rab al-mal can pay the mudarib a performance bonus from time to time. This bonus is termed ‘hiba’ (gift). Performance bonuses are non-obligatory and cannot be pre-agreed in the mudaraba partnership agreement.

If the Shariah board declares the mudaraba partnership ‘fasid’ – or not viable – then the mudarib:

- serves merely as an employee of the mudaraba portfolio,
- is not entitled to any business or travel allowances,
- only receives the 'ujra al-mithl', or fair market rate, wage for services offered to the mudaraba portfolio. The rab al-mal or arbab al-mal bear the entire loss based on capital contribution ratios.

The mudarib does not bear any loss except if it is proven that he was grossly negligent.

If the mudaraba business has incurred losses in one portfolio, the profits from the other portfolios will be used to offset the loss, after which profits shall be distributed according to pre-agreed profit-sharing ratios.

Mudaraba Termination

Partners may unilaterally terminate their partnership participation at any time provided that suitable prior notice is given. However, a 'lock-in' clause may be drafted into the Master Mudaraba Agreement (MMA) stating that the mudaraba shall remain operational for either a fixed or unlimited tenure except in the case of force majeure or natural unexpected events such as death.

If the mudaraba is terminated, assets in the form of cash are distributed to the partners on the basis of capital contribution ratios. Profits are distributed on pre-agreed profit-sharing ratios. Illiquid assets are realized as cash and then the actual profits and cash are distributed according to capital contribution ratios and profit-sharing ratios.

Mudaraba Application

Mudaraba Deposit Account Facility (MDAF)

Islamic banks offer clients a 'Mudaraba Deposit Account Facility'. In this, the bank receives depositors' money in the capacity of mudarib, or investment partner. The depositors are the arbab al-mal, or investors.

The Islamic bank forms a mudaraba pool, which it uses to invest in Shariah-compliant investment portfolios. Musharaka and mudaraba pools serve as strategic and important liquidity tools for Islamic banks.

The MDAF is offered in various denominations such as term deposits or general cheque and savings accounts.

Islamic banks generally provide clients with an ROI (return on investment) rate. This is simply a financial forecast and what clients or account holders can typically expect to receive.

Islamic banks cannot guarantee return rates, however, as that would not be Shariah-compliant.

Combined Musharaka and Mudaraba

As a general rule, the mudarib cannot invest in the mudaraba business. However, he can invest on the basis of a combined musharaka and mudaraba. In this, the mudarib remains an investment manager as part of the mudaraba agreement, while becoming a business partner under the musharaka partnership.

Nick – Example

Nick, a specialist investment manager, and Al-Yusra Private Equity enter into a mudaraba partnership. Nick serves as mudarib while Al-Yusra is the capital investor. Nick also wishes to invest in Al-Yusra Private Equity. He invests $50,000 in Al-Yusra Private Equity as business partner under a separate musharaka agreement.

Parallel Mudaraba

The mudarib can invest the mudaraba capital in other mudaraba portfolios as a parallel investment. Should this be here? It was in the middle of the previous section for some reason, which didn't make sense. It is very hazy. Could it be expanded a little or should it be disposed of altogether?

Mudaraba Capacity

1. Amin: One who is entrusted with an item or goods.

2. Wakil: Agent on behalf of the bank.

3. Sharik: Business partner.

4. Dhamin: All legal implications of a transfer of ownership are now on the client.

5. Ajir: Lessee

Notes:

Chapter Seven

Ijara (Islamic Leasing)

'Ijara' is an Arabic word for 'lease', 'rent' or 'wage'. According to Islamic jurisprudence, ijara is defined as the transferral of the usufruct of specific assets or provision of services to the client for a fixed tenure in lieu of a fixed rent or remuneration.

In an Islamic lease, the usufruct of the leased asset is transferred to the client and not actual ownership of the asset. Ownership is generally transferred in an Islamic contract of sale.

Ijara Types

There are two broad categories of Ijara:

- Ijara al-manafi
- Ijara al-amal

Ijarah al-Manafi

'Manafi' is an Arabic word meaning 'benefit'. Ijara al-manafi is a lease contract in which the benefits or usufruct of an asset are transferred to the client in exchange for a fixed rental. For example, Nakheel Property Investments leases out 100 luxury suites in exchange for a fixed rent of $10,000 per month for a fixed tenure of one year.

Ijara al-Amal

Ijara al-amal refers to a lease contract to engage the services of a person for a fixed remuneration over a specific tenure. For example, Zaid hires Bakr to carry his luggage to the airport.

In an ijara al-amal, the 'ajir', or labourer, provides his services to the 'mustajir', or employer. The 'ujra' is the wage or rental fee.

Usufruct Lease Categorization

Usufruct leases can be further categorized as follows:

- Quantified Asset Lease: A lease of a known asset type not specifically identified by the lessee. For example, the leasing out of an unspecified boat.
- Specific Lease Asset: A lease of a specific asset indentified by the lessee. For example, the leasing out of a five bedroom house with an indoor swimming pool, servants quarters, garages, and tennis courts.

Ijara Models

Standard Ijara

The lessee benefits from the usufruct of the leased asset without eventual transfer of ownership. The asset remains in the ownership of the lessor even during the tenure of the lease.

Diminishing Ijara

The lessee buys the shares of the leased asset from the lessor in stages over a fixed period of time. Total ownership is eventually transferred to the lessee. The standard ijara contract and the purchase and sale of the equity shares must be clearly separated.

Ijara Fundamentals

- The service or asset must be owned by the lessor
- Ownership of an asset is never transferred in a standard ijara. Only the usufruct is transferred to the client. Anything that cannot be used without consumption is not considered as a Shariah-compliant lease assets – for example, food
- The leased asset must be a legal Shariah commodity of value (mal al-mutaqawam)
- All financial liabilities related to the ownership of the leased asset are the responsibility of the lessor and not the lessee
- The risk of the leased item remains with the lessor throughout the leasing tenure.

Miscellaneous Rulings

- The ijara asset must be clearly defined
- The legal title of the leased asset may be transferred into the lessee’s name to comply with certain financial and government regulations
- Jointly owned properties can be leased out provided that the rental is either shared according to property ownership ratios or mutually agreed ratios
- The subject matter in an ijara must be Shariah compliant.

Ijara Commencement

An ijara contract can be set for a future date on condition that the rent is only payable after the leased asset comes into the possession of the lessee. An Islamic contract of sale, on the other hand, cannot be effectuated for a future date. Forward contracts are not Shariah-compliant.

Ijara Rental Determination

- The rent or remuneration must be clearly defined before execution of the ijara.
- The rent may be in the form of cash, kind or usufruct.
- Different rentals may be fixed for different leasing phases on condition that the rental for each phase is clearly defined. This is termed ‘variable rental’. For example: Zaid leases out his holiday property to Amr for a tenure of seven years. The rental payment schedule for the lease agreement is as follows:

Year One - $5000

Year Two - $7000

Year Three - $8000

Years Four to Seven - $9000

- The lessor cannot unilaterally increase the rental amount
- Advance rental is permissible according to Shariah
- Rentals may be linked to a widely known financial benchmark such as Libor or the consumer price index. These rates should be so well known and defined that there is no cause for future dispute. For example, Zaid leases his car to Bakr for ten months with a rental price linked to the country's inflation rate.
- The lease period only begins once the lessee takes possession of the asset and can benefit from it.

Ijara Default

Default in an ijara refers to the lessee's failure to meet ijara payment schedules or to make ijara payments.

The mujir, or lessor, may take legal recourse and reclaim the leased assets in the event of an ijara default as a valid Shariah-compliant alternative. The lessor and lessee may agree on a default clause in the Ijara Master Contract (IMC) stating that the mujir has the legal right to claim his monetary rights.

The mujier can also grant the lessee respite until the lessee's financial condition improves.

Financial penalties for late payment are not Shariah compliant.

Ijara Renewal

An ijara may be contracted for short tenures that can be extended upon maturity. An ijara extension or renewal must be effectuated by mutual consent of the lessor and lessee. Both parties have the right to reject the renewal, in which case the lessee is obliged to vacate the leased asset.

Ijara Maintenance

The lessee is responsible for the general upkeep and maintenance of the leased asset. The lessee must ensure that the asset is used for its intended purpose and no other.

Lessor’s Duties and Rights

Duties

- The lessor is the owner of the leased asset and therefore bears the full risk of the asset even during the lease tenure.
- The lessor must hand over the leased property in such a condition that the lessee may take benefit from the asset. If the asset is not put at the disposal of the lessee, the lessee is not obliged to pay any rental.
- The lessor must ensure that the leased asset is kept in a sound, proper and usable condition. The lessor is responsible for major maintenance costs and all necessary improvements..
- The lessor is responsible for all costs involved in the delivery of the leased asset to the lessee, unlike in conventional leases. The lessor can, however, integrate these financial costs within the rental amount.

Rights

- The lessor may rescind the ijara in the event of improper or unintended use of the leased asset – for example, trading from a residential property.
- The lessor may contract an ijara with two or more lessees.
- The lessor may reclaim the leased asset in the event of an ijara default. Penalty fines cannot be charged for late payment. The lessor can hire the services of a legal expert to provide legal assistance in reclaiming his financial and monetary rights.

Lessee’s Duties and Rights

Duties

- The lessee is obliged to pay rent for the amount of time that the leased asset is at the lessee’s disposal.
- The lessee is obliged to pay the fair market value in the event that the ijara becomes ‘fasid’, or ‘voidable.

- The lessee must use the leased asset according to customary practice, or 'urf'. The lessee must ensure the asset is not used for any unintended or unlawful purposes.
- The lessee must return the property undamaged. Normal wear and tear is excused.

Rights

- The lessee has the right to fair and intended usage of the leased asset.
- The lessee has the right to rescind the ijara contract at any time within the lease tenure if the lessor fails to ensure that the leased asset provides reasonable intended usage.
- The lessee has the right to agree or disagree on the rental amount, payment schedule and non-essential contract terms and conditions before contract execution.
- The lessee can make useful improvements to the leased asset provided that those improvements do not damage nor hinder the normal usage of the property.

Ijara Sub-Lease and Assignment

Sub-Lease

The lessee is allowed to sub-lease the leased asset if the lessor expressly and clearly agrees, on condition that the sub-lease rental amount is equal to or less than the original rental amount. If the sub-lease rental amount is more, the surplus must be given in charity.

The surplus amount can be kept by the secondary lessor if:

- The sub-lease rental currency is different from the original rental currency.
- The lessee developed the leased asset by making certain useful improvements.

Assignment

- The lessor cannot assign the lease to a third party in exchange for monetary benefit, but may do so without financial gain. For example, Zaid assigns his lease to Amr, who is then entitled to receive monthly rentals from the lease contract.

- The lessor is allowed to sell the leased asset, in which case the lease contract will be established with the new owner, who is bound to fulfil and honour all the terms and conditions of the ijara contract.

Negligence in Ijara

The lessee is merely an ‘amin’, or ‘trustee’, of the leased assets. According to Shariah law, an amin is not ‘dhamin’, or ‘legally responsible’. Therefore, the lessee will only be held liable for any loss caused to the leased assets as a direct result of the lessee’s misuse or negligence. The lessee is not responsible for any loss that occurs to the leased assets due to force majeure or factors beyond his control.

Modern Application

Islamic banks, investment firms and private equity companies offer Islamic ijara products.

In these, the Islamic bank may appoint a ‘mustajir’, or lease holder, as its agent, or ‘wakir’, under a separate agency contract to purchase the lease asset.

The bank enters into an ijara contract with the client or mustajir after agreeing terms, conditions, lease tenure, payment schedule and rental amounts.

The Islamic bank leases out the asset to the mustajir after concluding the ijara contract.

The fundamental stages of an Islamic Financial Lease are:

1. Lease Requisition

The client submits a lease requisition to the Islamic bank. The bank approves the ijara facility on the basis of the client’s credit rating and its own due diligence checks.

2. Signing of the Master Ijara Facility Agreement

A Master Ijara Facility Agreement, or MIFA, is signed between the Islamic financial institution and the client. The MIFA includes:

- Credit facility approval
- Terms and conditions of the facility
- Dispute resolution clause
- Payment schedule and mechanisms
- Lease asset specifications
- Unilateral promissory agreement

The client signs a separate promissory agreement undertaking to rent the lease assets once acquired. This is a non-legally binding agreement completely separate and independent from the master contract.

3. Agency Agreement

The Islamic financial institution appoints a third party or the client as agent to purchase the lease asset on its behalf. The bank does not have to appoint an agent to purchase the asset, however. The agency agreement must be well defined, with no vague clauses that could cause future dispute.

4. Agent's Possession

The agent signs the purchase order form after the agency. The bank disburses the money to the agent who pays the supplier for the lease asset on behalf of the bank.

5. Agent's Transfer of Possession

The agent transfers the leased asset to the Islamic financial institution.

6. Offer and Acceptance

The Islamic financial institution and client make an offer and acceptance to enter into the lease agreement. The ijara is concluded upon acceptance of the contract. Either party can make the offer.

7. Transfer of Possession

The Islamic financial institution transfers the lease assets to the mustajir. The mustajir only assumes possession but not ownership. The Islamic Banks bears all the financial risk of the leased assets. Legal title may be transferred to the client for financial regulatory reasons.

8. Ownership

The Islamic financial institution may unilaterally gift the leased assets to the mustajir upon maturity or sell the leased assets to the mustajir.

Ijara Termination

An ijara contract can be terminated for the following reasons:

- Maturity of the lease agreement / contractual terms
- Bilateral rescission of the lease agreement
- Destruction or loss of the leased asset's usufruct
- Failure by the lessee to meet lease terms and conditions
- The lessee losing his sanity during the ijara tenure
- Death of the lessee

The lessee can terminate the ijara contract if the leased asset has such defects that normal usage of the asset's usufruct is hindered and the lessor refuses to repair the asset.

The Shariah Supervisory Board, or SSB, or the External Shariah Audit Committee, or ESAC, is tasked with determining a reasonable compensation amount.

The SSB and ESAC are tasked with auditing the Shariah compliancy of the ijara products of the Islamic bank. This may be done by conducting qualified sample audits at regular intervals. This will ensure that the Shariah non-compliancy risk of the Islamic bank is kept to a minimum.

Notes:

Chapter Eight

Murabaha (Cost plus Financing)

Murabaha is the most widely used financial instrument by Islamic banks and financial institutions.

A murabaha is a sale in which the seller's cost in acquiring the asset and the profit earned from its sale are expressly disclosed to the client.

A murabaha contract can only be Shariah compliant if the cost of the asset's acquisition can be ascertained. If not, then the asset can only be sold on the basis of a general 'musawama', or bargaining, contract without any reference to cost and profit.

Islamic banks offer murabaha contracts for real asset purchases and not as a liquidity financing tool. Musharaka and mudaraba are the original liquidity financing instruments.

A Murabaha is not an interest-bearing loan. It is rather the sale of a real asset in exchange for profit with reference to the cost price. Murabaha contracts can only be used to finance real asset purchases.

Murabaha Fundamentals

Subject of Sale

- The subject of the murabaha must exist when the contract is executed. For example, a murabaha can be contracted for an existing boat, but a boat yet to be manufactured cannot be used as a murabaha commodity.
- The murabaha commodity must be in the ownership of the seller or bank. Ownership can either be physical or constructive.
- The murabaha commodity must be a commodity of value and be Shariah compliant. A murabaha cannot be executed for currencies or media of exchange such as gold and silver, or commercial papers.
- The subject matter must be well defined. For example, if Zaid wishes to sell ten vehicles to Bakr on the basis of a murabaha, the exact specifications of the vehicles must be clearly specified. This ensures

there is no possibility of a future dispute between the two contracting parties.
- The murabaha commodity must be acquired from a third party.

Price

- The entire cost of the murabaha asset acquisition must be declared to the client before execution of the contract.
- Cost refers to all expenses incurred in acquiring the asset including freight costs, handling fees, customs charges, etc.
- The contractual parties agree a specific and fixed price .
- The murabaha price may be paid immediately as a lump sum, or deferred and paid as a lump sum at contract maturity, or paid in instalments to a mutually agreed schedule.
- The murabaha price must be fixed before contract execution.
- The price must not be left vague or in any way uncertain, and should not be dependent on a future contingency.

Contract

- The murabaha sale must be instant and absolute. Forward murabaha sales are impermissible and not Shariah compliant.
- The sale must be unconditional unless it is a permitted condition.
- Murabaha buy-back sales are not Shariah compliant.

Modern Application

Islamic banks and financial institutions that use murabaha as a financial instrument must adhere to certain Shariah procedures:

1. Purchase Requisition

The client makes a purchase requisition to the Islamic bank. The bank approves the facility on the basis of the client's credit rating and its own due diligence checks.

2. Signing Master Murabaha Facility Agreement

The Master Murabaha Facility Agreement, or MMFA, is signed by the Islamic financial institution and the client. The MMFA includes:

- Credit facility approval
- Terms and conditions
- Dispute resolution clause
- Payment schedule and mechanisms
- Murabaha asset specifications
- Unilateral promissory agreement

The client signs a separate promissory agreement undertaking to purchase the murabaha asset. This is a non-legally binding agreement completely separate and independent from the MMFA.

Key Points:

- The MMFA must undergo rigorous Shariah checks and tests by the SSB before reaching the final approval stage.
- The SSB must approve the MMFA before submission to the ESAC for final approval.
- There must be no element of insurance involved in the MMFA.

3. Agency Agreement

The Islamic financial institution appoints a third party or the client as agent to purchase the murabaha asset on its behalf. The Islamic term for agency is ‘wakala’.

There are two types of wakala agreement:

- Specific Agency Agreement (wakala al-muqayada): The agent is restricted to purchasing the murabaha asset from a particular dealer or supplier. For example: Zaid, the murabaha client, may only purchase the murabaha asset, a car, from ABC Motors.
- Global Agency Agreement (al-wakala al-mutlaqa): The agent is allowed to purchase the murabaha asset from any dealer or supplier. The bank grants the client various sweeping and general powers.

Key Points:

- The agency agreement is not a pre-requisite for the validity of the murabaha. Islamic banks appoint their clients as agents for logistical reasons.
- Islamic banks should only appoint their clients as agents in exceptional and difficult conditions.
- The bank should ideally purchase a murabaha asset itself, or appoint a third-party agent to purchase the asset on its behalf.
- An Islamic bank must ensure the asset is not in the possession of the client at the time the murabaha contract is executed.
- The Islamic bank should limit the time frame of the agency agreement as its risk is extremely high at this stage.
- Islamic banks may develop good working relationships with local and international suppliers to ensure clientele honesty and transparency.
- The banks hold the risk of murabaha assets until stage six.

4. Agent's Possession

The agent signs the purchase order form. The bank disburses the money to the agent, who pays the supplier for the murabaha asset on behalf of the bank.

5. Agent's Transfer of Possession

The agent transfers the leased asset to the Islamic financial institution.

6. Offer and Acceptance

The Islamic financial institution and client make an offer and acceptance to enter into the murabaha agreement. The agreement is concluded upon acceptance of the contract. Either party can make the offer.

7. Transfer of Possession

The Islamic financial institution transfers ownership of the murabaha asset to the client. The client assumes all financial risks and rewards associated with the asset.

Murabaha Capacity

The Islamic bank and client assume different respective roles during the execution process of the murabaha contract as described above:

- Stages one-three: Promissor and Promisee
- Stages four-five: Principal and Agent
- Stage six: Buyer and Seller
- Stage seven: Creditor and Debtor

Murabaha Security and Risk Mitigation

Islamic banks may require clients to provide a security in order to effectively manage risk. An Islamic security is termed as 'rahn'. Islamic securities can only be furnished upon the incurrence of liabilities and debts. Therefore, an Islamic bank may only request a security from the client after stage seven, when the client becomes the debtor and the bank the creditor. The security must be well defined. An Islamic bank may also request the client to provide a third party guarantee. An Islamic guarantee is termed a 'kafala'.

Two of the key risks in a murabaha contract are:

Transit Period Risk: The risk posed to the Islamic bank once it purchases and possesses the murabaha assets and before effectuation of the murabaha contract.

Shariah Non-Compliance Risk: The risk that arises out of non-compliance with the correct Shariah sequence of a murabaha contract. This is one of the greatest risks that Islamic banks face. Shariah supervisory boards must conduct strict Shariah compliancy tests.

Murabaha Prohibitions

A roll-over is the extension of a debt in exchange for an increase in the original payable amount. This is clear and evident riba, or interest, as it is nothing more than the re-scheduling and re-structuring of the payable amount in exchange for the increase.

Re-scheduling is the practice of extending the loan tenure in order to make debt repayment easier for the debtor. Conventional financial institutions generally offer re-scheduling facilities on the basis of additional interest amounts. This is totally impermissible under a murabaha contract. Islamic banks may offer re-scheduling facilities, though without any additional fees or payment charges.

Murabaha Default

A client cannot be charged any late payment penalties or charges in the event of a murabaha payment default.

The Islamic bank can either grant the defaulting client respite for a reasonable period of time or institute legal claims. The bank can only reclaim its monetary and financial rights and cannot claim for any further damages.

Modern Murabaha Applications

- Import financing
- Export financing
- Vehicle and other asset financing
- Land financing
- Machinery and equipment financing

Early Rebate

An Islamic Bank can offer a rebate or discount for early payment to the client provided that this facility is voluntary and not made a pre-condition of early payment.

For example: A client enters into a murabaha contract with an Islamic bank on June 3 and the murabaha is fully executed and effectuated on August 1. The murabaha payment schedule allows for a tenure of 24 monthly instalments of $5000. The client, however, makes complete payment after 20 months. The Islamic bank offers the client a rebate of $6000. This discount is offered on a completely voluntary basis with no strings attached. If the Islamic bank does not offer a discount, then the client has no legal claim against it.

Notes:

Chapter Nine

Salam and Istisna

Salam and istisna are types of sales contract where payment is in advance and the specified goods are delivered at a future date. In the case of istisna, the goods have yet to be manufactured.

Salam

In a salam, the subject of the sale does not have to be in the possession of the seller at the time of the contract. The price is paid in cash. The ‘rabb al-salam’, or buyer, concludes the purchase with the ‘muslam ilaihi’, or seller. The capital is termed the ‘ra’s al mal’, while the subject of the sale is the ‘muslam fih’.

Salam contracts were initially used to fund the liquidity requirements of agriculturalists and commercial farmers, who would sell their commodities before actual production.

Islamic banks fund the operations of large agricultural corporations and syndicates on the basis of salam contracts.

Salam contracts facilitate the liquidity requirements of sellers while offering prices lower than market rates to purchasers.

Salam Preconditions

- The quality of the salam commodity must be fully defined in order to avoid any element of ambiguity which may lead to a future dispute.
- The exact quantity of the salam commodity must be fully determined before salam execution.
- Salam cannot be executed for goods having a specific measure and weight since there will be no recourse for the seller in the event that the goods are unsalable, defective or damaged. For example, Zaid cannot sell two tons of wheat based on his own measurements.
- The location of delivery must be specified and the salam goods must be

delivered on a fixed date. Delivery of salam commodities can only take place after three days.

- The salam goods must be easily available in the market on the date of contract maturity, so that if they are in any way defective they can be readily replaced.
- The price must be fixed and defined before contract execution. There should be no ambiguity in the salam price. The price must also be paid for contract execution.

Salam Fundamentals

Salam Subject Matter

- The units of a salam contract must be of a similar nature to each other or capable of substitution with similar items. For instance, Zaid purchases twenty black sedans from an Islamic bank on the basis of a salam contract. The sedans are sold in units of a similar nature and are thus termed as homogenous or fungible goods.
- The subject of the salam contract can also be goods that are measured by volume and weight, such as agricultural produce.
- The subject matter of the deal must be clearly defined before contract execution. The quality and quantity must be well defined and specified.
- The subject matter must be a commodity of commercial value, or 'mal mutaqawam', and lawful under Islamic law.
- Currencies may be used as the salam subject matter provided they are different and exchanged at the current market rate.
- The salam subject matter can be replaced before contract maturity on the basis on mutual agreement.

Salam Price

- Any Shariah-compliant legal tender or value of exchange used in a normal sale can be used as the salam price – i.e. usufruct, goods or cash.
- Goods that serve as the salam price cannot be from the amwal al-ribawiya category – the six commodities mentioned in the hadith (gold, silver, dates, wheat, salt and barley).

The term ‘usufruct’, or ‘manafi’, refers to the benefit derived from an asset. The purchaser may offer the usufruct of an asset to the seller in exchange for the salam goods. For example, Zaid concludes a salam with Yusuf to deliver 500 black sedans in exchange for 1,000 working hours of Yusuf’s oil tanker.

Modern financial institutions and banks calculate the salam price on the basis of investment tenures, capital funding, etc.

Salam Tenure

Salam tenures can be mutually agreed upon by the purchaser, or rab al-salam, and the seller, or muslam ilaihi, before contract execution on condition that a tenure is not less than three days.

Islamic banks and financial institutions offer short-term, medium-term and long-term salam financing.

Salam Delivery

- The location of salam commodity delivery should be specified and clearly defined before contract execution.
- The date of delivery must likewise be clearly specified and determined before contract execution.
- Salam contracts should ensure the provision of a commodity delivery clause.
- The delivery location should be mutually agreed upon by both parties before salam execution.
- In the event of a dispute, the contract execution location will become the delivery location.
- The purchaser cannot charge a penalty if the seller is unable to deliver the salam goods upon contract maturity.

Salam Termination

- A salam contract cannot be unilaterally revoked or rescinded after contract execution.
- A salam contract may only be revoked by mutual agreement between the contracting parties.

- A bilateral revocation may be complete or partial, by returning either the full or proportionate salam price.

Salam Security

The purchaser in a salam contract may request the seller to furnish a security. The purchaser has the right to request a security since the salam goods are due against an advance payment.

In the case of default, the purchaser may make an application for security liquidation to the Shariah Supervisory Board, or SSB, and External Shariah Audit Committee, or ESAC, who will review the application and approve the liquidation accordingly.

If the application is successful, the purchaser may then liquidate the security and regain his financial rights.

The contracting parties may also mutually agree on an automatic liquidation clause before contract execution. In the case of default, the security is automatically liquidated.

It is important to remember that the salam security must be clearly defined, specified and distinguishable in order to ensure Shariah compliance. The salam security must also be free of all financial and legal obligations.

Unintentional Salam Default

If a seller is unable to meet the delivery schedule due to unforeseen circumstances:

- The purchaser may grant the seller respite for any amount of time

or

- The parties may agree to terminate the contract and the purchaser may be reimbursed for the full salam price

or

- The parties may agree to replace the original salam subject with another.

Intentional Salam Default

In the event of a default for which the seller bears responsibility:

- The purchaser may compel the seller to deliver the salam goods.
- The purchaser may liquidate the security according to the security liquidation clause of the salam contract.
- The purchaser may institute legal proceedings against the seller.

Salam Options

Khiyar al-aib (Option of Defect) – 'Khiyar' is Arabic for 'option', while 'aib' means 'defect'. Khiyar al-aib is an option to return the subject of sale which the purchaser may exercise if the salam goods are found to be defective or not meeting the agreed specifications. Khiyar al-aib cannot be exercised for perishable goods such as food items.

Khiyar al-ru'yah – 'Ru'yah' is the Arabic for 'to see'. Khiyar al-ru'yah refers to the option to revoke a purchase in the event of non-conformance to specifications on condition that the purchaser did not see the goods before purchase. There is no khiyar al-ru'yah in salam.

Parallel Salam

Parallel salam refers to the execution of two contracts simultaneously. An Islamic financial institution is the purchaser in the first contract and the seller in the parallel contract.

For example: Zaid enters into an arrangement to sell 500 oil tankers to the Al-Nakheel Islamic Bank. Zaid is the purchaser while Al-Nakheel is the seller. Al-Nakheel Islamic Bank pays Zaid $1,000,000 before the salam execution.

Al-Nakheel Bank profits from the two contracts by recouping the disbursed amount for the initial Salam from the parallel Salam as well as profiteering from the Salam contract.

Parallel Salam Essentials

- The original salam contract and the parallel salam must be completely separate, with entirely separate legal documentation, rights and obligations.
- The original and parallel contracts should not be contingent upon each other. For instance, the delivery of the parallel salam goods cannot be made contingent upon the delivery of the initial salam goods. What if the initial seller could not deliver the Salam goods?
- Parallel salam contracts are only permitted with third parties. A seller cannot become the purchaser in the parallel contract. 'Buyback' contracts are not Shariah-compliant. However, the seller can purchase in a parallel salam provided the total shareholding in the purchasing company is less than 50%. For example: ABC Holdings, a Japanese car manufacturer listed on the Japanese Stock Exchange, sells two million cars to Lever Capital under a salam arrangement. Lever Capital then sells the cars to YMI Holdings, in which ABC has a 25% stake.

Modern Salam Application

An Islamic bank may purchase a commodity under an initial salam contract and then sell it via a parallel salam. The tenure in the parallel contract is much shorter than for the original salam contract and with a higher mark up. The Islamic bank earns a legitimate and fully Shariah-compliant profit from the price difference between the first and second contracts.

The Islamic bank may execute a promissory agreement to sell the salam commodities with a third party in the event of default.

Alternatively, the bank may execute a unilateral promissory agreement with a third party to purchase the salam commodities upon maturity of the initial contract.

Istisna

Istisna is a contract executed to procure an asset or commodity manufactured to order. The istisna contract may be executed with the actual manufacturer of the commodity or any other third party.

The 'mustasni', or istisna requestor, orders the mustasna, or manufacturer, to manufacture certain goods or commodities. Both parties must agree on all commodity specifications before contract execution.

An istisna contract is executed by the mutual undertaking of one party to manufacture the goods and the other to pay a specified amount for them. An Istisna contract cannot be executed for an already manufactured item.

Istisna Fundamentals

Istisna Subject Matter

- The subject matter in an istisna contract must be clearly defined before contract execution.
- The parties may mutually agree on changing the specifications of the subject matter.
- The manufacturer, not the istisna requestor, must procure the istisna production materials.
- The subject matter must undergo generally accepted market norms of manufacturing.
- The subject matter must be non-existent at the time of contract execution.
- The subject matter in an istisna does not have to be owned at the time of contract execution.

Istisna Price

- All Shariah-compliant counter values may be used as the istisna price – i.e. usufruct, goods and cash.
- The istisna price must be clearly specified and agreed before contract execution.
- The price need not be fully paid before contract execution, as in the case

of salam contracts. The istisna price may be settled by a one-off payment or in installments to a fixed schedule.

- The istisna price must not be unclear in any way.
- The price must not depend on future contingencies such as inflation rates or manufacturing costs.

Istisna Options

The istisna requestor has the right to exercise the khiyar al-aib but not the khiyar al-ru'yah.

Istisna Tenure

The contracting parties may mutually agree a fixed time period. Istisna tenures can be for any amount of time. In the time is not specified, the general market tenure for the production of the goods may be used to determine the tenure. Alternatively, the parties may agree on a tenure even after contract execution. It is not a necessary element of an istisna contract that the tenure be fixed.

Prohibition of Buy-Back

There must be no buyback agreements in an istisna contract. Parties should ensure legal and contractual independency at all times. Islamic banks and financial institutions may deal with subsidiary companies if their shareholding is less than 50%.

Early Rebate

The istisna requestor may grant the manufacturer a rebate on the istisna price in the case of early delivery. Rebates may not be stipulated or pre-agreed, however, at contract execution.

Istisna Deposits

Islamic banks may request the client to furnish an ‘amanah’, or ‘trust’, deposit. In conventional finance this would be a safety deposit.

Alternatively, the bank may make it a contractual requirement for istisna clients to provide initial one-off payments such as, for example, 25% of the total istisna price.

Islamic banks may also request istisna clients to provide guarantees in order to lower the risk profile of the transaction.

Istisna Default

A penalty may be imposed on the manufacturer for late delivery of goods. This penalty, or shart al-jaza, established before contract execution, allows for a reduction in the istisna price. This clause is only applicable to Shariah-compliant manufacturing contracts.

Istisna Termination

Each contracting party can unilaterally terminate the istisna contract on condition that production of the istisna goods has not yet started. Both parties are legally bound by the istisna contract once manufacturing has begun, after which termination of the contract must be by mutual consent.

Parallel Istisna

Parallel istisna contracts are secondary istisna contracts executed alongside the original istisna contract but completely independently of it.

The contracting parties must ensure that the parallel and original istisna arrangements are totally independent and separate legal entities.

The manufacturer in the original contract becomes the istisna requestor in the parallel contract.

For example, Zaid enters into an istisna arrangement with Al-Nakheel Islamic Bank for the manufacture of 1,000 corporate suites. Zaid is the istisna requestor, while Al-Nakheel is regarded as the manufacturer. Al-Nakheel is a bank, however, and must enter into an arrangement with a real estate developer or building contractor to develop the units. Al-Nakheel therefore executes a parallel istisna with Al-Mabroor, a real estate developer.

Upon maturity, Al-Mabroor hands over the suites to Al-Nakheel, who then hand over the units to Zaid under a separate and independent istisna transaction.

Al-Nakheel may appoint Zaid as agent to supervise and monitor the development of the real estate units. This promotes financial transparency and trust between the contracting parties.

Modern Istisna Application

Real Estate Istisna Financing

Islamic financial institutions offer real estate financing on the basis of istisna financing. Islamic banks conclude an istisna arrangement with the client for the development of a certain number of real estate units after agreeing specifications. The client provides the land while the bank develops the units. The Islamic bank executes a separate and independent parallel istisna with a real estate developer to build the units, while ensuring that the developer adheres to the agreed upon specifications. The bank profits from the difference in prices.

Infrastructure Development

Governments may finance infrastructure development using istisna contracts. For example, a government issues tenders to various construction and development companies to develop highways, with the price being the usufruct of the highway over a fixed tenure.

Governments may even execute combined arrangements such as two-tiered istisna and salam arrangements.

Examples of other contracts:

- BOT (buy, operate, transfer)
- Construction financing
- Local and export istisna products

Notes:

Chapter Ten

Islamic Private Investment Funds

Islamic Private Investment Funds are joint shareholdings of investors in non-listed companies, limited partnerships and joint ventures to invest in Shariah-compliant commodities.

They allow investors to diversify their asset portfolios while being able to personally supervise their investments. Private funds have a much higher risk profile than public funds but generally enjoy higher returns on investment (ROI). Private investment funds can be closed- or open-ended.

For example, ten investors invest $1,000,000 in a large real estate investment target company on the basis of a closed-end musharaka partnership. Partners agree on profit ratios, management duties, legal vehicles, exit strategy and contract terms before partnership execution. They agree a tenure of five years, after which the musharaka is terminated.

Investment Types

There are various asset classes which may be covered by Islamic Private Investment Funds:

1. Private Equity Investment Funds

2. Real Estate

3. Mixed Funds

4. Trade Finance

Investment Scope

Major investment classes:

1. Real Estate Development

2. Healthcare
3. Education
4. Services
5. Telecommunications
6. Technology
7. Research
8. Asset Financing

Investment Classes

Private Equity Investment Funds

A private equity fund is a joint shareholding in companies not listed on the stock exchange. Investors pool their excess liquidity in joint asset portfolios with the intention of gaining profit from the trading of company shares or sharing dividends according to pre-agreed profit ratios.

Conventional equity funds can co-exist and merge with Islamic private equity investment funds subject to certain conditions.

Investors must agree on matters including management scope, legal vehicles, fund structures, profit ratios, investment strategy, legal issues, and Shariah governance.

Private Equity Shariah Fundamentals

- All investors or subscribers must agree on profit ratios before fund initiation.
- Losses are shared according to capital contribution ratios.
- All investors should agree on investment tenures.
- There must be no gambling
- There must be no conventional insurance

- There must be no debt financing, debt restructuring or non-compliant debt rescheduling
- There must be no interest
- The underlying investment assets should be Shariah-compliant. The Shariah Supervisory Board should develop standard financial filters to screen target companies for non-compliancy.
- Management scope should be clearly defined before fund initiation. Investors may appoint separate fund managers to manage the asset portfolios.
- In order to ensure Shariah compliance when trading in private equity stocks, the fund should consist of at least 33% of tangible and illiquid assets.
- There must be no gharar, jahala (ambiguity) or other non-compliant elements.

Islamic Private Equity Fund Structure

- Documentation Submission – The fund or company promoter submits the articles of association, governance structure, business plan and all other relevant fund documentation to the Shariah Supervisory Board for approval.
- Investment – After approval from the SSB, the investors pool their monies into the Islamic Private Equity Fund.
- Fund Management – The investors either appoint external fund managers or appoint co-investors to manage the fund.
- Shariah Supervision – The SSB monitors and supervises the compliancy of transactions. The Shariah advisor conducts a Shariah assessment and gives the board of directors the Shariah Assessment Report.
- Investment Management – Asset portfolio managers invest the funds in various target companies.
- Profit Distribution – The investment managers conduct detailed portfolio analysis, risk assessments and the like, and provide these reports to the investors. Profit is either generated on the basis of periodic returns or after a planned exit.

Islamic Private Equity Challenges

- Asymmetry of information
- Governance structures

- Government regulations and legal frameworks
- Legal structures and vehicles
- Taxation
- Shariah supervision
- Expropriation and dispute resolution

Real Estate Private Investment Fund

In this, investors pool money to invest in real estate. They agree a fixed tenure upfront and then exit the fund with either a buy-out or buy-in clause.

Investors must ensure that all elements of the fund such as profit ratios, management scope and third-party agreements are Shariah-compliant.

Islamic Real Estate Investment Trust (IREIT)

IREITs are Shariah-compliant certificates or securities of equal value representing the undivided ownership of real estate assets. IREITs allow investors to invest in various real estate classes under a Shariah-compliant trust fund. They operate under a normal trust fund structure, with trustees, fund managers, unit holders and property managers.

IREIT Check List

- Rentals must be derived from Shariah-compliant business activities.
- Conventional insurance is not permitted.
- All cash flows, investment types, deposit and financing instruments must be Shariah-compliant.
- All structures and systems must be pre-determined and pre-agreed.
- All certificates and securities must represent underlying assets.

Mixed Fund

Subscribers pool their funds in investment bouquets or diversified portfolios of assets such as equities, commodities and real estate.

Investors must ensure strict Shariah-compliance in accordance with international standards.

Trade Finance

Closed-end funds used to invest in non-negotiable murabaha certificates.

Murabaha certificates cannot be negotiable since the murabaha clients of Islamic banks and financial institutions generally purchase the commodities on credit. Accounts receivable cannot be exchanged in lieu of money.

Notes:

Chapter Eleven

Liquidity Management for Islamic Finance

Liquidity management refers to the financial management of an excess or shortage of cash funds.

Islamic banks must meet the demand for cash deposit withdrawals, routine cash flows and other liquidity requirements. Financial institutions must maintain optimum liquidity levels in order to operate efficiently and competitively.

Banks may place their excess liquidity in various profitable investment portfolios and access funds from the interbank and money markets in the event of liquidity shortages.

Islamic banks must adopt a coherent and financially prudent liquidity management strategy. They must have in place a Contingency Funding Plan, or CFP, to deal with heightened liquidity stress.

Liquidity stress testing is an important tool in determining an optimum CFP.

Measures of Liquidity

Financing to Deposit Ratio

The Financing to Deposit Ratio is a measure used by financial institutions and banks to determine liquidity risk, or the possibility of a bank being unable to fund its financing commitments or meet demand for cash withdrawals. The ratio expresses the relationship between a bank's financing requirements and its total deposits. The lower the deposits, the higher the liquidity risk.

Liquidity Ratio

The ratio of a bank's liquid assets – being the total amount of cash and cash-equivalent reserves, as well as deposits with other banks – to its liabilities is known as its liquidity ratio. Islamic Banks generally have much higher liquidity ratios than conventional financial institutions.

Liquidity Management Instruments

Musharaka Investment Pools

Islamic banks and financial institutions create diversified investment portfolios to finance equities, murabaha arrangements, musharaka partnerships, lease-based contracts and various other contracts.

An Islamic bank will transfer assets from a general investment portfolio to a specific investment pool based on its liquidity management strategy. The bank runs the specific investment pool for a fixed tenure. The pool is dissolved upon maturity and the assets returned to the general pool.

Musharaka Investment Pool Fundamentals

- The pool must consist of a minimum 33% in tangible assets when trading in stocks.
- The Islamic bank manages the funds as a working partner, while the investors serve as silent partners.
- The bank must ensure proper profit calculation and distribution.
- It must also ensure that the assets realize a profit above their actual value.
- The assets must be Shariah-compliant.
- All contracts must be regularly monitored by the Shariah Supervisory Board.
- An Islamic bank may also serve as the fund manager, in which case it would become an employee of the investors. Alternatively, the bank may serve as agent of the investors and receive a fixed agency commission.
- All non-permissible income is filtered into a specific charity fund.

Asset Pool Management System

- The Islamic bank executes a Deal Confirmation Agreement with the financial institution.
- The assets are recorded and a transfer voucher is generated.
- Each specific investment pool is assigned a unique pool identification number, or PIN.
- Each transaction is given a unique deal/ticket number.

Interbank Mudaraba Contract

Islamic banks can also manage liquidity using an interbank mudaraba facility agreement, which has a maximum period of 180 days. Mudaraba is a partnership between two or more parties where one party provides the investment management expertise and the others the capital investment.

The master mudaraba facility agreement contains the following key elements:

- The Islamic bank and investors agree on a specific and fixed profit ratio before contract execution. The investors bear the full loss of the contract, although the bank can be held responsible for proven negligence. Islamic banks allocate different weightings for different asset and investment classes to calculate profit-sharing ratios.
- The venture must only invest in Shariah-compliant assets.
- The Islamic bank and investors agree a fixed tenure.
- The agreement is submitted to the Islamic bank's Shariah Supervisory Board for approval.
- The bank and investors execute the transaction once approved by the SSB.
- The transaction is reported to the bank's Treasury Department.
- The Treasury Department reviews and approves the transaction, weightages, and contract terms and conditions.
- The Islamic bank manages the portfolio, and declares profits or losses at regular intervals until maturity.
- The mudaraba is terminated and liquidated upon maturity.

Wakala (Agency)

An Islamic bank appoints another bank as its agent to invest excess liquidity in various Shariah-compliant portfolios under an interbank wakala agreement. The Islamic bank serves as the muwakil, or principle, while the investing bank serves as the wakil, or agent.

Interbank Wakala Execution

- The principle identifies a suitable Shariah-compliant investment portfolio and discloses the investment strategy of the portfolio.

- The principle and agent agree terms such as tenures, agency commission and brokerage charges, and scope of management.
- The principle and agent execute the interbank wakala transaction after receiving approval from the Sharia Supervisory Board.
- The agent receives a fixed commission for each successful transaction.
- The principle receives profits in excess of the agency commission.
- The wakala is terminated and liquidated upon maturity.

Wakala Negligence

The principle is entitled to receive compensation for any losses suffered by the business venture as result of the agent's negligence.

Islamic Real Estate Investment Trusts

Islamic banks can invest in Islamic Real Estate Investment Trusts or IREITs provided all Shariah compliancy requirements are met.

The banks can use IREITs to fulfil short-term liquidity requirements or to manage excess funds.

Shariah-Compliant Private Equity

Islamic banks may invest in private equities to manage an excess of liquidity. All Shariah compliance criteria must be met before investment execution.

Interbank Wadiah Deposits

Islamic banks may place excess liquidity with other banks under an interbank wadiah agreement, in which the holding bank serves as custodian of the wadiah portfolio. The wadeah depositor may offer a dividend on a purely voluntary basis. The holding bank may charge an administrative fee.

Local Currency Commodity Murabaha

The local currency commodity murabaha instrument can be used for various maturities, even including overnight maturities. They can be used by financial institutions to manage excess liquidity or to receive liquidity injections.

1. The Islamic bank appoints an agent to take possession of the commodities on behalf of the bank. The agent issues a delivery order for the commodities when instructed by the bank.

2. The bank then purchases the commodities from a financial broker for the spot cash price.

3. Another financial broker representing a bank facing liquidity shortages issues a delivery order to the Islamic bank's agent. The agent informs the Islamic bank of the order.

4. The Islamic bank sells the commodity to the bank facing liquidity shortages on a deferred payment basis. The financial institution now owns the commodity. Both banks work out fixed tenures and agree on a common benchmark.

5. The financial institution facing liquidity charges sells the commodity to a third party broker based on the original price. The financial institution receives much needed liquidity to fund its operations.

6. The financial institution pays the initiator bank upon contract maturity.

Foreign Currency Commodity Murabaha

The foreign currency commodity murabaha instrument is used for absorbing and investing excess liquidity funds.

1. An Islamic bank with excess liquidity purchases aluminium through a financial broker.

2. The Islamic bank maintains the amount payable to the broker as foreign currency in a separate bank account.

3. The Islamic bank executes a murabaha transaction for the aluminium with another financial institution on a deferred payment basis. The bank pays for the commodities in foreign currency within 90 days. The initiator bank discloses the profit margin, commodity purchase price and all other costs.

4. The financial institution sells the aluminium to a third party broker on the basis of a Murabaha transaction for a foreign currency payment.

5. The third party broker then sells the aluminium to the first broker on a deferred payment basis.

6. The Islamic bank then pays the first broker the foreign currency payment upon contract maturity.

7. The first broker then pays the second broker.

8. The financial institution with a shortage of liquidity receives payment from the second broker.

Islamic Placement Accounts

Islamic banks deposit excess liquidity in Islamic deposit/placement accounts, or IDA, which the counter bank invests to earn profit. The Islamic bank and financial institution agree on a fixed tenure with fixed profit ratios.

Shariah-Compliant Foreign Exchange

Shariah-compliant foreign exchange contracts can be executed on the spot or on a mutually agreed date via a promise to purchase. The client and Islamic bank agree a fixed exchange rate and promise to execute the contract on a the agreed date.

Islamic Liquidity Management Challenges

Islamic banks and financial institutions face various challenges in managing their liquidity portfolios including:

- The absence of a global Islamic capital and interbank money market
- An absence of secondary Islamic markets
- A shortage of financially sound and prudent Shariah-compliant liquidity instruments
- The absence of a Shariah-compliant lender of last resort
- The absence of a global Shariah monetary and regulatory organization

Notes:

Chapter Twelve

Risk Management in Islamic Banking

Risk is defined as the exposure to uncertain future events that could adversely affect the objectives of a financial institution.

Among the common uncertainties an Islamic financial institution faces are the failure of a debtor to meet financial obligations, poor profitability, fraud, exchange rate fluctuations, insolvency, and Shariah non-compliance.

Under a Shariah-compliant contract, the contracting parties are entitled to profits in relation to their risk assumption. This is termed 'essential risk' or 'risk for return'.

Also under a Shariah-compliant contract, the seller bears the full risk of loss until the title of the item sold is transferred to the purchaser, who then assumes all associated risks including risk of defect, damage or depreciation.

Risk Management

Risk management is the process by which various risk exposures for a financial institution are identified, measured, mitigated, controlled, reported and monitored.

It is not necessarily conducted to minimize risk, but to optimize the relationship between risk and reward.

Risk Register

An effective risk management plan would include a risk register, which records all the finer details of the financial institution's risk profile including risk grading, risk mitigation, prescribed strategies and risk impact.

A risk register will include:

- A unique risk identification code
- A description of the risks
- Risk gradings (low, medium, high)
- Risk mitigation strategy
- Mitigation costing

The register must be regularly monitored and updated by the chief risk officer at the financial institution.

Risk Profile

An Islamic financial institution faces both generic risks such as those faced by conventional companies and the unique risks associated with Islamic finance.

Generic Risk

- Credit Risk – The potential for a counterparty to fail to meet its financial obligations under the agreed terms and conditions of a credit contract.
- Market Risk – The potential impact of adverse price changes such as benchmark rates, exchange rates, and equity prices on the economic and financial value of assets.
- Operational Risk – The potential direct or indirect loss resulting from inadequate or failed internal processes, human resources, systems or external events.
- Liquidity Risk – The potential risk of loss arising from the financial institution's inability to meet financial obligations.

Unique Risk

- Equity Investment Risk – The risk arising from entering into a partnership to participate in a particular business or financing activity. Musharaka and mudaraba fall under this risk type.
- Rate of Return Risk – The potential impact on returns caused by market volatility. In the context of Islamic finance, rate of return risk refers to the potential impact on a financial institution's income or market value of equity.
- Displaced Commercial Risk – The risk that a bank has to pay returns that exceed the actual return rate. Banking clients may have expectations

of higher rates of return, forcing the Islamic bank to match these to retain depositors.

- Liquidity Risk – The risk of loss arising from an Islamic bank's inability to fund its financing commitments and meet demand for cash withdrawals as they cannot lend based on debt but based on equity and assets.
- Shariah Non-Compliance Risk – Risk of loss arising from a failure to adhere to Shariah operational procedures and processes.
- Inventory Risk – Risk arising from holding items in inventory. Non-binding murabahas and ijaras are susceptible to inventory risk.

Risk Profiles – Shariah-Compliant Contracts

Murabaha Risk Profile

- Market Risk – Exposure to adverse commodity price changes.
- Inventory/Transit Period Risk – The risk associated with the murabaha commodities after the Islamic financial institution has procured them and before they are sold to the client.
- Operational Risk – The client takes possession of the goods from the supplier without informing the Islamic bank.
- Credit Risk – The client does not pay instalments according to agreed payment schedules
- Supplier Risk – The supplier is unknown to the bank, which may result in delays in delivering the goods, non-conformity to commodity specifications, and fraudulent activity.
- Shariah Non-Compliance Risk – The client does not adhere to the strict procedures and processes of a Shariah-compliant murabaha as outlined in the Master Murabaha Facility Agreement.
- Legal/Regulatory Risk – The risk associated with non-compliance to legal frameworks and government regulations, especially tax regimes.

Ijara Risk Profile

- Inventory Risk – The risk that the lessee will back out from the lease, forcing the bank to liquidate the asset at a lower-than-market price.
- Asset Risk – The risk that the asset depreciates, or is damaged or stolen.
- Credit Risk – The risk that the client is unable to meet payment schedules.

- Shariah Non-Compliance Risk – The risk that the client does not follow Shariah procedures.
- Liquidity Risk – The risk that a financial institution will be unable to fund major maintenance of ijara assets due to a shortage of liquidity.
- Country/Transfer Risk – The risk associated with transferring ijara assets to foreign lessees.

Salam Risk Profile

- Settlement & Delivery Risk – The risk associated with non-conformity to specifications or delayed delivery.
- Market Risk – The risk associated with a depreciation of the market value of commodities due to market volatility.
- Rate of Return Risk – The risk associated with a reduction in value of commodities resulting in lower return rates.
- Risk of Early Termination – The risk associated with the client's early termination of the contract before maturity.
- Credit Risk – The risk that the counterparty does not fulfil financial obligations.
- Transfer Risk – The risk that the client sells the commodity before taking ownership.
- Legal Risk – The risk associated with litigation proceedings against the Islamic bank.

Musharaka Risk Profile

- Legal Risk - The risk that a partner institutes legal proceedings against the partnership in the event of a dispute.
- Regulatory Risk – The risk that the partnership does not conform to government regulations.
- Operational Risk – The risk associated with partners not adhering to agreed policies and procedures.
- Shariah Non-Compliance Risk – The risk associated with debt funding, prohibited funding sources, and other forms of non-compliance with Shariah standards.
- Liquidity Risk – The risk that partners fail to meet funding requirements.
- Equity Investment Risk – The risks associated with entering into an equity-based partnership. Such risks include fraudulent behaviour and misrepresentation.

Risk Mitigation

Unique Mitigation Tools

- Agency Agreements – Islamic financial institutions appoint clients or third-party agencies to procure commodities according to specifications.
- Promise to Purchase – The client signs a unilateral, non-legally binding promissory agreement to purchase commodities at a specified date.
- Securities – The Islamic bank maintains a security furnished by the client.
- Legal Clause – The client signs an agreement stating that the financial institution may institute legal proceedings in the event of default.
- Guarantees – An Islamic guarantee is taken from the client to fulfil financial obligations.

Islamic financial institutions may adopt strict guidelines for all Shariah products in order to manage operational risks more effectively. Strict reporting and handling guidelines for Shariah non-compliance may also be adopted as part of the risk management plan.

Options

- Khiyar al-Sharth – An option in a sale's contract established at the time of signing the agreement giving one of the two parties to the contract a right to cancel the sale within a stipulated time.
- Khiyar al-Aib – The option of return in case of a defective asset.
- Khiyar al-Wasf – The option that the buyer has to rescind the sale in the event the goods do not conform to specifications.
- Khiyar al-Ghaban – Option covering deception with regard to a fundamental element of the sold item.
- Khiyar al-Ru'yah – The option of refusal based on which the buyer may decline from accepting the goods of a sale as a result of non-conformity to specifications.

Displaced Commercial Risk

- Smoothing of Returns

- Short-Term Liquidity Financing
- Efficient Fund Management

Generic Risk Mitigation Tools

Credit Risk

- Credit Recovery Policy
- Consumer Grading
- Due Diligence Standard Protocol

Operational Risk

- Management Awareness and Self Assessment (MASA)
- Key Risk Indicators (KRI)
- Customer Complaints Service

Shariah Risk Governance

Shariah risk governance refers to the governance of risk management, evaluation and assessment for Islamic financial institutions in accordance with Shariah law.

Shariah risk governance policies and guidelines form the backbone of the risk management plan of an Islamic bank. Operational manuals ensure strict implementation of policies and guidelines.

The risk policies, guidelines and operational manuals must be approved by a financial institution's Risk Board, a special committee set up to deal with risk identification, assessment, mitigation and approvals, in consultation with the various bank sub-committees including the Audit Committee, Risk Committee, Board of Directors, Shariah Supervisory Board and External Shariah Audit Committee.

All risk policies, strategies and guidelines must be reviewed on an annual basis to ensure risk optimization.

Risk Policy & Guideline Sample

An operational risk policy is aimed at effectively and efficiently managing operational risk in accordance with the strategy adopted by the Risk Board.

Operational Risk Policy Guidelines

- Operation Risk Management Guidelines
- Management Awareness and Self-Assessment (MASA)
- Fraud Handling & Reporting Guidelines
- Key Risk Indicators (KRIs)
- Information Technology (IT) Guidelines
- Customer Complaints Guidelines
- Regular Stress Testing

Notes:

Chapter Thirteen

Hawala and Kafala (Islamic Cession and Surety)

Hawala

The transfer and cession of a debt obligation to a third party is known as ‘hawala’.

Hawala assigns the debt rather than sells it.

The person who transfers the debt – the original debtor – is known as the ‘muhil’. The creditor is known as the muhtal’, while the person to whom the debt is transferred is the ‘muhtal alaihi’ refers to the transferee. The subject of the cession or reassignment of debt is the ‘muhtal bihi’.

For example: Zaid owes Bakr $10,000. Zaid is the debtor while Bakr is the creditor. Zaid cannot fulfil his financial obligations towards Bakr. However, Yusuf agrees to undertake the fulfilment of the debt. Bakr agrees to this arrangement, and Zaid is no longer obliged to pay Bakr the $10,000. Here, Zaid is the muhil, or assignor, while Bakr is the muhtal, or assignee. Yusuf is the muhtal alaihi, or transferee, and the $10,000 is the muhtal bihi, or cession item.

Hawala Fundamentals

- A hawala contract is initiated by the mutual acceptance of the muhtal, the muhil and the muhtal alaihi.
- Each party to the contract must be adult and sane.
- Securities cannot be assigned under hawala contracts.
- The muhtal bihi must be clearly specified before hawala execution.
- The hawala must be effectuated immediately and not suspended for future contingencies.
- The transaction should not be conditional on any assignment fees or commission.

Hawala Types

Hawala Mutlaqa, or Global Cession

Global cession refers to the transfer of a debt to a third party with the mutual agreement of the assignor, assignee and transferee.

For example, Mark owes John $5,000. Paul agrees to undertake the fulfilment of the debt on Mark's behalf. Paul, John and Mark are all in agreement for this arrangement. The debt is transferred to Paul and Mark is no longer responsible to fulfil the debt obligation.

Hawala Muqayyada, or Specific Cession

A specific cession is the assignment of receivables to the creditor with the mutual agreement of the assignor, assignee and transferee.

For instance, Zaid owes Yusuf $10,000. Yusuf owes Bakr $10,000. Yusuf and Bakr agree to a specific hawala arrangement under which Yusuf assigns the $10,000 debt of Zaid to Bakr. Bakr receives an official letter of endorsement from Yusuf stating that Zaid is obliged to pay the $10,000 to Bakr.

Hawala Term

A hawala can be executed for any mutually agreed period of time between the muhil, muhtal alaihi and muhtal. However, the term of the hawala must be determined and specified before hawala execution.

Hawala Obligations

- The muhtal cannot claim from the muhil once the hawala has been executed.
- The muhtal alaihi may claim the hawala amount from the muhil upon paying out the debt to the muhtal.
- The muhtal alaihi cannot claim the muhtal bihi from the muhil before fulfilling the debt obligation.
- The muhtal alaihi cannot legally claim from the muhil if the muhil

fulfilled the debt after hawala execution.

- The muhtal alaihi cannot claim more than the muhtal bihi amount. Any excess amount given by the muhtal alaihi cannot be claimed from the muhil.
- The muhtal alaihi will not be obliged to fulfil the hawala if the muhtal absolves the muhtal alaihi from the hawala

Hawala Special Obligations

The muhtal cannot legally claim from the muhil unless:

- The muhtal alaihi denies the hawala and wins the hawala court case.
- The muhtal alaihi dies and does not leave sufficient funds to fulfil the debt.
- An Islamic judge declares the muhtal alaihi insolvent.

Hawala Termination

The hawala is terminated once the muhtal alaihi completes payment of the muhal bihi.

The muhtal alaihi may request an ‘iqala’, or voluntary dissolution, of the hawala.

Modern Applications

Islamic bills of exchange are one of the most common hawala instruments. Others include Islamic cheques and travellers cheques.

An Islamic bill of exchange is a mutually agreed order requiring the addressee to pay on demand or at a future date a sum of money to a specified person or bearer of the bill. It facilitates the transfer of financial obligations from one person to another, thereby facilitating credit.

For example, Zaid wishes to purchase a new vehicle from Mark, a car dealer. The price of the vehicle is $5,000. However, Zaid does not have the ready cash to purchase the vehicle. Therefore, Zaid, as the drawer, signs a bill of exchange instructing John to pay Mark the sum of $5,000 on January 21. John is the drawee while Mark is the payee.

Kafala

Kafala refers to the undertaking of a guarantor to pay a debtor's debt. The liability is shared with the original bearer of the debt.

In a kafala, or Islamic surety, the creditor can claim from both the original debtor and the transferee debtor, while under a hawala, the creditor may only claim from the transferee debtor. Unlike hawala, the original bearer is not absolved of his financial responsibilities in a kafala.

The guarantor who assumes the debt's liability is known as the 'kafil', while the 'asil' is the original bearer of the debt. The creditor is the 'makful lahu', and the subject of the guarantee is the 'makful bihi'.

Guarantees are intended to secure financial obligations and civil rights, and to prevent bad debt. For example, Zaid makes a loan requisition to Bakr for $50,000. Bakr requests Zaid to provide a guarantee to secure payment. Yusuf offers a guarantee to Bakr for the debt obligation.

Here, Zaid is the asil, or original bearer of the debt, while Bakr is the makful lahu, or person seeking the guarantee. Yusuf is the kafil, or guarantor.

In the event of a default, Bakr has a legal right to claim the full payment of the debt from Yusuf and Zaid.

Kafala Types

Kafala BilNafs

Kafala bil nafs refers to the assumption of liability for the physical appearance of the debtor under a lawsuit before the court. Kafala bil nafs is termed as a physical or legal guarantee.

For example, John is charged by the Supreme Court with murder. John appeals for bail. The Supreme Court Judge grants John bail on condition that he obtains a physical guarantee. John obtains a physical guarantee from Paul and thus obtains the court bail.

Kafala Bil Dayn, or Mal

Kafala bil dayn, or mal, refers to the pledge given by the guarantor that the debtor will pay the debt. Kafala bil dayn is the financial guarantee.

Kafala Fundamentals

- The kafala is executed by the mutual offer and acceptance by the kafil and makful lahu.
- The kafala contract is executed by generally accepted expressions denoting kafala.
- The kafil and asil must be both adult and sane to ensure the validity of the contract.
- The makful bihi, or subject of the guarantee, must be something for which the asil can be held legally responsible.
- The makful bihi should be clearly specified well in advance of contract execution in the event of kafala bil nafs, or physical surety.

Guarantee Order of Demand

The guarantor is entitled to arrange the guarantee order before contract execution. The creditor will only have the right to claim from the guarantor in the event of the original bearer’s default.

Guarantee Recourse

Under this, the guarantor has the right to claim from the debtor the full guarantee object in the event of kafala liability discharge. Guarantee recourse is only valid with the prior consent and approval of the creditor.

Under a non-recourse guarantee, which refers to the voluntary guarantee of the guarantor without the prior consent or requisition of the creditor, the guarantor is not entitled to any financial recourse.

Guarantee Combination

Kafala bil nafs and kafala bil mal may be contractually combined. For example, a guarantor guarantees that he will present the debtor before the court at a pre-agreed time, failing which the guarantor will be liable for the debt.

Guarantee Duration

Current Guarantee: The guarantor may claim within the term of the original debt.

Deferred Guarantee: The term of the original debt is extended, allowing for the extension of the guarantee.

Guarantor's Responsibilities

- The kafil is liable to pay the guarantee item in the event of the original bearer's default.
- The creditor can claim from both the guarantor and original bearer.
- The kafala tenure is extended in the event of a loan extension.
- The kafil's obligation to honor the kafala remains in the event of the asil's death.
- In the event of a kafala termination, the debt obligation remains with the asil.
- If the asil honors the debt or the creditor absolves the debtor from the debt, the kafala obligation is removed from the kafil.

Kafala Prohibition

Kafala fees or charges are not Shariah-compliant since kafala is a charitable, voluntary contract. However, volitional payments are permissible.

Modern Applications

- Performance Guarantee
- Tender Guarantee
- Letter of Credit
- Credit Facilities Guarantee

Notes:

Chapter Fourteen

Shariah Governance

Shariah governance refers to the structured organizational policies and processes of an Islamic financial institution to ensure complete Shariah compliance.

It is based on the three fundamental tenets of corporate governance: accountability, transparency and trustworthiness.

Islamic financial institutions must establish a sound and robust Shariah governance framework to ensure that their business operations are Shariah-compliant.

The terms and conditions governing the Shariah Supervisory Board (SSB) should be clearly defined and agreed in advance.

Shariah scholars should meet the right Shariah selection criteria and have access to continuous professional development.

Independency, academic honesty and integrity are the fundamental elements of a Shariah supervisory governance policy.

Reporting structures, codes of conduct and ethics, roles, responsibilities, scope of duties, risk reporting, oversight functions and various other policies and procedures must be clearly determined and documented in an Islamic financial institution's Shariah Governance Framework.

Fundamentals of Shariah Governance:

- Oversight & Responsibility
- Independence & Integrity
- Competency
- Confidentiality & Consistency
- Ethics
- Procedures & Processes

Oversight & Responsibility

- The Board of Directors, or BOD, of the Islamic financial institution is responsible for the coordination and integration of the Shariah Governance Framework.
- The BOD approves all policies and procedures after consulting with the Shariah Board.
- The BOD may appoint the Chairman of the Shariah Supervisory Board, or SSB, as a board member to enhance coordination and cooperation.
- The SSB is responsible for the general Shariah compliance of the financial institution.
- The management of the institution is responsible for the effective and complete implementation of the rulings and decisions of the SSB.
- Management should ensure effective reporting of non-Shariah compliance operations.
- Management is responsible for developing a sound and robust Shariah governance culture throughout the entire Islamic financial institution.
- Management should ensure that the Shariah governance structures of the financial institution are adequately funded.

Independence & Integrity

- The BOD must ensure the complete independence and integrity of the SSB and Shariah governance structures.
- The SSB should have access to accurate information at all times.
- The SSB shall be supreme in matters pertaining to Shariah law.
- The BOD may only dismiss an SSB Member after providing sufficient and reasonable explanation to the Chairman of the SSB and the External Shariah Audit Committee, or ESAC.

Competency

- The BOD, audit committee and risk committee members should have adequate knowledge of Islamic finance.
- The BOD should organize continuous professional development programs.
- The BOD should appoint an external Shariah auditor to formally assess the effectiveness, integrity, academic excellence and competence of the Shariah Supervisory Board.

Confidentiality & Consistency

- The SSB should have access to all confidential documentation of the financial institution, including minutes of meetings, internal memoranda, official decisions, and product development.
- Each Shariah board member should ensure confidential documentation remains confidential.

Ethics

- Shariah board members should always undertake activities that are compatible with their position do not compromise the integrity and independence of the board.
- The Chairman of the SSB may enforce disciplinary sanctions on defaulting board members.
- All members of an Islamic financial institution should follow a general Shariah Code of Ethics.

Procedures & Processes

- The Shariah Governance Framework defines a complete reporting structure that covers all departments and sub-departments of the Islamic financial institution.
- The SSB reports directly to the BOD.
- The management reports to the SSB on Shariah matters.
- The Shariah Audit Committee, Research Committee and Secretariat report directly to the SSB.

Shariah Governance Model

The following is an example Shariah Governance Model:

- The Shariah Supervisory Board is tasked with overall Shariah compliancy and oversight on Shariah Governance Structures. The SSB reports to the BOD directly.
- The Shariah Risk Management Board is responsible for the effective and optimum management of risk. The SRMB reports directly to the SSB.

- The Shariah Audit Committee is responsible for overall Shariah assurance. It reports to the SSB.
- The Shariah Risk Management Department identifies, measures, monitors and controls Shariah risks. The SRMD reports to the SRMB and coordinates risk management with the bank's management.
- The Shariah Review and Research Departments report to the SSB. The Shariah Research Department conducts in-depth Shariah research and analysis.
- The Shariah Audit Department reports directly to the Shariah Audit Committee.
- The Shariah Secretariat coordinates internal meetings, records minutes of meetings, publish and distributes Shariah decisions and rulings. It serves as the official public liaison body for the SSB.
- The External Shariah Audit Committee, or ESAC, is appointed by the BOD and conducts regular Shariah reviews to ensure strict Shariah compliancy. This promotes financial transparency. The ESAC reports directly to the BOD.

Shariah Supervisory Board (SSB)

The Shariah Supervisory Board is responsible for developing Islamic financial products and instruments, and for the general supervision and monitoring of the Shariah compliancy of an Islamic financial institution.

The SSB should have a minimum of three Shariah scholars, including the chairman of the board.

The chairmanship of the SSB should be rotated each financial year. Every Shariah scholar should be assigned specific tasks over and above certain general tasks of the SSB.

Appointment, Resignation & Dismissal

- The Board of Directors should appoint a nomination committee, which will recommend the appointment of the Shariah scholars to the SSB.
- Shariah scholars should undergo a rigorous selection process before appointment, and all should fulfill the minimum qualification criteria.
- The Board of Directors may only dismiss a Shariah scholar after providing reasonable and sufficient explanation. Notice periods must be well documented prior to contract execution.

- The BOD and SSB members execute a service contract with the following clauses: appointment tenure; appointment and dismissal authority; notice of dismissal period; duties; remuneration and benefits; special clauses.

Reporting & Operating Structures

- The SSB shall report to the BOD on matters pertaining to Shariah law.
- Meetings should be held regularly to ensure that the business of the Islamic financial institution is not adversely affected.
- The chairman of the SSB shall have veto rights in decision making.
- All reported statements and directives must be well recorded and archived for future reference.
- The SSB should have a Shariah Process Manual documenting the relevant procedures and processes.

Primary Duties & Responsibilities

The SSB is primarily responsible and accountable for the general Shariah compliancy of the Islamic financial institution, as well as for:.

- Providing Shariah advice
- Reviewing & endorsing Shariah policies and guidelines
- Endorsing & validating relevant Shariah documentation including Shariah contracts, agreements, forms, and legal documentation used in executing Islamic transactions
- Overseeing the computation and distribution of zakat and purification funds in charitable avenues
- Providing Shariah counsel to relevant parties including legal, compliance, credit and audit bodies
- Providing written Shariah decrees, or fatwa
- Assessing the Shariah Audit, Risk and Research Departments.

Independence

The Shariah Supervisory Board should maintain complete independence and integrity at all times to ensure independent and impartial judgment on Shariah matters.

Powers & Authority

The SSB may be vested with certain powers and authorities as decided by the BOD.

Communication

The BOD & SSB should agree on a special communication strategy and reporting mechanism.

Shariah Research Department

The Shariah Research Department conducts in-depth studies on Shariah law, product innovation and development, and high-level consultancy.

Shariah research scholars may seek the assistance of economists, actuaries and legal experts to ensure the comprehensiveness of the Shariah Research.

Shariah Secretariat

The Shariah Secretariat coordinates meetings, records Shariah rulings and decisions, records and archives minutes of meetings, documents SSB meeting attendance, and publishes and distributes Shariah decisions and rulings.

Shariah Audit Department

The Shariah Audit Department determines the degree of Shariah compliance within the financial institution and communicates its assessments to the appropriate authority.

Islamic financial institutions should conduct periodic Shariah audits. The Shariah Supervisory Board should appoint an independent Shariah lead auditor, who should be assisted by the internal auditor of the financial institution. Shariah auditors should have adequate knowledge of the key management controls, organizational controls and operational controls of the Islamic bank.

The Shariah audit should be a top-down operation targeting the front, middle and back offices. The reporting line of the Shariah Audit Department should be designed to maximize independence and impartiality.

The Shariah auditor should be assisted by an internal IT Auditor to review and evaluate the controls and security of the Shariah operating system and software.

Shariah audit reports should be published in the institution's annual financial statement.

Scope of the Shariah Audite

- Financial operations
- Operational and procedural policies
- Product & instrument Shariah compliance
- Shariah governance compliance

External Shariah Audit Committee

The Board of Directors should appoint a wholly separate and independent External Shariah Audit Committee, or ESAC, to review, evaluate and monitor the general Shariah compliancy of the financial institution.

The ESAC ensures the SSB does not review itself.

Notes:

Chapter Fifteen

Takaful (Islamic Insurance)

Conventional insurance is impermissible under Shariah law for the following three reasons:

1. Qimar (Gambling)

The insured person pays premiums expecting a much greater return in the event of a loss. However, the insured loses all the premiums paid if there is no such loss.

2. Gharar (Future Uncertainty)

The outcome of the insurance contract is based on an uncertain future.

3. Riba (Interest)

The total premiums paid by the insured party are sometimes worth more than the insurer's payment against a claim.

The Islamic alternative to conventional insurance is known as 'takaful' – an Arabic word meaning 'mutual guarantee'.

Islamic insurance is based on the concept of ta'awun, or mutual cooperation, with each policy holder signing a mutual promissory indemnity form to protect each other against loss. Takaful is offered on the basis of good faith and mutual understanding, allowing the contracting parties to make full disclosures of the insurance fund details.

Islamic Insurance Financial Structure

- Musharaka: The participants of the joint fund pool monies together to share risk and indemnify each other.
- Wakala: The Islamic insurance company serves as manager on behalf of the policy holders.
- Mudaraba: The fund manager, or operator, invests a percentage of the funds in various Shariah-compliant investment portfolios.

The above three agreements must be wholly independent of each other.

Islamic Insurance Fundamentals

- The policy holders pool their monies in a joint fund.
- The takaful operator manages the fund for a fixed fee, A percentage of the funds is maintained in the indemnity portfolio while the rest is put into Shariah-compliant investments.
- The insurer cannot guarantee indemnification in the case of loss nor can he guarantee the investment, as he only acts as an agent.
- The Islamic insurance company manager may charge a fixed agency fee for administrative activities but cannot charge a fee based on investment returns.
- The returns from the investment portfolio are distributed between the operator (mudarib) and policy holders (rabb al mal) based on pre-agreed profit ratios.
- In the event of loss to any policyholder, the loss is distributed to each policy holder based on mutual understanding.
- In the case of damages from fraudulent claims and the like, the insurance company may take all necessary legal action to recover the damages.
- Islamic insurance companies should employ Shariah supervisory boards to monitor Shariah compliancy.
- The insured party must provide evidence to support any claim.

Notes:

Chapter Sixteen

Sukuk (Islamic Bonds)

Sukuk are Shariah-compliant certificates or securities of equal value representing undivided shares in the ownership of tangible assets, usufruct and services.

Sukuk is usually translated as 'Islamic bonds' and is the most active Islamic debt market instrument.

Holders of sukuk take direct equity stakes in tangible assets, as opposed to conventional bonds, which are money debt instruments.

Islamic banks invest in sukuk to receive profitable returns on their excess liquidity. Islamic banks may sell sukuk to manage a shortage of liquidity, to expand their investor base, to raise Shariah-compliant funding, to realise Shariah-compliant investment opportunities, or for Shariah balance sheet management and tradability.

Sukuk holders are exposed to asset-level risks and sukuk income is based on asset ownership rather than revenue rights.

General Shariah Guidelines

- All transactions must conform with Islamic Law (Shariah)
- Prohibition of interest (riba) but trading between parties is acceptable
- Prohibition of speculation (maysir)
- Avoidance of uncertain or excessively risky transactions (gharar)
- Prohibition of investment in unlawful goods and services (e.g. pork, alcohol, or gambling)
- Sharing of risk between parties

Specific Sukuk Shariah Guidelines

- Funds raised must be used for Shariah-compliant activities

- All funds raised may be used to finance tangible assets. Specificity of assets is important, since sukuk, unlike conventional bonds, cannot be used for the general financial needs of the issuer. Non-tangible assets may be used based on urf and aaadah, or custom and habit, subject to Shariah Board approval.
- Income received by sukuk holders (investors) must be derived from the direct cash flows generated by the underlying assets.
- Sukuk holders have a right to the ownership of the underlying asset and its cash-flows.
- Clear and transparent specification of rights and obligations of all parties to the transaction, in particular the originator (customer) and sukuk holders.
- No fixity in returns and no financial guarantees.
- Generic Shariah-compliant screening.
- All the rules of the original contract on the basis of which sukuk are created should be applied.
- The issuer cannot guarantee the face value of the certificate for the holder except in the case of negligence or misconduct.
- In sukuk based on sale and lease-back, the issuer can unilaterally undertake that he will purchase the asset after one year for a pre-agreed price.
- Different types of reserves (e.g. profit equalization reserve) or takaful pool can be created.
- Only those sukuk can be traded that represent proportionate ownership of tangible assets, usufructs or services.
- In sukuk of musharaka/mudaraba, the issuer can redeem the certificates on the market price. Purchase undertaking is allowed; however the purchase price should be the market value of the underlying assets.

Sukuk Vs Conventional Debt Instruments

Sukuk:

- Each sukuk unit represents an ownership of the underlying asset
- Maturity of the sukuk corresponds to the term of the underlying project or activity
- The sukuk prospectus contains all the Shariah rules related to the issue
- The underlying asset, project or business has to be Shariah-compliant

- The sukuk manager is required to abide by Shariah rules
- Sukuk holders have the rights to profits but also bear losses

Conventional Debt Instruments:

- Bonds represent pure debt obligations due from the issuer
- The core relationship is a loan of money, which implies a contract whose subject is purely earning money on money
- The issue prospectus does not include Shariah constraints
- The underlying asset, project or business can belong to any sector or industry, and can be issued to finance almost any purpose which is legal in its jurisdiction
- Bond holders are not exposed to losses on the asset, although they might bear losses in the event of insolvency by the issuer.

Sukuk Structures

Musharaka Sukuk

Issued with the aim of using the mobilized funds for establishing a new project, developing an existing project or financing a business activity on the basis of any of partnership contracts.

Participation Certificates represent projects or activities managed on the basis of musharaka.

Mudaraba sukuk represent projects or activities managed on the basis of mudaraba.

Investment agency sukuk represent projects or activities managed on the basis of an investment agency by appointing an agent to manage the operation.

Murabaha Sukuk

Issued for the purpose of financing the purchase of goods through murabaha so that sukuk holders become the owners of murabaha commodity

Salam Sukuk

Issued for the purpose of mobilizing funds so that the goods to be delivered on the basis of salam come to be owned by the sukuk holders

Istisna Sukuk

Issued for the purpose of mobilizing funds to be employed for the production of goods so that the goods produced come to be owned by the sukuk holders

Muzara'a (Sharecropping) / Musaqa (Irrigation) Sukuk

Issued for the purpose of using the mobilized funds for financing a project so that sukuk holders become entitled to a share in the crop as per the agreement.

Mugharasa (Agricultural) Sukuk

Issued for the purpose of mobilizing funds so that sukuk holders become entitled to a share in the land and plantation.

Sukuk Examples and Shariah Guidelines:

Sukuk Musharaka

- Musharaka financing can be securitized easily, especially in the case of large projects where huge amounts are required.
- A special-purpose vehicle, or SPV, is formed to collect funds from the Islamic investors, acquire assets and serve as partner in the musharaka agreement on behalf of the Islamic investors.
- The obligor serves as musharik and is typically appointed the management agent of the musharaka project.
- Each subscriber is given a musharaka certificate, which represents his proportionate ownership in the assets of the musharakah.
- After the project is started, these certificates can be treated as negotiable instruments. Certificates can be bought and sold in the secondary capital market.
- Securitization of musharaka can be used for construction of projects and factories, expansion projects, or working capital finance.

Sukuk Musharaka Shariah Guidelines

- Profit earned by the musharaka is shared according to an agreed ratio.
- Loss is shared on pro rata basis.
- The musharaka portfolio should consist of non-liquid assets valued at more than 33% of its total worth.
- However, if the Hanafi (one of the Islamic schools of jurisprudence) view is adopted, trading will be allowed even if the non-liquid assets are less than 33%, but the size of the non-liquid assets should not be negligible.
- Whenever there is a combination of liquid and non-liquid assets, it can be sold and purchased for an amount greater than the amount of liquid assets in combination.
- Bilateral undertaking (wa'ad mulzim) is not permissible in Shariah. However, unilateral undertaking (wa'ad ghair mulzim) is permitted.
- Guaranteed fixed returns are not permitted as this constitutes riba.

Sukuk Ijara

- Sukuk ijara are title deeds of equal shares in a leasing project giving their holders the right to hold shares, receive rental payments and dispose of their assets or properties. Ijara certificates are tradable on secondary markets.
- The lessor (owner) can sell the leased asset wholly or partly either to one party or to a number of individuals to recover his cost of purchase of the asset with a profit thereon.
- This purchase of a proportion of the asset by each individual may be evidenced by a certificate, which may be called the 'Ijara certificate'.
- The Ijarah certificate represents the holder's proportionate ownership in the leased asset.
- The holder will assume the rights and obligations of the owner/lessor to the extent of his ownership.
- The holder will have the right to enjoy a part of the rent according to his proportion of ownership in the asset.
- In the case of total destruction of the asset, he will suffer the loss to the extent of his ownership.
- The certificates can be negotiated and traded freely in the market and can serve as an instrument easily convertible into cash.

Sukuk Ijara Shariah Guidelines

- Rental payments may be structured such that they comprise of profits on the rental and the redemption amount on the principal. Rental payments cannot be guaranteed.
- Sukuk ijara do not represent debts, but undivided proportionate ownership of the leased asset (participatory certificates).
- Because the sukuk ijara are neither debts nor monetary, the issue of the sale of monetary debts with a discount do not arise. Hence sukuk ijara may be traded in the secondary market freely.
- It is essential that the ijara certificates are designed to represent real ownership of the leased assets, and not only a right to receive rental payments.
- The sukuk holders are responsible for major asset maintenance, whereas the obligor (lessee) is responsible for ordinary maintenance.
- All contractual agreements should be separated and individualized. For example, sale and lease agreements should be separated. Conversion should be well defined.

Sukuk Murabaha

- Murabaha is broadly understood to refer to a contractual arrangement between a financier (the seller) and a customer (the purchaser) whereby the financier would sell specified assets or commodities to the customer for spot delivery based on a profit and mark-up in exchange for fixed deferred payments.
- Murabaha is a transaction which cannot be securitized for creating a negotiable instrument to be sold and purchased in a secondary market since the murabaha certificates represent entitlements to shares in receivables from the purchaser of the underlying murabaha. Debt cannot be traded in Shariah except on par value.
- Sukuk murabaha certificates may still be negotiable if they form a small part of a larger portfolio consisting mostly of other negotiable instruments such as sukuk ijara, sukuk musharaka, and/or sukuk mudaraba.

Sukuk Murabaha Shariah Guidelines

- In murabaha securitization, the pool of assets should consist of ijara assets valued at more than 33% of its total worth.
- However, as described earlier if the Hanafi view is adopted, trading will be allowed even if the non-liquid assets are more than 10% of its total worth.
- Investors will have a mudaraba relationship with the manager of the pool.
- Investors in the pool will have a musharaka relationship and each one will be a proportionate owner of the pool.
- Profit will be shared according to an agreed ratio between the pool and the manager.
- The share of the pool will be further divided among the investors according to the rules of musharaka.
- The SPV should take physical possession of the goods to ensure complete transfer of liability (dhaman) to the purchaser.
- All transactions and documentation should be separated.

Sukuk Wakala

- In a wakala agreement, whereby one party entrusts another to act on its behalf, akin to an agency agreement, the investor appoints an agent (wakil) to invest funds into a pool of investments or assets. The wakil lends expertise and manages the investments on behalf of the investor for a particular duration, in order to generate an agreed-upon profit return.

Sukuk Wakala Shariah Guidelines

- The scope of the wakala arrangement must be within the boundaries of Shariah; i.e. the principal cannot require the wakil to perform tasks that would not otherwise be Shariah-compliant.
- The wakala agreement must be clear and well defined. The scope of services provided, appointment term, duties, terms and conditions and fees payable should be well defined. Any ambiguity will render the agreement void.
- All portfolio assets should be screened and endorsed by the Shariah Supervisory Board.

Shariah Compliance Issues

- The Shariah Supervisory Board should ensure the underlying structure, all financial documentation including prospectus, and implementation of the transaction is Shariah-compliant.
- The prospectus must mention the obligation to comply with all the guidelines and principles of Shariah as advised by the Shariah Supervisory Board.
- All transactions should be separated and individualized. No bilateral agreements are permitted in Shariah.
- An external Shariah oversight committee should be established to ensure optimal Shariah governance.
- Periodical Shariah audits should be conducted by the external oversight committee.

Glossary – Commonly Used Terms

AAOIFI: The Accounting and Auditing Organization for Islamic Financial Institutions, based in Bahrain, brings together Islamic finance scholars from around the world. AAOIFI Shariah standards are the de facto Islamic finance standard in more than 90% of the world's jurisdictions.

Advance Against Murabaha: The amount disbursed by a financial institution for the purchase of goods from a supplier.

Amwal al-Ribawiya: Goods which, when exchanged with each other, result in the accrual of interest by either of the contracting parties. Six items have been classified as such by a hadith of the Prophet Muhammad (Allah bless him and give him peace): gold, silver, wheat, barley, salt and dates. These items may only be exchanged for each other in equal measure and at spot.

Adadiya: These ar 'countables', or items measured as units rather than by weight, length or volume (e.g. eggs sold by the dozen or half dozen).

Adl: Justice, impartiality, fairness.

Adil: Trustee; an honest and trustworthy individual.

Agency Agreement: An agreement by means of which a third party – whether an individual or financial institution – is established as an agent to carry out an activity such as make an investment on behalf of the principal.

Ahadith: (pl.hadith) Report of the words and deeds of the Prophet Muhammad (Allah bless him and give him peace).

Ajr: Remuneration or compensation. In a service Ijara, the ajr is the price paid to the employee by the employer for services rendered.

Ajir: Employee.

Ajir al-Aam: An employee who is not restricted to the employment of a single employer but is free to work elsewhere so long as he fulfils his duties responsibly towards each.

Ajir al-Khas: An employee for a specified term, who only serves one employer.

Akl al-Suht: The illegal acquisition of wealth, such as by theft or bribery.

Al-Ajir al-Mushtarak: A worker who may concurrently serve or be contracted to a number of clients, for example a lawyer.

Al-Ajr al-Mithl: The prevalent price; the standard rate for a particular service.

Al-Akl bil-Batil: Wrongful acquisition of wealth.

Al-Amin al-Amm: Trustee for property other than that granted for safe-keeping such as the lessee in an ijara or the mudarib in a mudaraba.

Al-Amin al-Khas: Trustee for property held in safe-keeping as in the wadia (safe-keeping) contract.

Al-Ghunm bil-Ghurm: An Arab proverb according to which profit may lawfully be earned provided risk is shared for an economic activity that ultimately contributes to the economy.

Al-Hisab al-Jari: Current account.

Al-Sanadiq: Marketing investment funds.

Amana: Property in the safe-keeping of another (the 'amin') that must be preserved and protected; deposits maintained as trusts on a contractual basis.

Amin: Trustee.

Amil: A worker entitled to remuneration, i.e. the mudarib in a mudaraba contract or a zakat collector.

Amoor al-Mubaha: Commodities that are naturally available and may be benefited from by all. For instance, water from a river or the wood from the trees of a forest.

Amwal: (pl. mal); goods

Aqar: Real estate; immovable property, i.e. land, buildings etc.

Aqd: Contract.

Aqd al-Bai: Contract of sale.

Arbab al-Mal: Partners who contribute capital to the business (sing. rab al-mal.

Arbun: Non-refundable down payment received from the buyer or the istisna requestor securing the purchase of manufactured goods.

Ard: Land.

Ariya: A contract in which one party loans another the use of an item for an indefinite period of time.

Arif: An expert who is consulted in matters requiring an informed and just decision.

Arkan: (lit. pillars) Fundamentals of a contract.

Asil: Assets.

Average Balance: A formula for determining the eligibility of profit a partner or musharaka account holder can receive on their invested amount. Essentially, it is the minimum amount that must remain invested at all times in an account over a period of time for the account holder to be eligible to receive profit.

Ayn: Currency or ready money, i.e. gold, silver, coins, notes or any other form of ready cash.

Batil: Void, invalid; refers to a transaction, a contract governing a transaction or an element in a contract which is invalid.

Bay: Contract of sale.

Bay Batil: Void sale failing to meet Shariah requirements.

Bay al-Dayn: An exchange of debt, i.e. the sale of debt securities or certificates.

Bay al-Eenah: The sale of a commodity on credit and repurchase for a lesser amount in cash.

Bay Fasid: Voidable sale

Bay al-Inah: A buyback transaction that is prohibited in Islam.

Bay al-Istijrar: A contract where the supplier agrees to provide a particular product to the client on an ongoing basis for an agreed price and based on an agreed mode of payment.

Bay al-Kali bil Kali: Sale of debt for debt, specifically prohibited by the Prophet. In such a transaction, the creditor grants an extension of the repayment period in exchange for an increase on the principal.

Bay Makruh: 'Disliked' sale going against ethical requirements.

Bay Mawquf: Suspended sale

Bay Mu'ajjal (also, Bay bi-Thaman Ajil): A deferred sale, where one of the considerations of the contract such as its price or the delivery of its subject matter is delayed to a future date.

Bay al-Muata (Hand-to-Hand Sale: A sale where the seller hands the asset over to the buyer in exchange for a price without any verbal expression of offer or acceptance.

Bay Muqayada: A barter sale or counter-exchange of goods.

Bay Musawama: A normal sale without reference to cost price.

Bay al-Muzayada: The sale of an asset to the highest bidder in the market.

Bay Sahih: Valid, Shariah-compliant sale.

Bay al-Salam (also Bay'al Ajal): Sale where the price is paid in full on the contract's execution while delivery is deferred to a future date.

Bay Ta'ati: A sale concluded by the conduct of the contracting parties.

Bay Tawlia: A sale on cost price in which there is reference to the cost price between the buyer and seller.

Bay al-Wafa: A sale where the seller is allowed to repurchase property through a purchase price refund. It is a transaction prohibited by a majority of scholars.

Bay'atan fi Bay: Two sales in one. Also referred to as safaqatan fi safaqah.

Bayt al-Mal: The Muslim community's treasury.

Benchmark: A known and acknowledged standard that may already exist or alternatively be identified by means of expert appraisal.

Benchmarking: A method by which the rent for the remaining period of an ijara is based upon a known and acknowledged standard that may already exist or alternatively be identified by means of expert appraisal.

Bond: A certificate of debt based on which the issuer agrees to pay interest if any in addition to the principal, to the bondholder on specified dates.

Build, Operate and Transfer, or BOT: A contract by which the government hires a contracting company to assist in the development of infrastructure. Usufruct for a fixed period of time is established as the price of the contract, after which ownership is transferred to the government free of cost.

Bringing Forward Future Instalments: Based on this option, in the event a client defaults on his payment, all the instalments for the entire term of the contract fall due immediately.

Buyback: See Bay al-Inah, a prohibited type of sale in which an item is sold on credit and then bought back for a lower price.

Business Partnership: A joint venture or project between two or more parties entered into to make a profit.

Capital Recovery Risk: The risk of an inability to regain capital from the security maintained by the financial institution in case of a loss.

Catastrophic Risk: The risk arising from the possibility of the occurrence of a natural disaster causing loss of or damage to goods.

Charity Clause: A stipulation made at the time of contract execution which establishes a certain amount of payment to a designated charity in the event of a default.

Commodity Murabaha: A transaction where an Islamic bank purchases a commodity on spot and sells it for a deferred payment for the purpose of managing liquidity.

Compound Interest: The accrual of additional interest on existing interest payments due on the principal.

Commercial Interest: The excess paid in exchange for a loan taken for the establishment of a commercial enterprise.

Commutative Contract: A contract involving an exchange.

Conditional Agency Agreement: An agency agreement where the agent is limited by certain conditions and restrictions with respect to the execution of a required task such as the purchase of an asset.

Constructive Liquidation: Evaluating the capital value of a business, without actually liquidating or selling it off.

Constructive Possession: Any form of documentary evidence that proves rightful ownership of an asset, thereby sanctioning the seeking of gain from it, where the one possessing the asset is in a position to use the item for which it is intended.

Contract: A commitment to something enjoined by the association of an acceptance with an offer.

Conventional Insurance: The conventional form of providing indemnity against loss.

Credit Risk: The possibility of a counterparty failing to meet its financial obligations in accordance with the terms agreed upon in the contract.

Credit Stage: This stage begins once the goods for a murabaha are received by the financial institution and the documents of offer and acceptance are signed. It ends once the murabaha payment is recovered from the client. It is during this period that the bank has the right to accrue profit. This is also referred to as the ‘financing stage’.

Daftur al-Tawfir: Savings account.

Dayn: A debt created by a contractual obligation or credit transaction.

Dhaman: A contract of guarantee whereby a guarantor underwrites any claim or obligation to be fulfilled by the owner of the asset.

Deal Ticket: A form of documentation evidencing the acceptance of funds by one bank from another based on a musharaka contract.

Default: A contracting party’s failure to make a due payment.

Dhimmah: Liability.

Dhulm: Refers to all forms of injustice, exploitation or oppression through which a person deprives others of their rights or does not fulfil obligations toward them.

Diminishing Musharaka: A temporary partnership where an asset or property is jointly purchased by two partners and one partner eventually acquires ownership through a series of property share purchases.

Dinar: A gold coin used by early Muslims. Its standard mass was approximately 4.25 grams.

Displaced Commercial Risk (DCR): Islamic financial institutions manage the funds of investment account holders on a profit-and-loss-sharing basis. However, in order to maintain competitiveness with conventional banks which offer fixed returns, Islamic institutions typically surrender part (or all) of their profit share in order to allow their depositors to receive their expected profit allocation. This effectively means that the risk attached to depositors' funds is partially or wholly transferred to the Islamic financial institution's capital, which increases their overall risk.

Earnest Money: A sum received from the client as security that serves as compensation in the event the lessee backs out from entering into or continuing an ijara. The lessor makes up for the actual loss from it and returns the remainder to the client.

Equity: The ownership share in a business.

Equity Investment Risk: The risk arising from entering into a partnership in order to finance a particular or general business activity, where the manager of finance also shares the business risk.

Equity Market: The equity market is the place where company shares are traded, thereby providing viable investment opportunities to individuals, other companies and financial institutions seeking to avail them.

Faqih: Muslim jurist.

Faqir: A needy person.

Fasid: Voidable, usually said of a contract or an element within a contract.

Faskh: Cancellation of a contract, usually based on one of the contracting parties exercising an option, i.e. the option of return in case of a defective asset or the option of refusal to purchase an asset.

Fatwa: An authoritative legal judgment based on the Shariah.

Financing Stage: This stage begins once goods are received by the financial institution and the documents of offer and acceptance are signed. It ends once the murabaha payment is recovered from the client. It is during this period that the bank has the right to accrue profit.

Fiqh: Islamic jurisprudence.

Fiqh al-Muamalat: Islamic jurisprudence governing financial transactions.

Foreign Currency Commodity Murabaha: A transaction commonly used for investing excess funds which is available for maturities ranging from overnight to a period of one year.

Fuduli Transaction: A transaction with another's property without Shariah consent, for example, selling property before contracting an agency agreement with its owner.

Fungible Goods: Goods similar to one another and sold as units. Any difference between them is considered negligible.

Gharar: Contractual uncertainty that may lead to a major dispute between contracting parties that would otherwise be avoidable.

Ghasb: The misappropriation of property.

Global Agency Agreement: An agreement where the agent may purchase the required asset from any source of his choice. Such an agreement also lists a number of assets which the agent may procure on the bank's behalf without having to execute a new agency agreement each time.

Guarantee: A risk-mitigating technique that serves as a form of security in contracts and is provided by a third party, for example, a guarantee for the supply of specific goods at a specific time or a guarantee for a timely payment.

Hadith (sing. Ahadith): A report of the attributes, words and deeds of the Prophet Muhammad (Allah bless him and give him peace).

Halal: Permissible in the Shariah

Hamish Jiddiah: The Islamic financial term for a sum of earnest money received from the client as security that serves as compensation in the event the lessee backs out from entering into or continuing an ijara. The lessor makes up for the actual loss from it and returns the remainder to the client.

Haq: Right.

Haq Dayn: Debt rights.

Haq Mali: Rights over financial assets.

Haq Tamalluk: Ownership rights.

Haram: Prohibited in the Shariah.

Hawala: A contract by which a debtor transfers his debt to a third party.

Hawl: The amount of time that must elapse before a Muslim possessing funds equalling or exceeding the exemption limit (nisab), is required to pay zakat. Typically, one Islamic/lunar year.

Hiba: Gift.

Holding Risk: The risk accompanying the possession of assets by a financial institution before they are delivered to the buyer.

Homogeneous Commodities: Commodities that are similar to one another and are sold as units. The difference between them is negligible.

Huquq (pl. Haq): Rights.

Hybrid Sukuk: Certificates of ownership representing trust assets for more contracts than one.

ICD: Islamic Corporation for the Development of the Private Sector.

IDB: Islamic Development Bank.

IFI: Islamic financial institution; i.e. bank or financial organization operating commercially within the limits prescribed by Shariah.

IFSB: International Financial Services Board.

Ihtikar: Hoarding

Ijab: Offer, in a contract.

Ijara: A form of lease seeking to provide the benefits of an asset or a service to a lessee in return for payment of an agreed price or rent.

Ijara al-Amal (also Ijara al-Ashkhas): A contract of lease providing services for an agreed rental.

Ijara al-Manafi: A contract of lease executed for the transfer of the benefits of an asset in exchange for an agreed price.

Ijara Mawsufah fi Dhimma: A lease agreed upon and based on a deposit for the future use or delivery of an asset.

Ijara Muntahia bi Tamlik: An ijara based on a lessor's undertaking to transfer ownership of the leased property to the lessee at the end of the lease or by stages during the term of the contract.

Ijara Sukuk: Certificates representing the ownership of leased assets, the ownership of the usufruct of leased assets or the ownership of the rights to receive benefits from services.

Ijara wa Iqtina: An ijara conducted solely for the purpose of transferring the ownership of a leased asset to the lessee at the end of the lease period.

Ijma: Juristic consensus on a specific issue. It is recognized as one of the four sources of Shariah.

Ijtihad: Juristic reasoning based on the Quran and the Sunnah.

Illah: The attribute of an event requiring a specific ruling in all cases possessing that attribute; analogies are drawn based on it to determine the permissibility or prohibition of an act or transaction.

Inaan: (A type of Shirkah) A form of partnership in which each partner contributes capital and has a right to work for the business.

Infisakh: Contract cancellation without the will of the contracting parties, e.g. as a result of an asset's destruction or the death of a party to the contract.

Informational Asymmetry: A situation where important relevant information is known by some parties, but not by all.

In-kind: Where instead of cash, payment or capital contribution is made in the form of tangible assets, goods or services.

Interest: Any addition or increment involved in an exchange between contracting parties.

Investment Stage: This is the stage that begins after the execution of an agency agreement. It is the period during which the bank has disbursed the money for the purchase of the asset from the supplier but has not yet acquired possession of it in order to sell it.

Ishara: A gesture made by a person's head or hand taking the place of speech in expressing the will of two contracting parties.

Israf: Immoderateness and wastefulness.

Istighlal: Investment.

Istihlak: Consumption.

Istihsan: Judicial preference for one legal analogy over another in view of general public welfare.

Istijrar: A contract where the supplier agrees to provide a client a particular commodity on an ongoing basis for an agreed price based on an agreed mode of payment.

Istisna: A transaction for the purpose of acquiring an asset manufactured to order. It may be executed directly with the supplier or any other party that undertakes to have the asset manufactured.

Istisna Requestor: The party placing the manufacturing order.

Istisna Sukuk: Certificates representing proportionate ownership of manufactured goods.

Joala: A contract involving a reward for a specific service or achievement.

Jadwala: Rescheduling.

Jihalah: Ignorance; inconclusiveness in a contract leading to gharar.

Kafala: A third party taking responsibility for another's repayment of debt; a pledge given to the creditor that a debtor will repay his debt.

Kafil: The party assuming responsibility for repayment of another's debt in a kafala contract.

Kali bil Kali: The exchange of debt for debt.

Kharaj: The share of the produce from agricultural lands collected by Muslim rulers and added to the Bayt al-Mal.

Khilabah: Fraud in word or deed by a party to a contract to coerce another into entering into the contract.

Khiyanah: Deception by withholding information, or breach of an agreement.

Khiyar: Option or power to annul or cancel a contract.

Khiyar al-Aib: The option of return in case of a defective asset.

Khiyar al-Majlis: The option to annul a contract possessed by both contracting parties.

Khiyar al-Ru'yah: The option to revoke a purchase in the event of non-conformance to specifications on condition that the purchaser did not see the goods before purchase.

Khiyar al-Shart: An option in a sale's contract established at the time of signing the agreement giving one of the two parties to the contract a right to cancel the sale within a stipulated time.

Khiyar al-Ta'yeen: The purchaser's option to return an asset to the seller if it does not meet specifications as established at the time of contract execution.

Know-Your-Client (KYC): Due diligence checks carried out on customers to determine credit worthiness.

Legal Risk: The risk of having to resort to litigation for redemption of claims arising from a contract.

LIBOR: London Inter-Bank Offered Rate.

Lien: A charge, claim, hypothecation or mortgage, pledging an asset to a creditor.

Liquidity Management: The management of an excess or shortage of funds by financial institutions through interbank treasury transactions to meet day-to-day business needs and liquidity reserve requirements.

Local Currency Commodity Murabaha: In the absence of an organized asset exchange market, this murabaha is conducted for the management of funds at financial institutions with the help of local commodities exempt from value added tax.

Luqta: An item misplaced by its owner and found by someone else.

Mabee: Goods for sale, or subject of a sale

Madhab (pl. madhahib): A school of Islamic jurisprudence characterized by differences in the way Shariah sources are understood, forming the basis for differences in Shariah rulings derived from them. The four Sunni schools named after their founders are Hanafi, Maliki, Shafii and Hanbali.

Maisir: 1) The act of gambling or playing games of chance with the intention of making an easy profit; 2) the element of speculation in a contract; 3) chance or uncertainty with respect to an outcome.

Major Maintenance: Fulfilment of all the requirements that ensure a leased asset provides intended use.

Mal: Wealth; anything of value that may be possessed.

Mal Mutaqawam: Items that are lawful to use or consume by Shariah; or wealth considered commercially valuable under Shariah.

Maloom: A quantified market value

Manfa'a: Usufruct or benefit derived from an asset.

Maqasid al-Shariah: The establishment of goals and objectives by Muslim jurists in a way that assists the investigation of new cases and the organization of prior rulings.

Market Risk: The current and future volatility of the market value of specific assets to be purchased and delivered over a specific period of time such as the commodity price of a salam asset, the market value of a sukuk, the market value of a murabaha asset, or the fluctuating rates of foreign exchange.

Minimum Balance: A formula for determining the eligibility of profit a partner or musharaka account holder can receive on his invested amount. Essentially, it is the minimum amount that must remain invested at all times in an account over a period of time for the account holder to be eligible to receive profit.

Moral Hazard: Risk of a party acting either in bad faith or underperforming due to negligence and indifference, brought on by insulation from risk.

Mu'amala: A financial transaction.

Mubah: Object that is lawful; an item permissible to use or trade.

Mudaraba: Business partnership between two or more parties where, typically, one party supplies the capital for the business and the other the investment management expertise. Also known as Muqarada, or Qirad.

Mudaraba Muqayada: Restricted mudaraba.

Mudaraba Mutlaqa: Unrestricted mudaraba.

Mudaraba Sukuk: Certificates representing the proportionate ownership of capital for specific projects undertaken by an entrepreneur.

Mudarib: Partner responsible for management in a mudaraba. Also defined as an investment manager.

Mufti: A highly qualified jurist who issues fatwa, or legal verdicts.

Mugharasa: An agricultural contract similar to muzara'a in which a land owner agrees to grant the farmer a share of the harvest from the fruit orchard he tends.

Mujtahid: A highly qualified fiqh specialist who engages in independent juristic reasoning.

Mukhabara: An agreement between a landowner and a farmer, similar to a muzara'a, the only difference being that in a muzara'a the seeds are provided by the landowner whereas in a mukhabara they are supplied by the farmer.

Muqarada: Alternative name for mudaraba or qirad.

Muqassa: Setting off two debts at an agreed exchange rate.

Murabaha: A contract in which the cost of acquiring the asset and the profit to be earned from it are disclosed to the client or the buyer.

Murabaha Facility Agreement: An agreement including approval of a credit facility extended to the client, the terms and conditions of the contract, the specification of the murabaha asset, and the client's promise to purchase.

Musaqa: A partnership whereby the owner of an orchard agrees to share the produce with a farmer as recompense for the farmer tending the land.

Musharaka: A business partnership set up to make profit, where all partners contribute capital and effort to help the business run.

Musharik: A partner in a Musharaka.

Muta'ayyan: Specified

Mutual Insurance: A form of insurance in which a group of people exposed to a similar risk make by mutual consent voluntary contributions to a pool of funds to share that risk and provide one another with indemnity against loss.

Muwada/Mua'hida: A bilateral promise.

Muwakil: The principal in an agency agreement.

Muzara'a: Share-cropping; an agreement where one party agrees to allow a portion of his land to be farmed by another in exchange for a part of its produce.

Najash: Deceiving a potential buyer during pre-sale dialogue, through insincere bidding by a third party or false claims on the seller's part.

Negligence: Loss resulting from violation of the conditions of a contract.

Nisab: The exemption limit for paying zakat. A Muslim possessing wealth below the nisab is exempt from zakat.

Numeraire: A basic standard by which comparative values are measured, or a unit of account.

Offer and Acceptance: The actual execution of a sale, where one contracting party makes an offer to sell or purchase an asset and the other accepts it.

Operational Risk: The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events, as well as non-compliance with Shariah regulations or a neglect of fiduciary responsibilities.

Parallel Istisna: A second contract of istisna executed alongside the original istisna. The manufacturer in the original contract serves as the istisna requestor in the parallel contract and profits from a difference in price.

Periodic Maintenance: Regular maintenance of a leased asset.

Permanent Musharaka: Also referred to as an 'ongoing musharaka', a partnership where there is no intention of terminating or concluding the business venture at any point.

Physical Possession: The actual or corporal possession of an asset and the ability to benefit from it.

Pledge: A form of security that is taken from the client and maintained by the financial institution. It may be in the form of an asset or cash.

Profit and Loss Sharing (PLS): Used to describe interest-free Islamic finance schemes, typically represented by musharaka and mudaraba.

Possession: The ownership of all the risks and rewards associated with an asset.

Premium: The amount of contribution made by the insured to the pool of funds established for the purpose of providing indemnity against loss.

Price Risk: The risk arising from fluctuating prices of goods in the market, thereby affecting the value of the goods in a contract.

Private Equity: Shares in a business that are not for sale to the general public but are sold exclusively through invitation to certain parties.

Project Finance: The financing of large infrastructure and industrial projects based on a comprehensive financial structure for operation.

Promise: An undertaking by the client to enter into a contract with the financial institution for the sale or lease of an asset in the future.

Provisional Profit: The profit earned by an investor for the period of time funds remained invested.

Pure Risk: The risk that involves the possibility of loss or no loss. For instance damage to property due to a fire that may or may not occur.

Qabd: To take possession of an exchange commodity in an exchange transaction.

Qard: Loan.

Qard al-Hasan: A goodwill loan against which interest is not charged; where only the principal amount is to be returned in the future.

Qimar: An agreement where the acquisition of an asset is contingent upon the occurrence of an uncertain event in the future.

Qirad: Alternative name for mudaraba or muqarada.

Qiyas: Drawing a comparison; deriving law through analogy from an existing law if the basis for both is the same; also one of the Shariah sources.

Qubul: Acceptance, in a contract.

Rab al-Mal: The investor or owner of capital in a mudaraba contract.

Rahn: Collateral. A pledge or the transaction which governs such a pledge.

Ras al-Mal: Capital; the money or capital which an investor (rab al-mal) invests in a profit-seeking venture.

Rate of Return Risk: The risk that a financial institution is exposed to as a result of an undetermined or variable amount of return on an investment.

Receivable: An asset or cash that a business is due to receive as a result of a prior transaction.

Restricted Mudaraba: A mudaraba in which the mudarib has to observe certain restrictions regarding the running of the business. Typically, these restrictions may relate to sector, activity, and/or region in which the business may operate (various other restrictions also may be included).

Re-Takaful: A new takaful arrangement consistent with principles and guidelines provided by the Shariah board. It is enacted in the event that the funds in the original takaful are not sufficient to meet the needs of its members.

Riba: Any amount charged in excess which is not in exchange for a due consideration. Conventionally it is referred to as interest and is prohibited in Islam.

Riba al-Fadl (or **Riba al-Buyu, Riba al-Hadith):** The riba of exchange surplus. Any barter transaction where like commodities are exchanged in unequal measure, or the delivery of one commodity is postponed, is characteristic of riba al-fadl.

Riba al-Nasi'ah (or **Riba al-Qu'ran):** The predetermined excess repayable on the principal extended as a loan.

Ribawi: Goods subject to Shariah rulings with respect to riba in the event of their sale.

Risk: The possibility that an action or event could result in the direct loss of earnings and capital or the imposition of constraints in a bank's abilities to meet its business objectives.

Risk Management: The process of evaluating and responding to the exposure facing an organization or individual. It is a structured and disciplined approach employing people, processes, and technology for managing uncertainties.

Rishwa: Bribery.

Roll-over: The provision of an extension in return for an increase in the original payable amount.

Rukn: (lit. pillar) Fundamental of a contract.

Sa': A dry measure in use in Medina during the time of the Prophet used to weigh dates, barley and similar items.

Sadaqa: Voluntary charitable donations.

Sahih: (lit. sound, correct) In reference to: 1) A valid contract, 2) A highly authenticated hadith.

Salaf: A loan that draws no profit for the creditor. Salaf is also referred to as 'salam' when the price of the subject matter is paid in full at the time of the contract's execution while the delivery is deferred to a future date.

Salam: A sale where the price of the subject matter is paid in full at the time of the contract's execution while delivery is deferred to a future date.

Sale Contract: The commitment to trade a commodity in a specific manner for a consideration in cash or kind, evidenced by the exchange of an offer and acceptance.

Salam Sukuk: Certificates representing financial claims arising from the purchase of commodities to be delivered in the future based on an advance payment of price.

Sarf: Currency exchange.

Sayarifa: Early Islamic bankers

Securitization: The process of issuing certificates of ownership against an asset, an investment good or a business.

Share: A form of equity ownership representing claims on earnings and assets.

Shart (pl. shurut): A necessary condition or stipulation that must exist to ensure the validity of a transaction.

Shart al-Jaza: A penalty established at the time of the execution of an istisna contract which allows for a reduction in the price of the manufactured goods in the event of a delay in their delivery.

Shariah: Islamic law.

Shariah Advisory Board: A panel of Shariah scholars appointed by Islamic financial institutions to supervise all transactions and ensure their Shariah compliance. Its role also includes conducting regular and annual audits.

Shariah Non-Compliance Risk: The risk arising from non-compliance to the standards of Islamic law.

Sharik: Partner.

Shirka (or **Sharikah):** (lit. sharing) Refers to different kinds of business partnerships based on sharing.

Shirkat al-Amal: A partnership based on the pooled provision of services.

Shirkat al-Amwal (or **Shirkat al-Inan):** The commonest type of shirkat al-aqd: a partnership between two or more parties for the purpose of earning profit by means of investment in a joint business venture.

Shirkat al-Aqd: A business partnership established through a deliberate contract.

Shirkat al-Milk: Primarily a ‘partnership of joint ownership’, which may come about deliberately or involuntarily.

Shirkat al-Wujooh: A 'partnership of goodwill' where the subject matter is bought on credit from the market on the basis of a relationship of goodwill with the supplier, with the aim of reselling at a profit to be shared.

Sigha: Formulation of the contract; often referred to as 'offer and acceptance'.

Silent Partner (or **Sleeping Partner):** A partner who contributes capital but takes no part in management of the business.

Simple Interest: The excess or increment that is charged over and above the initial investment.

Sole Proprietorship: A business fully owned and managed by one person.

Special Purpose Vehicle (SPV): An independent entity created based on a mudaraba contract for the purpose of generating funds by acquiring assets from a company and issuing certificates of proportionate ownership against them.

Specific Agency Agreement: An agreement based on which the agent is restricted to purchasing a specified asset from a specified supplier only.

Speculative Risk: The risk representing potential gain or profit, i.e. the risk involved in a new business venture.

Specific Commodities: Commodities possessing specific attributes that make them different from one other. One may not be replaced by another, for example, livestock or precious stones.

Standard Ijara: A lease contract executed for the provision of usufruct for a fixed term at the end of which the ownership of the leased asset is not transferred to the lessee.

Stock Company: A company in which the capital is partitioned into equal units of tradable shares and each shareholder's liability is limited to his share in the capital; it also represents a form of partnership.

Sublease: The lease of an already leased asset to a third party with the primary lessor's consent.

Sukuk (sing. Sak): Certificates of equal value representing undivided shares in ownership of tangible assets, usufruct or services.

Sukuk al-Ijara: Certificates representing ownership of leased assets, of the usufruct of leased assets, or of the rights to receive benefits from services.

Sukuk al-Mudaraba: Certificates representing the proportionate ownership of capital for specific projects undertaken by an entrepreneur.

Sukuk al Murabaha: Certificates representing an investor's shares in receivables from the purchaser of assets based on a deferred sale.

Sukuk al-Musharaka: Certificates representing proportionate ownership of a musharaka asset, be it a partnership for new projects or a partnership for the expansion of existing projects.

Sukuk al-Salam: Certificates representing financial claims arising from the purchase of commodities to be delivered in the future based on an advance payment of price.

Sunna: The personal example, comprising words and deeds of the Prophet Muhammad (Allah bless him and give him peace).

Ta'awun: Co-operation.

Tabburro: Gift or contribution.

Tadlis al-Aib: Refers to the activity of a seller concealing the defects of goods.

Takaful: A Shariah-compliant system of insurance based on the principle of mutual co-operation. The company's role is limited to managing operations and investing contributions.

Takaful Operator: The manager of takaful funds.

Taqwa: Religious restraint; to be conscious of Allah.

Tawarruq: A mode of financing, similar to a murabaha transaction, where the commodity sold is not required by the client but is bought on a deferred payment basis and sold to a third party for a lesser price, thereby becoming a means of liquidity generation.

Thaman: Price.

Thaman al-Bay: Sale price.

Tijara: Trade.

Time-Sharing Leasing Contract: The lease of a single asset to multiple lessees by means of different leasing contracts for different time periods, and where no contract overlaps another.

Tirmidhi: One of six major Sunni collections of hadith concerning the acts and sayings of the Prophet Muhammad.

Trade Finance: The financing of international trade transactions, which involves satisfying the needs of importers and/or exporters.

Transit Period Risk: The risk posed to a bank for the period that ensues after assuming possession of murabaha goods from the supplier and before selling them to the client.

Treasury Operations Department: The section of a financial institution that deals with the maintenance of funds and capital reserves and their movement in and out of the bank.

Two-Tier Business Model: Where one set of capital investments enables a stream of follow-on investments in multiple Shariah-compliant ventures.

Ujrah: Financial payment for the utilization of services.

Ulema: Muslim scholars.

Ummah: The Muslim community.

Unconditional Agency Agreement: An agency agreement where the principal does not stipulate any conditions or restrictions upon the agent's performance of duties. The agent is allowed to exercise his own discretion with reference to the assigned task, taking into consideration the market norm.

Unrestricted Mudaraba: A mudaraba in which the mudarib has a free hand regarding where and how to invest the capital of the business.

Uqud al-Ishtirak: Partnership contracts.

Uqud al-Muwadat: Exchange contracts.

Uqud al-Tabbaruat: Charitable contracts.

Urf: Market norm.

Ushr: Islamic tax on agricultural produce.

Usufruct: The benefit received from an asset in a contract of lease.

Usul al-Fiqh: Sources of law.

Usury: An exorbitant amount of interest, or any rate of interest or the excess paid in exchange for a loan granted for personal use.

Voluntary Contract: A contract based on the mutual co-operation of contracting parties for which remuneration is not granted or received.

Wada: Promise; an undertaking regarding future actions.

Wadia: Safe-keeping deposit.

Wadia yad Dhaman: Goods or deposits granted for safekeeping. As wadia is a trust, the depository becomes the guarantor for repayment on demand of all the deposits or any part that remains outstanding in the accounts of depositors. The depositors are not entitled to any of the profits but the depository may grant them a portion of the returns at its own discretion.

Wakala: An agency contract which usually includes in its terms a fee for the agent.

Wakalatul Istithmar: An investment management contract.

Wakala Muqayada: Conditional agency agreement.

Wakala Mutluqqa: Unconditional agency agreement.

Wakalatul Ujrah: Agency executed for a fee.

Wakil: Agent.

Wakil bil Bay: The agent assigned to sell.

Wakil bil Khasooma: The agent assigned to deal with common disputes.

Wakil bil Qabd: The agent assigned to take possession of debt.

Wakil bi Shara: The agent assigned to purchase.

Wakil bi Taqazidain: The agent assigned to retrieve debt.

Waqf: A legal entity that has the potential to own, purchase and sell in addition to granting and receiving gifts.

Wasiya: Will, bequest.

Weightages: Ratios calculated for the appropriate allocation of profit and assigned to investment categories at financial institutions. They are subject to change with changes in market trend; the longer the term of deposit, the greater the weightage assigned to it.

Working Partner: A partner who is responsible for running the business.

Wujuh (lit.face)**:** Interpreted in financial transactions as goodwill or credit for partnership.

Zakat (or **Zakat al-Mal:** A tax imposed by Islamic law on all persons possessing wealth at or above an exemption limit (nisab). A Muslim must pay 2.5% of his yearly savings at or above the nisab to the less fortunate members of the community. Its objective is to collect a portion of wealth from the affluent members of society and distribute it among the underprivileged. It may be collected by the state or distributed by the individual himself. Zakat is obligatory for all Muslims who have saved the equivalent of 85g of gold at the time when the annual zakat payment is due.

Zakat al-Fitr: A small obligatory tax imposed on every Muslim who has the means for himself and his dependants. It is paid once annually at the end of Ramadan before Eid al Fitr.

Zakat al-Hubub: Zakat on grain/corn.

Zakat al-Madan: Zakat on minerals.

Zakat al-Rikaz: Zakat on treasure/precious stones.

Zakat al-Tijara: Zakat on profit from trade.

Chapter Seventeen

Special Articles on Islamic Finance

Who is Mufti Ismail Desai?

https://www.linkedin.com/pulse/who-mufti-desai-ismail-ebrahim-desai

Question:
We intend to conduct our dealings according to Islamic law. We contacted several institutions and organizations including the Darul Iftaa to advise us regarding Shariah Compliance and Islamic Finance Investments approved by Mufti Desai. Kindly advise.

Answer:
In the Name of Allah, the Most Gracious, the Most Merciful.
As-salamu 'alaykum wa-rahmatullahi wa-barakatuh.

Your question dated 24 February 2017 refers.
We wish to advise you that the institutions and banks you refer to are in all probability approved by Mufti Ismail Ebrahim Desai who is a well known Shariah Advisor to various institutions.Mufti Ismail Ebrahim Desai has Ijaazah/academic endorsement from various leading Ulema/scholars worldwide including Mufti Ebrahim Desai, Shaykh Saéed Ramadhaan al-Buti, Shaykh Moulana Mazhar Ibn Shaykh Arif Billah Moulana Hakeem Akhtar, Moulana Fahdlur Rahman Azmi, Shaykh Osama al-Rifaié and other senior and reputed scholars.

Mufti Ismail Desai also has a qualification in banking from London School of Economics (LSE) among various other professional qualifications and honorary endorsements. Mufti Ismail has also issued several thousand Fatawa (religious edicts) on Islamic Finance and Economics which have been published and disseminated via various platforms and media. Mufti Ismail Desai has also delivered speeches at various conferences, seminars and forums on Islamic Finance and Banking globally. He has visited various countries in the pursuit of promoting and propagating Islamic Finance and Banking including Russia, Malawi, UK, Turkey, Malta, Italy and the Middle East. Mufti Ismail has also authored several works and delivered several research papers on the topic.

You may contact Mufti Ismail Desai to seek clarity on any Shariah financial/investment products approved by Mufti Ismail Desai or any Shariah financial/investment products alluding the approval of Mufti Ismail Desai or TAIF.AE.

Mufti Usmani,
Sharia Advisory Board, TAIF.AE

How Shariah Compliant Are you?

https://www.linkedin.com/pulse/how-shariah-compliant-you-ismail-ebrahim-desai?articleId=7952305797787546976

Securities, merchant banking, rollovers, gilts, structured finance, mortgages, shares, bonds: a never ending list! There may be hundreds of terminologies in circulation in the financial world of today, yet these concepts were addressed by the Shariah hundreds of years ago. The Quran, Ahadith and the books of Fiqh (jurisprudence) are replete with investment schemes, financial ethics, instruments and products far beyond what is present today. Many of the terminologies, financial products and schemes common today are an evolved reflection of what was prevalent in the past.

Did you know?

- The Quran has 35 verses relating to Finance and Economics.
- Verse 2:282 is the longest verse in the Qur'an regarding Finance and Economics.
- Revelation (wahi) concluded with the verse 2:281, warning traders in Business and Economics. After discussing interest, Allah states:

"And fear a Day when you will be returned to Allah. Then every soul will be compensated for what it earned, and they will not be treated unjustly."

Did you know?

- The most celebrated compendium of Hadith in the Islamic world, Sahih al-Bukhari, contains 113 chapters on Finance.
- 471 Ahadith are devoted to Finance and Economics.

Hidaayah is a famous book in jurisprudence compiled by Ali ibn Abi Bakr al-Farghani al-Marghinani. It contains 24 intricate and complex chapters addressing the following: cash sales, credit sales, spot sales, FEC's, short sales, currency exchange, collateral, partnerships, leasing, endowments, laws of succession and many more subjects.
Many people presume that the Sahabah radiallahu anhum were poor, frail and weak. We imagine them to be illiterate and uneducated.

However, the reality is to the contrary. Every nation has its affluent and disadvantaged, likewise in the Sahabah there were those who were affluent and disadvantaged. The wealthy ones were expert investors. They had diverse investment portfolios. They had mastered the art of trade. The affluent ones were spearheading mass imports and exports. They were hiring, securitising their investments, dealing in collaterals, standing as guarantors, currency trading, investing in joint commercial enterprises and other profitable schemes. They were transacting in the millions.

Abdur Rahman Ibn Auf radiallahu anhu would import 700 camels laden with goods. He once gave 40,000 Dinars and 44,000 Dirhams in charity. That is equivalent to a remarkable R73, 328,651.42 (seventy three millon, three hundred and twenty eight thousand, six hundred and 51 Rands and 42 Cents)!! (Asad al-ghabah 3/143 Dar al-Ma'rifah)

Sayyiduna Zubair radiallahu anhu had an estate equalling to a staggering 52,200,000 Dirhams! That is equivalent to R124,992,763 (one hundred and twenty four million, nine hundred and ninety two thousand, seven hundred and sixty three Rands)! (Sahih al-Bukhari)
Imagine the value of these amounts 1400 years ago including the inflationary element and currency fluctuations.

Shariah has considered factors which create imbalance and injustice in the elements of supply and demand. Shariah has barred gambling, hoarding, monopolising, interest, speculative sales and all such transactions which create disharmony in the free competitive market.

The Shariah has the solutions to today's financial crisis which are clearly expounded in the Qur'an and Ahadith. The Shariah has an innate elasticity to recognise new financial concepts and instruments. Hereunder are some questions which we need to be asking ourselves in order to evaluate our personal and business financial positions from a Shariah perspective:

1. Where am I depositing my funds and do I earn interest on these funds?
2. How do I finance my new home/car?
3. How do I invest my money and where do I invest?
4. How does my business finance the working capital requirements?
   Am I financing my business via debt based instruments?
5. What are my financial and business ethics?
6. How do I fund the expansion of my business?
   Is my capital raising strategy Shariah Compliant?
7. How do I insure my business/life/assets?
8. Is my financial arrangements Shariah Compliant?
   Have I reviewed these arrangements?
9. What are my HR Policies?

You can contact Mufti Ismail Desai should you wish to learn the Shariah solutions to the above issues.

By Mufti Ismail Desai

What is Shariah Investing?

https://www.linkedin.com/pulse/what-shariah-investing-mufti-ismail-ebrahim-desai-gifs

Financial markets are witnessing the growing success story of Islamic finance, a unique form of investment which corresponds with the values of socially responsible investing which is also Shariah Compliant. Islamic finance is an equitable mode of finance that derives its principles from the Shariah, the Islamic law. The most distinctive element of Islamic finance is the prohibition of interest, whether nominal or excessive, simple or compound, fixed or floating. Shariah Compliant financial transactions are based on the essential maxim of sharing risk and reward. The customer and the financier share the risk of any investment on agreed terms, and divide any profits between them. Islamic finance does not allow creating new financial risks in order to gain profit; it is about protecting society from trickery, fraud and social tensions.

Shariah products also stress accountability, fairness and transparency. In addition to risk sharing and the prohibition of interest, under the principles of Shariah, investment is also disallowed in businesses that deal with alcohol, pork, gambling, weapons, tobacco, media, 'conventional' financial institutions, pornography and anything else which it deems 'Haraam' (unlawful). It is also ensured that not only the underlying investments but also the contractual terms agreed between the investors and the investment manager conform to Islamic principles. Islam also disallows certain contracts due to inherent elements which render them 'Haraam' (unlawful). This concept covers particular types of uncertainty or contingency in contracts such as options trading, short selling, futures, derivatives and conventional insurance. Shariah compliant investments by the Shariah board comprised of respected Shariah scholars who are highly qualified to issue "Fatwas" (religious rulings) on financial transactions.

This panel of Shariah experts ensures full compliance of the investments and transactions with Islamic principles. All Islamic investment fund companies have appointed Shariah boards which not only provide approvals on individual investments on a regular basis but also conduct a Shariah audit annually to ensure all activities of the investment funds are fully compliant. All dividends and profits are screened by the Shariah Audit Committee to ensure full Shariah Compliance of the final declared dividend or profit.

Shariah Compliance Screening

There are certain criteria which must be fulfilled when investing in a company in order for such an investment to be Shariah Compliant. There are essentially two stages involved in the Shariah screening process. It is important that the holding company including the subsidiary company fulfils the industry screen. For example, a vehicle asset manufacturing company may have a vehicle asset financing subsidiary which generates impermissible income via conventional and interest bearing lending practices, therefore investing in the holding company would be impermissible.

1. Sharia Industry Screen

The following business activities are impermissible:

1.1) Conventional Banking and Insurance
1.2) Alcohol
1.3) Pork and all non-Halal food items
1.4) Gambling
1.5) Tobacco
1.6) Adult Entertainment and all other impermissible actions as decided by the Shariah Supervisory Board
1.7) Conventional derivatives
1.8) Weapons

2. Shariah Financial Screen

The Shariah Financial Screen monitors the impact of non-Shariah Compliant practices of a company and its potential impact on corporate performance. The investment companies must be compliant with the Shariah Financial Ratios as decided by the Shariah Supervisory Board.

Screen:

2.1) Conventional Debt/Total Market Capitalization - 33%
2.2) (Cash +Interest Bearing Deposits)/Total Market Capitalization - 33%
2.3) Total Interest/Revenue -2%

Shariah Governance and Shariah Board

Shariah Governance refers to the structured policies and procedures of the Islamic Investment Fund to ensure full Shariah Compliance. All Shariah compliant investments must be certified by experts in Shariah, generally through a panel or board comprised of respected Shariah scholars who are qualified to issue "Fatwas" (religious rulings) on financial transactions. This panel of Shariah experts ensure full compliance of all Shariah compliant investment funds. The Shariah Supervisory Board not only provides initial approvals on investment objectives and investment strategy of all funds, but also reviews the investments periodically to ensure the continuous compliance of the investments of the funds to Islamic principles. Moreover, the Shariah Audit Committee conducts annual Shariah audits of all funds to ensure adherence to their rulings during the year.

Common Shariah Investment Funds

The most common forms of Shariah compliant investment funds are equity funds, private equity funds, trade finance funds, real estate funds and money market funds. Such funds are either unlisted private funds, listed funds, private or public partnerships. These investment funds employ Islamic contracts which ensure that the terms and rights of all parties are safeguarded in conformity with Islamic principles (examples and definitions are given below).

Musharakah: A partnership where profits are shared according to a pre-agreed ratio while losses are shared in proportion to the capital investment of each partner. This equity financing arrangement is widely regarded as the purest form of Islamic financing.

Mudarabah: An investment partnership under which the investor (the "Rab-ul-Mal") provides capital to the investment manager (the "Mudarib") in order to undertake a business or an investment activity. While profits are shared on a pre-agreed ratio, losses are borne only by the investor.

Ijarah: An Islamic lease agreement. Instead of lending money and earning interest, Ijarah allows the investor to earn profits by charging rentals on the asset leased to the user.

Murabaha: Purchase and resale of an asset. Instead of lending money, the investor purchases the specific asset from a third party and resells it at a predetermined higher price to the user. By paying this higher price over instalments, the user of the asset has effectively obtained credit without paying interest.
The classical equity instruments in Islamic commercial law (musharakah and mudarabah) require partnership and profit sharing. In financial markets, investing in stocks and equity funds is permitted but must conform to certain guidelines. Conventional interest-based lending or bonds are not permitted. Islam encourages asset-backed financing with the risk being shared by the provider and the user of the asset.

Contemporary Matters and Conclusion

Shariah Investments must follow the same rigorous regulatory and compliance requirements as conventional funds to ensure transparency, reliability and sustainability for investors. A mere Shariah certificate is not sufficient proof or attestation to the credibility of Management or the business case of such investment funds. Investors should seek proper professional advice and conduct background checks before undertaking to make any investment. Investors must seek the following basic fundamentals in any investment:

1. Regulatory Compliance – Never invest your hard earned money into a non-regulated entity as the funds are not monitored or reported to the regulator and there is very little recourse in the event of default or irregularity. A Shariah fund does not mean your money is necessarily protected from fraud, theft and mismanagement. It has happened in the past so beware.

2. Governance Structure – Never invest in one-man band investments as that is a recipe for Ponzi schemes and financial ruin. Investigate Management and Ownership carefully. There are many wannabe investment guru's and financial advisors who have little or no experience in financial investment management.

3. Risk and Audit – Always seek audited financials signed and endorsed by a reputable firm before investing into any company. The investment fund must have an audit and risk committee that oversee the risk management and internal audit functions.

4. Target Assets – Always understand the underlying assets of the fund. Many Shariah funds are not balanced and are over-aggressive exposing you to unnecessary high risk.

5. Shariah Audit – A Shariah Audit signed by a reputed scholar is extremely important as that allows external parties to review the operations of the fund internally.

6. Rate of Return (ROI) – Always seek market related returns or slightly above average. High returns are signs of systemic and inherent financial risks to the business models of such investment funds which offer high returns. Remember if it is too good to be true, it probably is. The fund fact sheet will be a good indicator of historical performance.

7. Shariah Certification – A fund being Shariah Compliant is not an endorsement of the credibility of any investment. Every individual must conduct their own research and investigation before making a decision.

8. Emotion - Greed and fear are the most common emotions which have led to the destruction of many empires. Let your decisions be guided by sound and robust financial and economic wisdom.
The wealth that we have is an Amaanat (Trust) bestowed by Allah upon us. We are taught as Muslims to protect such wealth within the parameters of Shariah in the most safe and protected manner.

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Islamic Finance – Opportunities and Challenges

https://www.islamiceconomist.com/?p=1447

The Islamic financial system has witnessed considerable developments in the past four decades and is now regarded as one of the fastest growing segments of the global financial system. Islamic finance assets grew at double-digit rates during the past decade, from about US$200 billion in 2003 to an estimated US$2.336 trillion at the end of 2015 (Global Islamic Finance Report 2017).

Key Islamic finance jurisdictions such as Malaysia and the GCC have gained much growth and traction over the past few years. However, other jurisdictions in Africa such as South Africa, Nigeria and Kenya have made considerable progress in the growth of Islamic finance. Bangladesh and Indonesia in the Asian region have shown key potential for growth.

European countries such as the UK and Germany have also shown heightened activities in the industry. Islamic finance has made considerable progress in the African region, spurred by demand from Muslims and non-Muslims. The Nigerian Central Bank issued a license to Jaiz Bank Plc, to operate as a fully-fledged non-interest financial institution (NIFI). There are other Islamic banking windows operational in Nigeria, which serve the Muslim population of 173.6 million.There remains huge opportunity for Islamic banks to setup in Nigeria given the huge Muslim population and growing demand. Nigeria has facilitated the issuance of sukuk (Islamic bonds) by amending the regulations by the Securities and Exchange Commission of Nigeria (SECN). The State of Osun sold US$61 million of sukuk in 2013, becoming the first state in Nigeria to sell sukuk.

South Africa's National Treasury wants to make the country the hub for Islamic finance in Africa. The South African banking regulators have taken various measures to develop and promote the industry including amending tax laws to create an equitable and level playing field for Islamic finance. The country currently has one full-fledged Islamic bank; Al Baraka Bank was registered in South Africa in 1989. Other banks such as First National Bank (FNB), Absa Bank and HBZ Bank house Islamic finance windows alongside their conventional banking services. The South African government issued their debut sukuk in the third quarter of 2014. The US$500 million 5.75-year was oversubscribed more than four times and attracted Middle Eastern and Asian investors. In West Africa, Senegal successfully launched a four-year XOF100 billion (US$171.96 million) sukuk in June 2014. This sukuk represents a new era in the use of Islamic financing instruments in the country's public finances. Senegal may consider additional sukuk issuance to support the country's infrastructure needs and Dakar is aiming to position itself as the continent's hub for Islamic finance.

Cote d'Ivoire launched its 150 billion CFA francs sukuk priced at a profit rate of 5.75% in the last quarter of 2015. Cote d'Ivoire mandated the ICD as the lead manager for its inaugural local currency sukuk programme worth XOF300 billion (US$515.87 million), which will be issued over the 2015-20 period in two equal phases.
In East Africa, the government of Uganda has approved the Financial Institutions (Amendment) Bill 2015, paving the way for Islamic banking and finance in the country. Kenya has set its sights on becoming the Islamic finance hub of the East Africa region. With two fully fledged Shari'a-compliant banks in operation, licensed takaful and retakaful businesses and a number of financial institutions offering products that comply with Islamic law.

There have been several key growth points for Islamic finance in the Asian region. Bangladesh is the third largest Muslim country in the word. With a predominantly Muslim population of 160 million, the industry has doubled in size in the past four years. The Islamic Bank of Bangladesh Limited (IBBL) was launched in 1983. The country has seven standalone Islamic banks and 16 conventional banks with Islamic banking windows (IFSB, 2014) The market share of Islamic banks in Bangladesh is sizeable and accounts for 18.9% of the total banking deposits and 21.1% of total financing (Annual Report, Bangladesh Bank, 2013). There is also a sizeable takaful market in Bangladesh with 8 takaful operators. The central bank has a small short-term sukuk programme, which issues six-month tenors to help Islamic banks manage their liquidity requirements. The central bank auctioned three-month and six-month sukuk on Jan. 1, 2015, selling 855 million taka (US$11 million) and 936 million taka, respectively.

Indonesia has the world's largest Muslim population with 12.7% of the world's Muslims. Indonesia's capital market regulator has published a five-year strategy for the Islamic finance industry. Indonesian authorities want Indonesia's Islamic banks to hold at least 15% of the market by 2023. Islamic banks in Indonesia comprise of 12 fully fledged Islamic banks and 22 conventional banks have Islamic banking windows. There are 45 Islamic insurance institutions in the country. Furthermore, there are 316 Shari'a-compliant stocks, which have been classified and listed under Shari'a listed stocks comprising of 60% of the total stocks in Indonesia.

Indonesia's Islamic bond market is the second largest in East Asia. The government issued its first retail sukuk in February 2009 for US$144.4 million. The government issued its first sovereign sukuk based on the ijara principle in August 2008 with the sale of 7-year (IFR0001) and 10-year (IFR0002) Islamic bonds. The government has allocated IDR6.94 trillion for infrastructure projects via government sukuk issuance.

There has been key growth in several European countries. The United Kingdom issued the first sovereign sukuk by a European federal government. The government raised US$339.5 million with a profit rate of 2.036% and a five year tenure. The order book was oversubscribed by nearly 10 times the issuance size. The government-backed export credit guarantee agency has provided cover for a US$913 million (£617 million) Islamic bond issued by Dubai’s Emirates Airline to purchase aircraft including the giant Airbus A380. More than 20 banks currently offer Islamic financial products and services in the UK. The value of sukuk already listed on the London market exceeds US$34 billion (£21 billion) over the past five years with more than 50 bonds quoted by the London Stock Exchange.

With a population of 4 million Muslims in Germany, holding an estimated wealth of €25 billion, Germany potentially is a big market for Islamic finance. According to a 2010 survey, 72% of Muslims living in Germany are interested in Islamic finance products. Germany launched its first fully-functional Islamic bank in Frankfurt under the name KT Bank AG. FWU Group, a Munich-based financial services company, issued a US$20 million five-year Islamic bond backed by insurance policies in October 2013 and issued a US$55 million seven-year sukuk through a private placement that was backed by intellectual property rights in December 2012. Luxembourg issued a sukuk for US$253 million with a five year tenure in October 2014. The sukuk was twice oversubscribed.

Challenges

Despite the huge growth of the Islamic finance and bankingiIndustry over the past few years, the industry currently faces considerable challenges and in particular:

1. **Lack of Human Capital**

Qualified human resources play a pivotal role in the development and success of any industry. There is a dearth of qualified bankers and professionals who are well versed in Islamic laws as well as contemporary economics and finance. Currently, various universities and training institutes are offering courses in Islamic finance but they also face lack of competent human resources to conduct these courses. There also remains a huge lack of human resources on the expert level. There remains a significant shortage of Shari’a scholars who are well versed in Islamic finance. Business schools and religious schools should offer Islamic finance qualifications in co-operation and conjunction with industry experts to create the next generation of Shari’a experts and professionals. Academic institutions should also be encouraged to establish centres of excellence for the Islamic finance industry.

2. **Shari’a Standardisation and Harmonisation**

Islamic law accommodates for differences of opinion and interpretations of classical Islamic texts. This leads to different practices and policies adopted across different jurisdictions. This may impact on the growth and internationalisation of the Islamic finance industry. Islamic finance laws, policies and practices should be standardised and harmonised in order to create more unification and consolidation within the industry. This would strengthen the industry from a Shari’a perspective and root out weak and rejected views. Furthermore, Shari’a scholars should adopt these policies and procedures to prevent and mitigate Shari’a non-compliance risk.

3. Lack of Public Awareness

There remains a low penetration rate and lack of critical mass in the Islamic finance industry. This is due to mainly a lack of public awareness and knowledge of Islamic finance. Islamic banks, regulators and governments should undertake mass awareness programmes to drive the growth of Islamic finance and create critical mass for the industry.

4. Shari'a Law and Legal Framework

There remains a great need to harmonise Shari'a law with the existing legal frameworks. This creates huge difficulties and challenges in the event of disputes and legal matters as Islamic financial concepts are not recognized by certain legal frameworks. There should also be a drive to create more innovative products and gradual shift from products that closely resemble conventional financial products such as commodity murabaha and tawarruq.

5. Regulation and Supervision

Islamic banks are exposed to various risks such as displaced commercial risk (DCR). This forces Islamic banks to lose profits in order to pay comparable returns to investment account holders (IAHs) and depositors. This create huge challenges for Islamic banks in creating excess reserves to cover losses and how this is viewed from a regulatory perspective.

Islamic banks also face equity investment risk, rate of return risk, Shari'a noncompliance risk in the event of perceived non-compliance and liquidity risk due to the shortage of liquidity products. Other challenges include the divergent interests of investment account holders and the Islamic banks' shareholders. One of the major issues is that IAHs share profits and bear losses, but do not have shareholder rights (López-Mejía and others 2014). This leads to a lack of transparency in the reporting of profits and losses to the IAHs.

Various standards have been issued by the IFSB and AAIOFI. However, many jurisdictions have failed to implement these standards. There also remains a huge challenge in the adoption of Shari'a compliance. Various jurisdictions do not regulate and supervise the way Shari'a compliance is adopted. There should be a proper selection criteria for Shari'a scholars. Many jurisdictions have begun adopting central Shari'a boards in order to ensure harmonisation of Shari'a compliance within the industry.

6. Access to Finance

Muslim countries have shown a lower level of financial inclusion than other countries in the World. This can be resolved by creating a better business model, reforms to increase competition within the banking sector, consumer protection, better credit information and education.

7. **Monetary Policy and Liquidity Management**

Money and interbank markets for Shari'ah-compliant instruments have not yet developed in most countries, in part because of a lack of available instruments. There remains a huge shortage of Shari'a central banking facilities. Moreover many Islamic banks operate under a dual system of conventional and Islamic banking policy framework and are heavily influenced as a result by conventional banking instruments and conditions. Central banks should adopt more effective instruments and policies for Islamic banks. Many jurisdictions do not have a lender of last resort for Islamic banks. Only 6 out of 24 Jurisdictions for Islamic banking have a lender of last resort for Islamic banking.

8. **Tax Policy**

Regulatory/tax reforms play a pivotal role for the growth of any industry. There remains various tax issues which need to be resolved in order to level playing field between Islamic banks and conventional banks. Some of these issues include the treatment of Islamic finance under income taxes, sales taxes (for example, value added taxes), specific transaction taxes, and bilateral tax treaties. International standards can encourage governments and jurisdictions to facilitate tax reforms.

9. **Benchmark**

The usage of the conventional interest based benchmark (Libor) creates a negative perception among investors who tend to associate the Islamic financial system with the conventional financial system due to the usage of the interest based benchmark. Furthermore Islamic banks are placed at the mercy of the movements in the conventional money markets by using the conventional interest based benchmark.

About the Author

Mufti Ismail Ebrahim Desai is an internationally reputed Shariah scholar and Islamic finance expert who is a Shariah advisor and member of Infinity's Shariah Supervisory Board. In addition to his current position as TAIF's Sharia Advisory Board member, He currently serves as Shariah advisor to various Islamic financial institutions and educational institutes around the world including UTL Financial Services (Botswana),Centre for Advanced Islamic Economics (Pakistan), Infinity Consultants (India), Newfin Vehicle Finance (RSA), Al-Mabroor Investments (RSA), central banks, governments and various Islamic investment firms and real estate funds around the world. Mufti Ismail has developed various Shariah auditing, governance and risk management standards for Islamic financial institutions and has issued several hundred expert legal opinions (fatawa) with a special focus on Islamic finance and economics. Mufti Ismail holds a Master's in Islamic Finance and a Master's in Islamic Theology from the Institute of Islamic Jurisprudence, Durban, South Africa.

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TRAINING & AWARENESS OF ISLAMIC FINANCE

About TAIF

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ABOUT THE BOOK

Your Brief Guide to Islamic Finance has been created to introduce you to modern-day Islamic finance. The past fifty years have seen dramatic changes in this sector of the global finance industry, with a marked growth in both the demand for and provision of products and services.

The Islamic finance industry is still growing at an exceptional rate as more companies expand into or further develop their offerings in this area. To know how Islamic finance may impact on you or your business efforts and what opportunities it may pose it is essential to understand the basic principles. We hope this brief guide will help you on your journey in understanding and learning the basic principles and laws of Islamic finance.