ADCB Master Key to Islamic Banking and Finance
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Why Islamic banking and finance?

ADCB’s planned series of Islamic finance booklets is designed to address the needs of various audiences, including bankers, government officials, and academic students. The series aims to present Islamic banking and finance in a way that is practical and relevant to the modern world. Retail banking clients, corporate executive managers, institutional investors, professional practitioners, and newcomers to Islamic finance will find the booklets useful.

The forthcoming booklets will cover more technical issues and provide practical guidance on how banking needs can be met using Islamic modes of financing. The objective is to educate readers about the potential capacity of Islamic finance in accommodating modern banking and financial needs.

Key to Islamic Banking and Finance – 2 is a companion to the first booklet and aims to lay down the basic foundation of Islamic finance. It is intended to address the most common queries that arise about Islamic banking and investment services. The booklet seeks to enlighten the public on the ethical and practical appeal of Islamic banking and investment services.

organized by Abu Dhabi Commercial Bank (ADCB) for the benefit of its highly valued clients. ADCB is committed to the gradual introduction of authentic Islamic banking products. We believe such an approach can take place effectively and sustainably only when coupled with a sound education and general awareness programme on the principles of Islamic finance. Harnessing the true potential of Islamic finance and reaping the full range of fruits and benefits that it has to offer would only be achieved through a sound understanding of the essential ideals that are embodied in this discipline.

This booklet represents the second cultural product relating to ADCB’s public awareness initiative, which aims to portray the ethical and practical dimensions of Islamic finance. It follows ADCB’s first booklet, ‘Master Key to Islamic Banking and Finance – 1’, which sought to provide some key fundamental answers to the broad question of why Islamic finance is needed, and how it fundamentally differs from conventional banking. The previous booklet presented a brief introductory expose of Islamic banking outlining the most basic functions that Islamic financial institutions may perform and emphasizing the condition that all Islamic banking activities must always be in accordance with Shariah (i.e. Islamic Law) which strictly prohibits usury (Riba).

In reality, the field of activity for Islamic banks is much wider than simple bank intermediation. Taking the subject forward, the present booklet seeks to, (inter alia), explain the actual role that Islamic banks perform in practice, based on the concept that the Islamic bank can play the roles of both investment manager (as a Mudarib or Musharik, etc) as well as of the investor (owner of funds – i.e. Rabb al Maal).

Also among the objectives of the current booklet ‘Master Key to Islamic Finance – 2’ is to outline the various alternative financing modes which are most often used in Islamic finance. This will pave the way for a more technical treatment of retail, corporate and investment banking which will be the subject matter of forthcoming editions in ADCB’s present series of Islamic finance booklets.

ADCB’s drive to promote awareness and provide information about Islamic business, finance and banking is meant to be inclusive, and is aimed at reaching a wide target audience with varying degrees of familiarity with Islamic banking and finance. It seeks to assist all those who want to understand the relevance of Islamic finance to the ever increasing challenges of the modern financial world. As such, it is hoped that bankers, corporate managers, institutional investors, government officials, students of economics and finance and many others would all be able to benefit from this series of Islamic finance booklets.

Introduction

Common properties of Islamic financing modes

Prior to reviewing the individual properties of each of the different Islamic modes of financing, as a prelude it is well worth looking at some generic properties shared by all of them. The gist of the first booklet, ‘Master Key to Islamic Banking and Finance – 1’, was to highlight that the essential factor distinguishing an Islamic banking system from a conventional banking framework relates to the concept of money itself. Islamic modes of financing view money simply as a medium of exchange rather than as an object of trade, and thus money is not allowed to ‘beget’ more money. However, in the case of conventional finance, money itself is the basis of numerous financial transactions such as loans of various kinds, such that the initial sum of money loaned serves as the basis on which the conventional bank makes further monetary profit (typically in the form of interest). This key distinction gives rise to certain features which apply to all modes of Islamic financing, and are listed as follows:

Common question: The fact that money in Islam is viewed exclusively as a medium of exchange results in all potential Islamic banking customers who seek financing, being asked the question: ‘what do you need the money for?’.

Thus, it is a condition that the Islamic bank should understand and participate
in the underlying business activity which the finance is to be used for. Although conventional banks may ask a similar question, this is usually only for purposes of classification or analysis.

In the Islamic paradigm, the response to this question will directly determine the financing mode used, giving rise to the view that Islamic finance is better suited to satisfy the real economic needs of customers for money, as opposed to simply selling money for more money as is the conventional way.

Common source of jurisprudence: Islamic modes of financing are all rooted in the jurisprudential sources of Islam, the primary ones being the Quran and the Sunnah (prophetic example). It is these sources which outline what is permissible to invest in and what is not, and which requires transactions involving interest, gambling and excessive uncertainty to be shunned. For example, the Quranic verse “God has permitted trade and forbidden usury” sets the rationale for the jurisprudence of economic exchange (fiqh al-beyou’) in Islam. Throughout this booklet, we will see that it is the adaptation of Islamic Jurisprudence which determines the validity of financial products and modes of business.

Common measure of financial return: Islamic modes of financing share the common property of generating legitimate ‘trade profit’ in conformity with the common Shari’ah maxim, ‘al-kharaj-bi-al-daman’ which means ‘profit (is justified) with risk’. The difference between the profit rate associated with trade and the forbidden usury was already noted in Master Key to Islamic Banking and Finance – 1

As mentioned earlier, Islamic banks may act as investor (by providing investible funds) as well as investment manager. Thus, Islamic ‘financing modes’ operated by Islamic banks may be regarded as ‘investment modes’, where the Islamic bank’s aim is to finance economic or investment activities of its clients. As an alternative activity, Islamic banks may act as an investment manager when it receives deposits from its customers/investors, by investing the funds received in various Shari’ah compliant activities itself.

At this stage it is more illuminating to focus on the ‘investor’ role of the Islamic bank, via which various financing modes are offered to customers. Treatment of investments is deliberately left to a special booklet which will be released in the near future. The above common properties provide a useful framework for introducing the different modes of Islamic financing. Therefore:

i) Regarding the question ‘what do you need the money for?’, each mode of financing will be shown to satisfy a real economic need;

ii) Regarding the underlying jurisprudence, each of the modes of financing will also be seen to invoke particular rules pertaining to their deduction and applicability;

iii) Regarding the distribution of financial return, each of these modes will be allied with a corresponding assumption of risk, justifying the returns.

Depending on the economic activities being envisaged, customers may respond to the common question ‘what do you need the money for’ in five different ways:

1. To acquire needed capital for a particular business activity.
2. To purchase particular goods already available in the market.
3. To benefit from the service/use of existing durable assets (e.g. equipments, buildings etc) for fixed periods of time.
4. To finance the production of natural products (agricultural, mining etc).
5. To finance the manufacturing of industrial products (equipments, buildings etc).

To satisfy the first response Islamic banks may offer customers one of two possible modes of financing: Mudaraba or Musharaka. The former is represented by a two-party contract involving the bank as the provider of capital...
(Rabb al-Mal) and the customer as manager (Mudarib) in the agreed trade activity. In the latter, the customer and the bank both contribute part of the capital, and so the two parties enter a partnership (‘shirka’). As a result of this partnership, they share the profits (and losses) generated by the business, as well as the management responsibilities.

The main contractual properties of Mudaraba or Musharaka will be presented later on in this booklet in the section ‘Salient Features of Variable Return Modes’ since the profit rate in these two modes can take any value depending on uncertain market conditions. In contrast, the second, third, fourth and fifth responses are best satisfied through the offering of fixed return financing modes, which are covered in the section ‘Salient Features of Fixed Return Modes’.

In particular, the second response calls on banks to acquire the requisite goods and sell the same to the customers through Murabaha.

The third response necessitates delivery of the required goods to customers, not via sale of goods itself (raqiya), but against sale of usufruct (marifia) for fixed periods of time through Ijara (rental/lease).

The fourth and fifth responses are examples of forward sales to meet specific needs and are based on financing modes known as Salam, and Istisnaa. Usually, an amount is paid upfront (this may sometimes be deferred, in case of Istisnaa) and delivery is agreed upon on a set date.

The above five are the generic Islamic financing modes which characterise the bulk of Islamic banking and finance operations commonly in practice. These modes serve as the basis upon which new, inventive, and often complex financing and investment structures are being researched and developed continually, as part of the recent and continuing surge in innovation in the Islamic financial industry.

Other than the aforementioned five generic modes, there are also other Islamic modes of finance in practice which are used somewhat less frequently; these include Investment Agency (wakala fi Istithmar), as well as three modes which relate specifically to agricultural business deals, namely Muzar’a, Mugharasa, Musaqa.

We will now elaborate on the special features for each of the generic modes listed above.

## Salient features of variable return modes

Mudaraba, as briefly introduced above, involves the bank as the capital provider (Rabb al-Mal) and the customer as manager (Mudarib) for the agreed trade activity.

At the core of any Mudaraba contract, there are four basic conditions:

- **Profit, when realised, has to be shared between the two parties in accordance with a profit-sharing ratio stipulated at the time of the signing of the contract.** Losses, in case they arise, would have to be borne entirely by the Rabb al-Maal (i.e. the bank) while the Mudarib only loses his management effort.
- **The Rabb al-Maal cannot interfere in the day-to-day management of the Mudaraba.** s/he can however restrict and define the possible fields of economic activity for the Mudarib. This provision, however, has to be made clear at the outset within the initial Mudaraba contract.
- **The Mudarib has a “hand of trust” (yad amana) in the management of Mudaraba capital, which means s/he is expected to work to the best of...**
their ability. It means there cannot be a guarantee of capital or profit to the Rabb Al-Maal.

- Loss of capital can be guaranteed by the Mudarib only when such loss is proven to be the result of mismanagement or delinquency of the Mudarib (mentioned above); or where such losses result from a breach of contract, for example investing in a field that falls outside the prescribed/specifed fields of economic activity.

Thus to elaborate further, the most salient features of Mudaraba are that, firstly, the Islamic bank plays the role of the investor and does not participate in the management of the business project, and secondly, while the profit distribution ratio for the Mudarib and the Rab Al Mal is clearly pre-defined, the actual amount of profit remains uncertain.

As can be expected, what attaches substantial uncertainty and risk to the Mudaraba profit rate is the undefined range of potential trade transactions and operations which the Mudarib can freely practice in the management of the Mudaraba capital. Hence, many Islamic banks, precisely in order to control this risk, resort to the restriction of the Mudaraba contract such that it relates to a pre-assigned set of well structured trade dealings in accordance with Shari’ah.

Musharaka carries a similar uncertainty with regards to the actual profit amount, as with a Mudaraba. The key difference is that the partnership is characterised by a sharing in both the capital and management responsibilities; therefore, in a Musharaka the customer is the bank’s ‘partner’ investor, and the bank also acts as joint investment manager, both aspects being unlike in a Mudaraba.

Moreover, the fact that part of the capital is contributed by the customer leads to special provisions in the Musharaka contract which can be summed up in the following:

- Partners in a Musharaka all have the right to engage in the day-to-day management of the Musharaka capital, except where one party deliberately gives up this right to the other partners. Many Islamic banks prefer to waive their rights of Musharaka management in favour of their customers on the grounds that the latter are more qualified to run their own businesses.

- Profit, when realised, is usually shared by the partners in proportion to their capital contributions (i.e. on a pro rata basis). Yet in the context of Islamic banking, it is possible for one party to get a proportionately bigger share of profit if this is to the mutual agreement of both parties. Loss, however, has to be strictly shared on a pro rata basis.

- No party can be held liable to guarantee capital or profit to another party. Only where mismanagement and delinquency are proven or where a breach of the Musharaka contract is committed, can the party so charged be held liable to guarantee capital contributions to other parties.

- Profit (or loss) cannot be prioritised within the Musharaka contract. No party (or group of parties) can be preferred to others in terms of profit distribution or loss allocation, and no pre-fixed return can be promised to any. The fact that all parties have to be fairly treated as per the pre-agreed profit distribution mechanism underscores profit & loss sharing (PLS) as the core concept of Musharaka.

As in Mudaraba, it is the undefined range of potential trade transactions in Musharaka which increases the risk factor associated with the returns. To control the risk of return in Musharaka, many Islamic banks limit the contract to well-structured, pre-specified trade dealings which conform to Shari’ah.

Moving on to the next section, it will be observed that the outright adoption of fixed return modes seems to have emerged as the more direct way for Islamic banks to mitigate risk.
Being deposit-taking institutions, Islamic banks act under social, ethical and religious responsibilities to guard depositors’ money and investors’ funds against risks which can otherwise be effectively controlled in accordance with Shari’ah. This is partly reflected in judicious efforts of Islamic bankers to develop well-structured financing and investment transactions with least possible risks.

Reduction of banking risk can be ethically favourable from an Islamic perspective so long as injustice is not committed to any party in this process. Acting under keen Shari’ah supervision, Islamic bankers developed a range of fixed return modes with calculated risks to depositors and investors. Three main factors tend to characterise fixed return modes:

• That they all focus on single packages of well-structured trade transactions - one at a time - rather than undefined pools of trade transactions which traditionally characterise Mudaraba and Musharaka.

• That fixity of return originates in the fixity of prices, which is an important Shari’ah requirement in all exchange transactions. Utilising this jurist property, financial innovation in Islamic banking has made tremendous progress over the years in the structuring of fixed return modes.

• That deferred prices can be higher than spot prices for goods and services so long as sale contracts conform to Shari’ah conditions. This makes it possible to define future re-payment schedules of bank dues in terms which reflect the time factor.

Contrary to common perception, there is consensus among Islamic scholars that it is permissible to ask for a higher sale price if the length of the deferred time period is also greater, as long as the underlying investments are deemed Shari’ah compliant and the agreed schedule for delivery and payment is set once and subsequently not altered.

**Murabaha to the Order of Purchaser (MOP)**

Murabaha is perhaps the most common tool of Islamic banking. It belongs to the class of ‘trust’ sales (beyou’ al-amana) in Islamic jurisprudence, which necessitate the disclosure of the original cost of goods before selling the same to a (third) party. Thus, in a Murabaha sale Islamic banks inform the customer of the original cost at which a good has been acquired together with the profit or mark-up required by the bank, before selling the same to the customer.

Banking Murabaha is more accurately described as Murabaha to the Order of Purchaser (MOP). It is a process which starts from a banking order placed by the customer, stating the customer’s intention to buy a particular good from the bank in accordance with the principles of Murabaha, provided that the bank acquires the good to meet his order. At this stage, it is crucially important to make sure that the good is not already owned by the customer in one way or other, for otherwise this would be tantamount to a conventional loan – the reason being that since no asset would be changing hands, the mark up would then be interest.

In a nutshell, the jurisprudence of Murabaha calls upon the bank to buy the required goods, thereby, satisfying the preconditions of ‘possession’ and ‘acquisition’ of the goods prior to their sale. Once acquired, the bank would sell the same to the customer on credit with the profit mark-up reflecting the time value of the deferred price. To make the MOP workable, there needs to be a promise by the customer to buy the goods once these have been acquired by the bank specifically to meet his/her order. The MOP raises special concerns about client’s promise to purchase the good once it is being acquired to his order. Without binding promises, immense damages would surely befall Islamic
 bankers, who would then end up having heaps of unwanted scattered goods due to failure of clients to honour their promises. For this reason, Shari’ah scholars have approved binding promises as means to dispel the risks.

Binding promises, however, should not be mistaken for enforcing clients to buy the goods as ordered. Indeed, any enforcement of this sort is sufficient to invalidate sale contracts in Shari’ah perspective. The client, therefore, is free to turn down the good if so he wishes, but the binding promise is a means to compensate the bank against loss of capital incurred as a result.

Fixity of price is a crucial provision which limits the bank’s ability to adjust the price once it has been agreed, even where the client defaults. It was made clear in the Master Key – 1 that any penalty charge due to client’s default is tantamount to riba al-Jahiliyyah (pre-Islamic usury). More generally, there is no scope for ‘floating’ markup in line with floating interest rates. Murabaha has proved particularly powerful in the financing of short to medium term investments.

More elaborate structures based on provisions of agency have been developed over the last ten years, particularly in international commodity trade.

Ijara is the Islamic banks’ most preferred mode in relation to long-term financing and investment. As briefly introduced above, Ijara is a sale of usufruct yielded by a durable asset (equipment, real estate etc) for an agreed period of time. Similar to Murabaha, the process of Ijara starts by the client’s express intention to hire the service of a specific durable asset if it can be acquired by the bank to the client’s order.

Also in line with Murabaha, the bank’s ownership of the asset must be confirmed before being ‘sold’ to a third party, except that the subsequent ‘sale’ in Ijara relates to the asset’s usufruct and not to the asset itself. The Ijara contract defines the customer as a lessee (musta’jir) and the bank as a lessor (mu’jir).

Since the asset’s usufruct can only be generated for a fixed period of time, the price of Ijara (ujra) must be expressed in terms of this finite period of time (number of months, years, etc). The generally accepted practice of Islamic banks is to spread the agreed price of Ijara evenly over the agreed period of time (monthly, quarterly etc).

Since the ujra is the price of usufruct, the bank’s entitlement of Ijara payments depends on the customer’s ability to actually use the asset during the contracted period. This means that such an Islamic lease differs from a conventional lease in the following respects:

1. The Lessee cannot guarantee the asset against ordinary wear and tear as a result of use.
2. Liability remains with the Lessor with regard to technical faults unlike a conventional lease where once the contract is signed, it is assumed the lessee bears responsibility.
3. Depending on the technical nature of the assets, the accepted practice among Islamic banks is to divide maintenance costs (inclusive of cooperative insurance, Takaful costs) between the bank and the customer, such that routine preventive maintenance is borne by the customer while structural maintenance is borne by the bank.

‘Ijara-cum-sale’ is a common technique practiced by Islamic banks, whereby the customer is given the option to buy the asset at a specified price – most often the asset’s scrap value – either during or at the end of the lease period. It is worth noting, the forbidden ‘combining of two sales in one contract’ in Islamic jurisprudence does not apply here since ‘Ijara-cum-sale’ is in effect a type of sale option which the customer may or may not exercise.
The Ijara contract has remained the focus of extensive innovation over the last ten years. A number of more advanced structures of Ijara have subsequently been developed, which are beyond the scope of this current booklet.

**Salam, an Islamic forward mode**

Though less commonly practiced than Murabaha and Ijara, Salam is gaining increasing importance as an Islamic futures’ mode of financing and investment. Conventional futures involve sale contracts where good’s delivery and price payment are both deferred to a future date. This, however, is not allowed in Islamic sales. Conventional future contracts are impermissible in Islamic jurisprudence on the grounds of being ‘debt-for-debt’ transactions.

Debt is known to arise in sale transactions through the deference of either ‘money’ or any fungible goods (items which can easily be replaced for one another: mithliyyat e.g. wheat, rice, minerals, petroleum etc). If money is used to buy a fungible good but the delivery of both items is deferred to a future date, this is effectively a ‘debt-for-debt’ transaction which is not allowed in Shari’ah. Hence, to avoid ‘debt-for-debt’ transactions, it is important that deference of fungible goods be matched by spot payment of money. Salam is such a mode which satisfies this property and it is, thus, presented as the means to finance Islamic futures.

Istisnaa, an industrial arm of Islamic finance

Istisnaa is the industrial counterpart of Salam. In essence, it is a biparty contract involving the maker of an industrial product (called saan’) and the demander of the product (called mustasni’), such that at a future date the former delivers to the latter a specific product (e.g. equipment, furniture, real estate property etc) of a specific quality against payment of a specified and agreed amount.

Salam financing is particularly suitable for the financing of large scale agricultural crops where banks provide liquid capital to clients against future delivery of crops. In the standard practice Islamic banks would normally close their Salam positions by entering into parallel Salam contracts. This makes it possible for banks to sell the original Salam goods at reasonable profit margins.

It is important, however, to conclude parallel Salam contracts independently of original Salam contracts. It means no cross-references must exist between an original Salam contract and the one parallel to it. This important provision ensures that the original obligation of a Salam-maker to deliver specific Salam goods at a future date will always remain valid regardless of any external conditions or circumstances.

Salam is gradually becoming a vital investment mode in international markets which involve agricultural products, petroleum products and minerals. Millions of dollars are being invested annually through Islamic investment vehicles in low risk Salam transactions.
At the face of it, Istisnaa may look exactly like Salam except for the nature of the goods traded in. Yet the nature of goods makes a crucial difference in Islamic jurisprudence. Without going into thorny jurist issues, it suffices to realise that industrial goods, in general, do not fall into the Salam category of fungible goods. Hence, the problem of debt-for-debt transactions should not arise with industrial goods.

The above difference with a Salam transaction gives Istisnaa more flexibility in terms of price payment. It now becomes possible to defer part of the price, which otherwise is strictly prohibited in Salam. Payment of price in an Istisnaa contract may therefore be spread over any period of time that is reasonably agreed by the two parties.

There is no wonder then that Islamic banks have successfully tapped into the immense potential of Istisnaa contracts in financing as well as investment management. This brief background concerning Islamic business and financing modes should prove extremely useful at a later stage when we tackle more practical issues related to retail, corporate and investment fund management.

Conclusion

Although the present booklet is brief and summarised, the aim has also been to keep it concise enough to be able to provide a satisfactory basic insight into the modes of business finance most commonly used within the Islamic finance industry. At a later stage we hope to tackle more industry-specific practical issues related to Islamic banking with a focus on retail, corporate and investment fund management.