Main Types and Risks of Islamic Banking Products

Rima A. Turk

Regional Workshop on Islamic Banking
International Monetary Fund
Center for Economics and Finance
Kuwait, April 27 - 30, 2014.

OUTLINE

1. Financing on a Profit-and-Loss Sharing (PLS) Basis
   – *Mudaraba*
   – *Musharaka*

2. Debt-Based Islamic Financing Products
   - *Murabaha:* Cost-plus sales
   - *Ijara*: Leasing
   - Islamic "Forwards": *Bai' Al Salam & Istisna'*

3. Islamic Insurance: *Takaful*

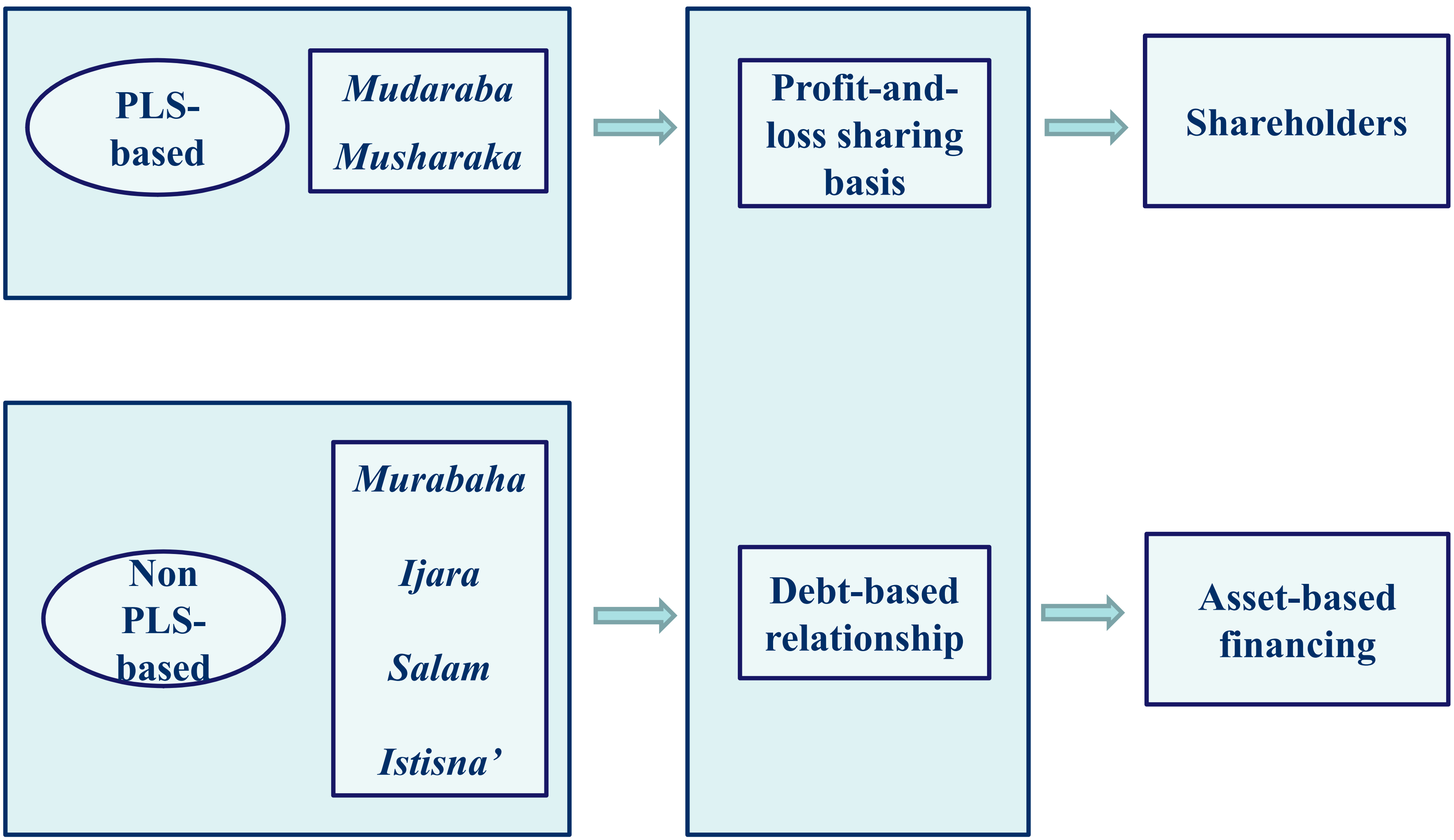
Part One:

Financing on a PLS basis

Islamic Financing Contracts

- Risk and uncertainty are at the center of financial contracts. Three alternative contracts are available to deal with uncertainty: debt, equity, and insurance contracts.
- In equity contracts, the return to the holder is determined by the performance of the issuer. It cannot be specified in advance, but is determined by the outcome of the project being financed.
- Debt contracts create a defined obligation to repay irrespective of the performance of the borrower.
- Insurance contracts are designed to mitigate risks in financial transactions.

Islamic Financing Modes



Financing on a PLS Basis

- Ensures justice between parties because returns are a function of operational results.
  - Losses are shared by the financier along with the entrepreneur in the ratio of their respective contributions.
  - Profits are shared in pre-agreed ratios.
- Ideal mode of financing.
  - Reduces inequitable distribution of income and wealth.
  - May lead to a more efficient and optimum allocation of resources compared to second line financing.
- Two major types of equity financing contracts:
  - *Mudaraba & Musharaka.*

Equity Financing: *Mudaraba*

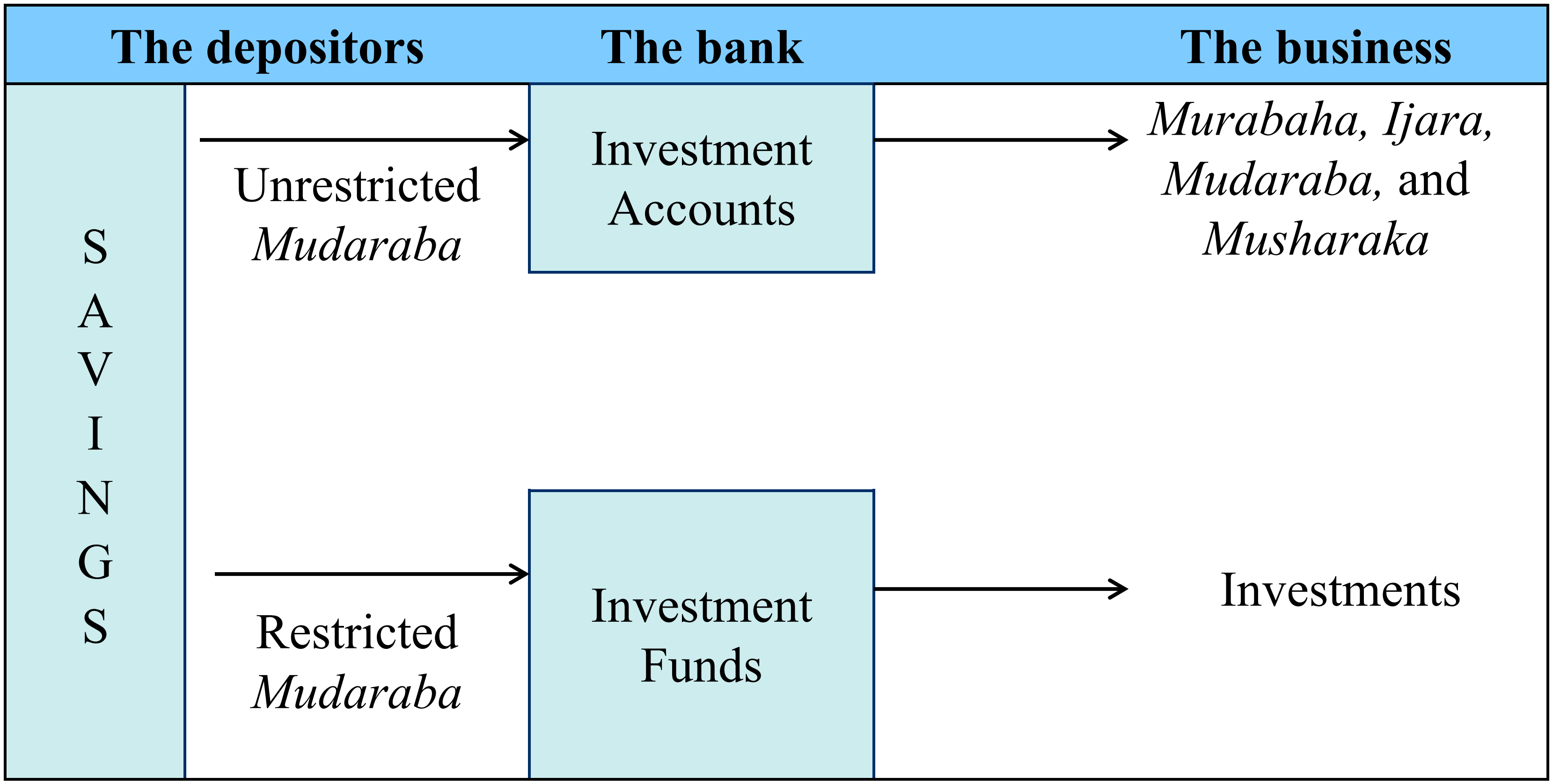
- Partnership in profit between capital and work:
  - One party supplies capital: *Rabbul Mal*, principal, or financier.
  - Other party provides personal time and effort: *Mudarib* or agent.
- A profit sharing partnership:
  - The share in profit is determined by mutual agreement.
  - Unless there is negligence by the agent, the loss, if any, is borne entirely by the financier, in which case the entrepreneur gets no share in profits (*Mudaraba* is not a loss partnership).
- A sleeping partnership:
  - The *Mudarib* actually runs the business and the *Rabbul Mal* does not have the right to interfere in management.
  - But *Rabbul Mal* has every right to specify conditions that would ensure better management of his capital.

Two Types of *Mudaraba*

- Restricted *Mudaraba* (*Mudaraba Muqayyadah*):
  - *Rabbul Mal* specifies the type of business to invest in.
  - E.g., the investment account holders authorize the bank to invest their funds based on *mudaraba* or agency contracts with certain restrictions as to how and where they are invested.

- Unrestricted *Mudaraba* (*Mudaraba Mutlaqa*)
  - *Mudarib* has full freedom to undertake any business but cannot invest the capital in an activity that is beyond his/ her main activity.
  - E.g., account holders authorize the bank to invest their funds without any restrictions, commingling them with their own funds or in a pooled portfolio.

Two Types of *Mudaraba*



Two-tier *Mudaraba* in Banking

- Replaces interest in conventional banking by profit sharing on both sides of the balance sheet.
- 1st tier *Mudaraba*: An agreement between depositors and the bank.
  - Depositors provide capital to the bank under unrestricted *Mudaraba* agreements in the form of Unrestricted Investment Accounts and the bank manages the funds.
  - Bank can aggregate funds and share their net profits with depositors after deducting a management fee.
  - As financiers, depositors are subject to losing some or entire funds.

Two-tier *Mudaraba* in Banking

- 2nd tier *Mudaraba*: An agreement between the bank (*Rabbul Mal*) and an entrepreneur (*Mudarib*).
  - Funds are provided to entrepreneurs under restricted *Mudaraba*.
  - While *Rabbul Mal* can monitor the projects being funded, it cannot interfere with management nor impose loan covenants
  - *Rabbul Mal* also cannot impose on the *Mudarib* the payment of a fixed return, but a profit rate is assigned to each party after deducting all business-related expenses.
  - *Rabbul Mal* cannot require any guarantee or collateral as a security against eventual loss, but a third-party guarantee is acceptable.
  - Liability of financier is limited to capital provided and that of the entrepreneur to his labor and effort.

Individual & Joint *Mudaraba*

Mudaraba can be individual or joint.

- In case of individual *Mudaraba*, an Islamic bank provides finance to a commercial venture run by a person or a company on the basis of profit sharing.
- The joint *Mudaraba* may be between the investors and the bank on a continuing basis.
  - The investors keep their capital in a special fund and share the profits without liquidating those financing operations that have reached the stage of final settlement.
  - Many Islamic investment funds operate on the basis of joint *Mudaraba*.

Rules for Profit Distribution

- Division of profits must be in the form of ratios rather than absolute numbers and profit distribution ratios may differ from the capital contribution.
  - Profit-sharing formula must be made clearly agreed upon, without any party having preferential rights over profits.
- Profit distribution can only take place after the capital-owner has recouped original capital.
  - Any periodic or interim distributions are treated as partial capital return and are subject to final review upon contract conclusion when the final profit or loss is determined.

Example 1: *Mudaraba*

- Consider a one-year $100,000 *Mudaraba* between a bank and a contractor with a 50:50 profit distribution.
- In the case where the bank's target return exceeds 12%, the *Mudarib* will be rewarded for good performance by receiving 90% of the amount that exceeds the target.
  - Most banks specify in the *Mudaraba* contract a target profit share.
- Assume that, at year end, net profits are $50,000 to be equally divided between the bank and the agent.
  - Mudarib receives $25,000 + 90% ($50,000-$12,000) = $34,200 or 68.4% of the profits.
  - Bank receives $12,000 + 10% ($50,000-$12,000) = $15,800 or 31.6% of the profits.

Example 2: *Mudaraba*

Given the information below, calculate distributable profits and the rate of return for each class of funds providers. Assume that profit distribution is in proportion of funds invested.

Funds available for investment	SAR in mn	Investment rate
Shareholders	200	100%
Investment accounts: 1 year	240	90%
Investment accounts: 6 months	825	80%
Investment savings accounts	1,200	60%
Total funds	2,465	

Profit-sharing distribution shares			
	Mudarib	Depositor	Total
Investment accounts: 1 year	10%	90%	100%
Investment accounts: 6 months	18%	82%	100%
Investment savings accounts	25%	75%	100%
Income to be allocated	SAR 90.0 mn		

Example 2: *Mudaraba*

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	Funds available for investment	Investment rate	Funds invested (1x2)	% of funds invested	SAR Share in profits (4)x90	Mudarib % share	Mudarib SAR share	Distributed profits (5-7)	Rate of return (9/3)
Shareholders	200	100%	200	11.14%	10.02	-	-	26.08	13.04%
Investment accounts: 1 year	240	90%	216	12.03%	10.82	10%	1.08	9.74	4.51%
Investment accounts: 6 mths	825	80%	660	36.75%	33.07	18%	5.95	27.12	4.11%
Investment savings accounts	1200	60%	720	40.09%	36.08	25%	9.02	27.06	3.76%
			1,796	100%	90.00			90.00	

Note: Shareholders' distributed profits are calculated as residuals, after deducting from the profits of 90 the share of different investment account holders.

Key Risks with *Mudaraba*

- Credit risk and default: *Mudaraba* is a high-risk mode of finance because it involves a high degree of moral hazard.
  - Managing the risk that the entrepreneur defaults and goes bankrupt is an issue because no tangible assets can be used as collateral against possible losses.
  - Credit risk is mitigated by engaging in due diligence
    - In respect to the past performance and reputation of the *Mudarib* before granting funds and
    - In reducing information asymmetry during the life span of the project.

Key Risks with *Mudaraba*

- Operational risk: The bank may take excessive risk with the funds of account holders, who have no governance rights over their management decisions.
  - Therefore, the bank is exposed to the risk that investment account holders withdraw their funds, especially if competitive returns are not paid.
  - In case of misconduct or negligence by the bank, these funds become a liability to the bank, leading to solvency problems.

Key Risks with *Mudaraba*

- Displaced commercial risk.
  - Risk that funds of investment account holders are retained by raising the rate of return or smoothing it at the expense of shareholders.
  - Risk arises (1) as a result of rate-of-return risk when funds are placed in assets with longer term maturity and the rate of return is no longer competitive, and (2) when bank underperforms and is unable to generate adequate profit distribution to account holders.
  - Banks set up reserves to mitigate this risk:
    - Profit Equalization reserve (PER) is funded by setting aside a portion of gross income before deducting the bank's share as an agent. PER is used to align ROR offered by the Islamic bank with the market rate of conventional banks.
    - Investment Risk Reserve (IRR), funded by a portion of the income to investors-depositors after allocating the PER.

Equity Financing: *Musharaka*

- *Musharaka* is the most authentic form of Islamic financing.
  - A contract of joint partnership where two or more partners provide capital to finance a project (old or new) or to own real estate/ movable asset, either on a temporary or permanent basis.
- All partners are entitled to a share in the profits from the *Musharaka* in a ratio which is mutually agreed upon.
- Losses, however, are always shared in proportion to each partner's capital contribution.
- Every partner has a right to take part in management.
  - In case partner waives right to management, he becomes "silent. His share in profit cannot exceed his capital contribution share.

Limited & Unlimited *Musharaka*

- *Shirka al'Inan* is a partnership where each partner is only the agent but not the guarantor of the other partner.
  - Different shareholders have different rights and are entitled to different profit shares.
  - *Al'Inan* is limited in scope to the specific undertaking and is more common than *Al Mufawada*.
- A *Mufawada* is an unlimited, unrestricted, and equal partnership.
  - All participants rank equally in every respect (initial contributions, privileges, and final profits)
  - Each partner is both the agent and the guarantor of the other.

Permanent *Musharaka*

An investor (Islamic bank) participates in the equity of a project and receives a share of profit on a pro-rata basis.

- The period of contract is not specified and the partnership continues for as long as the parties concerned wish it to continue.
- This technique is suitable for financing projects of a long life in which funds are committed over a long period.

Diminishing *Musharaka*

Musharaka Mutanaqisa: One partner promises to buy the equity share of the other partner gradually until the title of the equity is completely transferred to the buying partner.

– The contract begins with the formation of the partnership, after which buying and selling of equity shares takes place either at market value or at a price pre-agreed upon at the time of entering the contract.

– The buying & selling of equity shares is independent from the partnership contract and should not be stipulated in it.

– It is not permitted that one contract is entered into as a condition for conducting the other one.

Diminishing *Musharaka*

- Mostly used in home financing.
  - Customer forms a partnership with the bank for the purchase of property.
  - Unlike *Ijara*-based mortgage where house ownership remains with the lessor/ owner for the entire lease period, ownership is explicitly shared between the customer and the financier.
- The bank rents out its part of the property to the client and receives periodic payment divided into two parts.
  - One part paying a proportionate rental to the financier based on the financier's share of the property,
  - The other part is an equity contribution to gradually buy out the financier's share of the equity.

Other Applications

- Service sector: Purchasing a taxi to offer transport services.
- Small business: Starting the business of selling ready-made clothes.
- Commercial and real estate: Financing real estate and construction projects.
- Domestic trade/ import of goods/ letters of credit: Financing the sale and purchase of goods in the local/ international market as specified by a client.
- Agriculture: Financing the purchase of machinery for a land owner, such as tractors, irrigation pumps, etc.
- *Sukuk*: *Musharaka Sukuk* certificates in securitization.

Example 1: *Musharaka Sukuk*

Qatar Real Estate Investment Company *Sukuk*

Type of Structure	*Musharaka*
Status Type of Sukuk	Closed Corporate
Issue Size Minimum Subscription Increment	USD 270,000,000 USD 100,000 USD 1,000
Moody's Sector	Baa2 Real Estate
Exchange Listing	Luxembourg SE
Tenor Maturity Date Embedded Options	10 Years 31-Aug-16 Callable

The entire financing package (including a syndicated facility) will be $375 million.

Use of proceeds	The proceeds of the issue of the *Sukuk* Certificates will be used by the Issuer to pay the Issuer's Contribution to the *Musharaka*.
Profit Rate Profit Distribution 1st Profit Distribution Date	3 months LIBOR + 120 bps Quarterly 30Nov06 (On each 31 August, 30 November, 28 February and 31 May of every year, Certificate holders will receive from proceeds received from and in respect of the Trust Assets, a periodic distribution amount.)
Lead Manager Co-Lead Manager Book Runners	Qatar National Bank Dubai Islamic Bank Gulf International Bank Standard Chartered Bank Dubai Islamic Bank Gulf International Bank Qatar National Bank Standard Chartered Bank

Example 2: *Musharaka*

Project Description	*Grocery Store*
Capital investment	$30,000
Duration of *Musharaka*	One month
Bank's capital contribution	80%
Partner's capital contribution	20%
Bank's share in management	0%
Partner's share in management	25%
Profits	$1,000

Questions

1. What are the Bank's and the Partner's shares (in %) in the total profit of $1000?
2. Calculate the monthly and annual rates of return for the bank and the partner.

Example 2: *Musharaka*

1. Of the \$1000, \$250 would go for management and would all accrue to the partner.

   Of the remaining \$750, the bank would receive 80%, or \$600, and the partner would receive 20% or \$150.

   So the total receipts for the bank and partner would be \$600 and \$400 respectively. This implies a return of 60% (600/1000) and 40% (400/1000) for the bank and partner, respectively.

2. Monthly ROR for the Bank = 600/(80%x30,000) = 600/24,000 = 2.5% or an annual ROR = 30%.

   Monthly ROR for the Partner = 400/(20%x30,000) = 475/6,000 = 6.67% or an annual ROR = 80%.

Key Risks in *Musharaka*

- Credit risk: The bank is exposed to two types of credit risk.
  - Capital impairment risk: Bank can lose its share in capital invested in the project either due to ability and willingness of the partner to meet his commitment to purchase the shares or in case the value of *Musharaka* assets decline.
  - Default risk: Risk that the entrepreneur defaults and goes bankrupt.
- Operational Risk: Risk that the partner lacks technical expertise and the project fails.
  - Inadequate due diligence in the pre-establishment stage to appraise activity, credit worthiness, soundness, and reliability of customer.
  - Poor management during the life span of the project: inadequate monitoring of performance and control of management due to non-timely financial information.

Part Two:

Debt-Based Islamic Financing Products

Murabaha: Cost-Plus-Financing

- *Murabaha* is by far the most popular contracts of sale for purchasing products on credit.
- Rather than lending money as in the case of a conventional loan, in a *murabaha* agreement the bank purchases the commodity requested and sells it to the customer with a price mark-up.
- The goods are delivered immediately, however the payment is deferred to a date agreed upon by the two parties.
- This way, a customer can attain a commodity and pay for it at a later date.

Murabaha: Cost-Plus-Financing

The mechanics of the contract are as follows:

1) Customer approaches bank with request to purchase the required goods.
2) The bank agrees to purchase the good and gives the customer an offer for the sale of the proposed goods.
3) The customer promises to purchase the goods, but the promise is not legally binding because it is made before the bank gains ownership of the commodity.
   - *Sharia'* scholars consider this promise as an invitation to do business. It is not a commitment.
   - However, there is difference in opinion among scholars on whether the moral obligation is a legal obligation.

Murabaha: Cost-Plus-Financing

4) The bank purchases the goods from the supplier by paying the spot price P that is also known to the client, with immediate transfers of title.
   – Or it appoints the client as its agent to accept delivery of the goods on its behalf.

5) With the title of the goods now vesting with the Bank, the customer can now enter into a legally binding contract for the purchase of the goods at a marked-up price P+M, where M is the agreed profit.
   – Contract specifies the mode of payment (lump sum/installments).
   – The client can renege on his promise.

Murabaha: Cost-Plus-Financing

6) Once the contract is signed, the title of the goods is transferred from the bank to the client.

7) The period of credit is the service rendered by the bank and the mark up reflects the value addition.

<u>Note:</u> Ownership of the goods may be physical or constructive. This means that the bank may not have taken physical delivery of the commodity, yet it is in control of the commodity with all the rights, liabilities and risks. Hence the need for adequate documentation.

Murabaha General Conditions

1. The contract is valid if the buyer is a person of sound mind, of the age of puberty or mature, and intelligent.
2. He/ she must not be restricted from dealing with any business, i.e., neither a bankrupt or extravagant person.
3. Coercion nullifies a contract: one who would like to enter into a business contract must not being forced to do so.
4. The price must also be known in a specified currency as well as maturity and terms of payment.
5. The offer and acceptance must be of a definite and decisive wording.

Murabaha Specific Rules

- *Murabaha* must be based on a sale and cannot be used for a purpose other than purchasing a product.
- Merchandise must be in existence, permissible (no liquor, pork…), valuable, deliverable, and known to both parties.
- Goods must be owned by the financier at the time of sale, bearing all rights and liabilities, including risk of destruction
- In the event of default, seller has recourse only to item financed and no further mark-up or penalty may be imposed.
- Financier may ask for a third-party guarantee to protect against non-payment, for a security, or be named as the beneficiary of the asset in an insurance policy.

Murabaha Applications

- *Murabaha* is used in corporate finance for financing:
  - Working capital needs on a relatively short-term basis: Finance the acquisition of raw materials, stocks and inventories or semi-finished products. The bank allows the customer to settle payment on a deferred term of 30, 60, 90 days or any other period.
  - Fixed assets, such as land, building, machinery and equipment, automobiles, computers, furniture and the like.
- *Murabaha* is also used for the purchase of personal assets and consumer durables, such as PCs, cars, houses, etc.

Murabaha vs. Interest Loans

- *Murabaha* may appear similar to conventional loans, with a substitution of profit rate or mark-up for rate of interest.
  - Profit rate is often determined in relation to the market rate
- It is natural, albeit undesirable, for rates to align with each other, especially in an integrated market comprising both conventional and Islamic types of products.
- From an Islamic jurisprudence perspective, *Murabaha* is a sale transaction and not a loan transaction.
  - No money is loaned, but a specific asset is purchased for the client to ensure that the financing is linked to an asset.

Murabaha vs. Interest Loans

- The bank bears some risk during the period between the purchase of the good and its sale to the customer, justifying the mark-up.
  - If goods become damaged while in the bank's possession, or the customer chooses not to purchase them, the bank has to shoulder the loss.
- Mark-up in *Murabaha* is fixed and cannot be floating as for loans. Once fixed, it cannot be increased in case of default; nor can it be decreased in case of early payment.
  - Note that the IB can grant a rebate for early repayment, but the rate of discount cannot be pre-specified in the contract.

Key Risks in *Murabaha*

- Credit risk: Risk of default or deterioration in of the customer capacity for repayment.
  - The measurement of credit risk is done by assigning a credit rating to customers and assessing their probability of default
  - By measuring expected loss (exposure), banks can make sufficient provisions, while unexpected losses are charged against equity.
- Operational Risk: Two aspects.
  - There may be difference in the acceptability, compatibility, and tolerance of the *Murabaha* across different jurisdictions.
  - Purchasing the asset before selling it to the customer may raise legal complications and requirements that cloud the clarity of the transactions and their understanding among parties.
- Market risk: Under a non-binding *Murabaha*, the client may cancel the agreement and bank has to sell the goods in the open market, possibly incurring losses as well as selling expenses.

Musawama

- In a *Murabaha*, both parties to the transaction must know the cost and the profit or mark-up.
- When the seller does not disclose the cost and profit thereon, the transaction is called *Musawama*, which is also a valid transaction.
- *Musawama* contracts are local *Murabaha* contracts.

Tawarruq or *Reverse Murabaha*

- A mechanism for borrowing cash by undertaking two separate legal transactions.
  - A person buys a commodity on credit, deferring payment.
  - Once purchased, it is immediately sold to a third party at a spot price lower than the purchase price.
- However, scholars condemn this practice because it opens the door to borrowing money on the basis of *riba* and without creating economic activity, as the same commodity might be sold to different borrowers.
- *Tawarruq* is more disliked by scholars when the borrower sells the commodity back to the original seller.

Murabaha Example: Interbank Financing

- Suppose that an Islamic bank (IB) *X* needs $3mn for 1 month and it approaches IB *Y* for interbank financing.
- Assuming that IB *Y*'s opportunity cost is 3% per year, it will then require a mark-up of $3,000,000 x 3% x (1/12) or $7,500.
- IB *Y* buys platinum ounces on LME for $800 each, resulting in a total of $3,000,000 / $800 = 3,750 oz.
- It then immediately sells those 3,750 oz. to IB *X*, which will pay for them in one month at the price of $3,007,500/3,750 = $802 per oz. as a sale with deferred payment (دفع آجل).

Murabaha Interbank Financing *Cont'd.*

- On IB *X*'s balance sheet, A=3,750 oz. and L=3,750 oz. to be paid in one month.
- IB *X* signs a power of attorney to IB *Y*, granting it the right to sell the platinum oz.
- IB *Y* sells the 3,750 platinum oz. to another broker on the LME a the spot rate, gets the $3mn and gives them to IB *X*.
- Interbank financing is thus a combination of *Murabaha* sale contract and *Wakalas*.

Ijara Financing

- Technically, an *Ijara* contract is a contract of sale, not of a tangible assets, but rather the sale of the *usufruct* (the right to use the asset) for a period of time.

- *Ijara* conveys the sense of both lease and hire:
  - The lessor (*mujir*) transfers the usufruct of a property/ asset to the lessee (*musta'jir*). Rent payable is *ujrah.*
  - An employer (*mistajir*) hires the services of a human being (*ajir*).

- *Ijara* assets vary from vehicles and building machinery to equipment and even aircraft. Particularly suited for SMEs.

- *Ijara* is used in North America to provide mortgage housing.

- *Ijara* has been used in the successful launch of *Sukuk.*

Ijara Financing

- Quite similar to a conventional lease, but:
  - Lessor must own the leased asset for the entire lease period.
  - In the event of default or delay in paying installments, lessor can to revoke the contract and claim the contract price for the remaining period as well as compensation for any damage to the leased asset resulting from negligence.
  - Also, in the event of default or delay in paying installments, no compound interest may be charged.
- *Ijara* is justified on the grounds that the lessor, by retaining asset ownership that is subject to obsolescence, is also responsible for asset maintenance.
  - The element of risk is key in making *Ijara* permissible.

Ijara Financing

- *Ijara* or leasing results in financing against an asset, with the ownership of the asset serving as collateral or security against future losses.
  - Since ownership title remains with the lessor, he/ she can repossess the asset in case of non-payment.
  - Financing is not dependent on the capital base of the lessee but on their credit worthiness to service the cash flows.

Features of *Ijara*

- The lessor must maintain the asset so that it keeps generating income to the lessee.
  - Lessor is also responsible for any insurance premium costs.
- All terms of *Ijara* must be clearly stipulated in contract:
  - Asset being leased, its purpose, rental amount, payment schedule.
- Leased assets is a trust in the hands of the lessee.
  - Object leased must not be perishable or consumable.
- *Ijara* rents are usually floating, following a benchmark such as the LIBOR.
  - Absence of an internationally acceptable Islamic profit benchmark.
  - Floating rate ensures competitiveness with conventional leases, especially if the *Ijara* period is very long.

Ijara Applications

- In 1990, Emirates Airlines asked Al Rajhi Banking and Investment Corporation to raise $60 mn lease financing for an Airbus.
- In the same year, Gulf Air asked Faisal Islamic Bank of Bahrain (FIBB) to raise $365 mn for the purchase of 6 Boeings. FIBB offered a 12-year lease, but the deal fell through with the Gulf crisis.
- Albaraka International Bank in London financed the purchase of a new minicab fleet for Pakistani taxi drivers.

Ijara Wa Iqtina'

- Known as *Ijara Muntahiya Bittamleek* or hire –purchase.
  - In addition to the regular *Ijara* contract, there is a promise by the lessor to sell the leased asset to the lessee at the end of the lease agreement, with the price of the residual asset being predetermined.
  - The second independent contract gives the lessee the option to buy the leased asset at the conclusion of the contract or simply return it.
- Given the client's promise to lease the asset, the bank will purchase it and lease it to the client.
  - The bank recovers the purchasing cost and profit through all lease rental payments.
  - At the end of the lease agreement, the asset ownership transfers to the client at a nominal sale price, or as a gift by a separate contract.

Ijara and PLS Financing

- Combining *Ijara* with partnership (*Mudaraba* or *Musharaka*): Another method of *Ijara* ending with transfer of ownership to the client.
- This structure is quite common in house financing.
  - The bank and the client contribute to the equity or acquisition of the property in a certain ratio. The partnership then purchases the property and leases it to the client. With the lease payments, the client redeems the bank's stake over time.
  - This combination of *Ijara* with *Diminishing Musharaka* is a recent innovation of Islamic finance.

Example 1: *Ijara* Operating Lease

A customer requests financing for 5 air conditioning units (A/Cs) on a three-year lease from the bank. The bank buys the assets for a total value of $10,000 and leases them for three years, after which the A/Cs will have a book value of 4,000. What is the yearly *Ijara* rental the bank will charge in order to cover the costs and to make the required profit?

Financial details		US$
Cost of A/Cs		10,000
Five-year life – annual depreciation		2000 p.a.
Insurance (*Takaful)*		600 p.a.
Profit required by the bank:	Year 1	900
	Year 2	700
	Year 3	500

Example 1: *Ijara*

- Book value after three years is $4,000.
- The lessee pays the insurance *(Takaful)*
- Risk of loss is borne by the lessor.

	Year 1 ($)	Year 2 ($)	Year 3 ($)
Bank finance	2,000	2,000	2,000
Takaful Insurance	600	600	600
Profit required by bank	900	700	500
Yearly rental charge	3,500	3,300	3,100
Quarterly rental charge	875	825	775

Example 2: *Ijara* Financing Lease

A bank customer requests financing for 5 air conditioning units (A/Cs) on a three-year lease from the bank. The bank buys the assets and leases them for three years, after which the A/Cs will have no value on the balance sheet (i.e., the cost of the A/Cs are equally amortized over a three-year period). The lessee pays the insurance *(Takaful)*. What is the yearly rental the bank will charge in order to cover the costs and to make the required profit?

Financial details		US$
Cost of A/Cs		10,000
Profit required by the bank	Year 1	900
	Year 2	700
	Year 3	500

Example 2: *Ijara*

The risk of loss is now with the lessee.

	Year 1 ($)	Year 2 ($)	Year 3 ($)
Bank finance	3,330	3,330	3,330
Profit required by bank	900	700	500
Yearly rental charge	4,230	4,030	3,830
Quarterly rental charge	1,057	1,007	957

Ijara vs. *Murabaha* Similarities

- In *Ijara*, like *Murabaha*, the bank is not a natural owner of the asset. It acquires ownership upon receiving a request from its client
- Similar to *Murabaha*, *Ijara* rentals are also paid in installments over time, and are supposed to cover the cost of the asset or value of investment for the bank and to provide a fair rate of return on investment. Thus, both contracts create debt.

Ijara vs. *Murabaha* Differences

- In *Ijara*, the bank continues to be the owner throughout the contract period, while the client receives the benefits of using the asset. As such, risks associated with ownership remain with the bank, and the asset is supposed to revert back to the bank at the end of the *Ijara* period.
  - In *Murabaha*, benefits and risks of ownership of the asset are transferred to the client along with ownership.
- Another difference relates to cash flows. Under *Murabaha*, CFs are predetermined and no subsequent increase or decrease is allowed.
  - In case of *Ijara*, however, the rentals could be flexible and be made to reflect the changing economic and business conditions.

Key Risks in *Ijara*

- Credit risk: Risk that the lessee is unable to serve the lease rental when it is due.
  - Credit risk is mitigated by possessing the asset, although it might be difficult to repossess a movable asset or a home.
- Market risk: Risk that if default occurs, the bank has to re-rent or dispose the property on the open market at a lower price than agreed. Or if client decides not to take ownership of the asset at the end of the period, risk is that market price is lower than book value.
  - Market risk is partially mitigated by the value of the asset and *hamish giddiya* (advance payment) paid by customer.

Key Risks in *Ijara*

- Operational risk:
  - Exposure to risk of loss of the leased income and legal risk if the asset is used in activities that are not in compliance with *Sharia'* principles.
  - Risk of finding a new lessee.
  - Legal risk to enforce the right to repossess the asset, especially if the leased asset is a house and lessee enjoys protection as a tenant.
  - There is also the risk that the asset is damaged and the lessee refuses to fix it.
  - Also, if the asset is damaged as a result of causes not related to the lessee, the lessor has to provide an alternative asset.
  - Insurance mitigates such risk.

Other Debt-Based Financing

- *Murabaha* and *Ijara* account for a major portion of total financing activities of Islamic banks.
  - They are easily understood because of their proximity to conventional financing techniques, such as installment sales and leasing.
- There are, however, other debt-based "less popular" financing techniques that are emerging in Islamic finance: *Salam* and *Istisna'*.

General *Sharia'* Rules for the Validity of any Sale

A basic condition for the validity of any sale in Sharia' must be the physical or constructive possession of the asset.

1. The commodity must exist at the time of sale.
2. The seller must acquire ownership of the commodity before selling it.
3. Mere ownership is not enough. The commodity should have come into the possession of the seller, physically or constructively.
   – If the seller owns a commodity but has not taken delivery either himself or through and agent, he cannot sell it.

Salam Financing

- There are only two exceptions to the general *Sharia'* principle that one cannot sell a commodity before it comes into existence.
  - One of them is *Salam* and the other is *Istisna'*.
- *Salam* is a deferred delivery contract: A sale contract wherein the price is paid on the spot, but the delivery of the goods is deferred.
  - It is essentially a forward agreement where delivery occurs at a future date in exchange for spot payment of price.

Salam Financing

- The Prophet allowed for such transactions to take place to meet the needs of small farmers since they are not able to yield returns until several periods after the initial investment.
  - Under a *Salam* or *Salaf* agreement, a trader in need of short-term funds sells merchandise to the bank on a deferred delivery basis.
- Payment of the price in full at the time of effecting the contract is a vital condition for the validity of a *Salam*.
  - If both payment and delivery are deferred, the result is a debt-against-debt sale, which is strictly prohibited under *Sharia'*.

Salam Financing

- It is required that the subject matter, price, quantity, and date and place of delivery are specified in the contract precisely enough to dismiss any possible conflict.
  – Goods whose quantity or quality cannot be specified by exact specification cannot be sold through a *Salam* contract. One example if precious stones.

- For a *Salam* to be free of *Gharar*, the commodity should be freely available and can be tradable on the market.
  – The commodity should be a "well-described" and standard one.

Salam Financing

- The scope of *Salam* includes industrial and agricultural products as well as services.
  - *Salam* cannot be effected for buildings, pieces of land, specialized equipments and the like.

- In the event that the seller can neither produce the goods nor obtain them elsewhere, the buyer can either:
  - Take back his prices with no increase, or
  - Await for when the goods become available.

Salam Financing

- After the contract has been effected, the financier (the bank) is left with a contract ensuring the delivery of the purchased goods. In order for the bank to earn profit on the transaction, the purchased goods must be liquidated.

- Since "selling what one does not have" is generally frowned upon on grounds of *Gharar*, the bank cannot sell the merchandize before taking delivery of the same. Thus the bank would have to wait before it can get back its investments and profits.

Salam Financing

- A problem with the simplified structure is the price risk that the bank is exposed to.
  - It is quite possible that price of the commodity declines during time period t below the agreed upon price P resulting in losses to the bank.
- This risk is mitigated in a parallel or back-to-back *Salam*, as the bank needs not participate in the market at all. Or a third party makes a unilateral promise to buy the commodity at a predetermined price at time period t.
  - The unilateral promise is binding on this customer.

Salam Financing

- By entering into a parallel or back-to-back *Salam* with a third party, the bank does not commit its funds for the given time period.
- This structure has an additional requirement that the two *Salam* contracts must be independent and capable of existing individually.
  - Neither *Salam* sale should not be conditional on the other one. Should one of the parties fail to fulfill their contract, the bank will get back its initial investment but will have to accept the lost profit.

Applications of *Salam*

- A *Salam* sale is suitable for the finance of agricultural operations, where the bank can transact with farmers who are expected to have the commodity in plenty during harvest, either from their own crops or from the crops of others, which they can buy in case their own crops fail.
  - Thus the bank renders a valuable service to farmers enabling them to reach a production target.
- *Salam* is also used to finance commercial and industrial activities, meeting the various working capital needs of traders by supplying them with *Salam* financing in exchange for some of their commodity to re-market.

Bahrain's *Sukuk* Al-*Salam*

- Aluminum is designated as the underlying asset of the Bahrain government's *Sukuk Salam* contracts that it sells to different banks.
- The Government of Bahrain undertakes to supply a specified amount of Aluminum at a future date. At the same time, the buying bank appoints the Government of Bahrain as an agent to market the appropriate quantity at the time of delivery through its channels of distribution.
- The Government of Bahrain markets the Aluminum at a price that provides a return to the *Sukuk Salam* holders equivalent to those available though other short-term money market/ Treasury instruments.
- *Sukuk* investors bear counterparty (Gvt of Bahrain not delivering the goods) as well as market risks (Gvt having to sell the aluminum at price lower than cost). Thus, risks are similar to a sovereign risk.

Key Risks in *Salam* Financing

- Credit risk: Similar to all other sales-based contracts, *Salam* and parallel *Salam* are exposed to credit risk.
  - Settlement/ delivery risk where the goods are not delivered or not delivered on time.
  - The bank may be able to recover all or part of the capital invested through claims against advance payment (*urboun*) or financial guarantee. Taking a mortgage or guarantor is permissible.
- Market risk: The risk that, when the supplier of the *Salam* contract does not deliver the commodity under agreement, the bank has to purchase it on the open market at a higher price than the agreed price in order to meet its delivery obligations under the parallel *Salam* contract.

Key Risks in *Salam* Financing

- Operational risk.
  - In case of early delivery of the commodity, the bank will have to accept it as long as its specifications are met. It will then bear additional costs such as warehousing, insurance, or even damage if they are unable to sell the goods immediately after delivery.
  - If specifications are not as originally required, the bank will have to either accept it as per original price or decline the delivery. Under the parallel *Salam*, the bank will request that the customer accepts the goods or it will have to sell them at a lower price.
  - In case of non-delivery the bank may be exposed to legal risk if the customer does not agree to reschedule the delivery date.

Istisna' Financing

- In addition to *Salam,* there is another type of sale where a commodity is transacted before it comes into existence.
  - It is known as *Istisna'* and it enjoys more favorable payment rules than *Salam*.
- An *Istisna'* is a contract to manufacture a specific commodity.
- *Istisna*' is the frequently applied model for construction finance.
  - It is suitable to finance commercial or residential buildings, industries (clothes, furniture…), renovation works, roads, aircrafts, vessels, etc.

Istisna' Financing

- The ordered item should be permissible in Islam and its *halalness* must be assured (e.g., developing a casino aimed at facilitating the activities of gambling).
- The unique feature of *Istisna*' is that nothing is exchanged on spot or at the time of contracting.
- It is a pure and perhaps the only forward contract where the obligations of both parties relate to the future.

Istisna' Financing

- In theory, the contract could be made directly between the end user and the manufacturer, but typically it is a three-party contract, with the bank acting as intermediary.
- In this case, a structure called a parallel *Istisna'* is used, which involves two independent *Istisna'* contracts.
- Under the first agreement, the bank agrees to let the client pay back on a longer-term schedule, whereas under the second contract, the bank (as a buyer) makes progress installment payments to the producer over a shorter period of time.

Istisna' and Parallel *Istisna'*

- 1st agreement between the bank and customer:
  - Customer provides detailed specifications about the asset to be acquired, including its layout, materials to be used, desired quality, and time of completion. Customer may also identify contractors.
  - The bank adds a profit margin and quotes a price to the customer.
  - Upon approval and acceptance, the agreement will specify the mode of payment to the bank, lump sum or installments.

- 2nd agreement between the bank and contractors/ suppliers for the manufacture by a given date as per specifications.
  - Bank pays all costs directly to contractors.
  - Upon completion, the bank hands it over to the customer who pays according to the first agreement.

Istisna' Financing

- Just like any other buy and sell contract, the essentials elements to be specified to ensure the validity of *Istisna'* are:
  - Person who place the order (Purchaser)
  - Person who receive the order (Seller)
  - Ordered item: type, measurement, components, and quality
  - Price
  - Offer and acceptance

Istisna' Debt Financing

The price for the ordered product can be settled by any of the following methods:

- Pay the total price at the time of execution of the contract.
- Pay the total price at the time of the delivery of the product.
- Part payment is made at the time of execution of the contract and the remaining balance at the point of the delivery of the product.
- Price is settled on instalments basis as agreed between the seller and the buyer according to the actual progress in construction or manufacturing.

Istisna' Applications

- The UK-based ABC Bank has pioneered a Parallel Phased *Istisna'* that mitigates construction risk by breaking down the construction project into several *Istisna'*, which allows for staggered financing and lowering the cost of capital.
  - It financed the construction of an inner-city residential development in Leeds (UK), consisting of 183 residential flats and 72 parking spaces.
- Modern Buy, Operate, and Transfer (BOT) agreements can also be formalized using *Istisna'*.
  - A government wanting to construct a motorway may enter into an *Istisna'* with a builder, who may operate the motorway and collect tolls for a period of time.

Key Risks in *Istisna'*

- Credit risk: Three possible concerns,
  - Full recourse *Istisna'*: Risk that the customer is unable to honor the payment obligations for deferred installments when the work is already in progress. This occurs when repayment capability depends in full on customer strength and cash flow for sources other than the asset.
  - Limited and non-recourse *Istisna'*: Repayment capability depends in part or in full on the revenue generated by the asset. Risk arises from the asset's ability to generate revenues and not the client's credit worthiness.
  - Full or limited and nonrecourse parallel *Istisna'*: In both cases, bank may be exposed to completion risk when an advance payment has to be made and the subcontractor does not complete the work.

Key Risks in *Istisna'*

- Operational risk: Risk that the partner lacks technical expertise and the project fails. Four cases:
  - In case of delay from the subcontractor in the parallel *Istisna'*, the bank may not be able to deliver on time and have to pay penalties.
  - In case of excess of costs over agreed budget, the bank may have to absorb additional costs.
  - In case subcontractor fails in meeting specifications and standards, the bank may face legal risks unless parties reach a settlement.
  - In case the subcontractor does not complete the work, the bank will have to start the process of seeking a new contractor to complete the work.

The bank should thus exercise due diligence in appointing a consultant to assess the subcontractor before signing the contract.

Key Risks in *Istisna'*

- Market risk: The bank is exposed to price risk if the customer defaults on the contract and it has to find another buyer. In most cases, the bank sells the contract to another customer at a lower price.
  - The bank should ensure the recovery of losses incurred.
- Different risks mitigation:
  - Agreement may contain a penalty clause.
  - Another alternative is for the bank to nominate the client as an agent to oversee satisfactory completion of the job.
  - A bank can take various measures such as mortgage on land on which the asset is being built, or any other property or personal or third party guarantee to mitigate risks with *Istisna'*.

Istisna' vs. Salam

There are four main differences between *istisna'* and *salam* contracts, both of which deal with the deferred delivery of goods:

1. *Istisna'* is a contract specifically designed for the sale of unique manufactured goods as opposed to *salam* which can be effected on anything.

Istisna' vs. *Salam*

2. *Istisna'* does not require the full price to be paid in advance as is necessary in a *Salam* contract. An *Istisna'* contract allows for payment full on the spot, deferred payment or even payment in installments.

3. An *Istisna'* contract can be cancelled unilaterally until the date before the manufacturer starts working on the goods, while the *Salam* contract can be cancelled only before the contract has been effected.

Istisna' vs Salam

4. Whereas the time of delivery is fixed in *Salam*, an *Istisna'* contract does not require it to be fixed. However, the purchaser in an *Istisna'* can specify a maximum time for delivery after which he is no longer bound to accept the goods or pay the price as specified in the contract.

Part Three:

Islamic Insurance: *Takaful*

Islamic Insurance: *Takaful*

Stylized Facts

- Market growing in prominence, but still a small subset of the insurance industry.
- Currently the fastest growing sectors of insurance, growing at around 10% per annum in the ME and 30% per annum in the Far East.
- The terms General Takaful and Family Takaful express general insurance and life insurance respectively.

Islamic Insurance: *Takaful*

- In our times, insurance has become a necessity to trade and industry and in financial activities.
  - In western countries, the insurance sector is the largest single contributor to the capital market.
  - Bank and insurance companies even form international alliances for mutual benefit through synergy, called bancassurance.
- In Maylasia, the National Fatwa Committee declared in 1972 that conventional life insurance is unacceptable as it contains elements of *Gharar* (uncertainty), *Maisr* (gambling) and *Riba.*

Islamic Insurance: *Takaful*

Elements of *Gharar* in conventional insurance:

- Conventional contracts are one-sided in nature as they remain in favor of the insurer.
- The policyholder loses the rights over premium for a promise of benefits payable under certain circumstances in future.
- The company owns the premiums and any profit from such transactions accrues to it. It is up to the director to distribute part of these profits to policyholders.

Islamic Insurance: *Takaful*

- Takaful contracts minimize *Gharar* because they are based on mutual responsibility, mutual cooperation, and mutual protection.
- Returns from the pool are benefits payable as a share of profits in proportion to individual contributions.
- The loss-sharing aspect, however, is a last resort after other methods have been exhausted such as recourse to reserves and access to interest-free loan from shareholders (*Qard Hasan*) to correct the deficit.
- The last resort would be an increase in the price of future coverage rather than retrospective recovery for past losses.

Islamic Insurance: *Takaful*

- Islamic insurance is essentially an ethical form of insurance based on principles that are good for society. It conforms with the Islamic law (*Sharia'*), which in turn, is based on the teachings of the Quran.
- Islamic insurance is solidarity between the participants, which is an extension of social solidarity and is based on the principles of mutual help and cooperation.
- What are the differences between conventional insurance and Islamic insurance?

Conventional Insurance vs. *Takaful*

1. In conventional insurance, the insured substitutes certainty for uncertainty, in return for a predetermined payment, the premium. That is, the insured transfers to the insurer the possible economic losses from stipulated risks.
   – In Islamic insurance, members share all risks mutually and no transfer of risk is involved.

2. Participants to the pool essentially own the *Takaful* pool and the company is the trustee of that pool to manage it professionally.
   – The participants are the insured and the insurers. The risk is therefore borne by the participants collectively and they share in any surplus or loss from the pool.

Conventional Insurance vs. *Takaful*

3. Conventional insurance is motivated by the desire for profit. *Takaful* is committed to a system that is fair to all parties, i.e. participants and shareholders.
   – The profit incentives are achieved by ethical ways for the overall benefit of society without undue excesses and exploitations.

4. Conventional insurance is subject to exploitation. It is possible to charge a high premium (especially in monopolistic situations) and full benefit of such over-pricing goes to the company.
   – *Takaful* system has a built-in mechanism to counter such over-pricing through its feature of profit-sharing. No matter what premium is charged, if the overall results are positive, any surplus goes back to the participants in proportion to their contributions.