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Islamic financial Contracts

INTRODUCTION

Any financial system is mostly concerned with financial mediation and resources allocation. The conventional system is almost 400 years old. However, it has not yet provided the Muslim world with the suitable transactional contracts and services that are free of ethical disorientations and that comply with Islamic laws and principles.

The Islamic financial system came as a response for calls to an alternate system free of prohibited elements such as Riba, Gharar, and Maysar.

Being based on Islamic principles and compliant to Shariah rules, the Islamic financial system has widespread since its first emergence in the early seventies. It is still double-digit growing; a fact which made conventional banks think of creating their own Islamic branches or affiliated windows to have their stake in such a fast growing lucrative industry.

The Islamic financial system, as opposed to the conventional system, is based not only on financial mediation but also on investment intermediation through the various contracts offered by the system including sale contracts, profit / loss sharing contracts and trust contract.

In this paper, we are going to deal with the Islamic financial instruments including the transactional contracts, the financing contracts, and the social welfare contracts.

FINANCIAL INSTRUMENTS

Financial instruments are contracts that determine return and risk of the instrument. Contracts in Islam are deemed valid if they are free of any prohibitions such as Riba or Gharar. Contracts in Islam have their roots in the pre-Islamic era and many of them have been ascertained by Shariah.

Contracts can be classified according to their purpose in the economic system into the following categories:

Transactional contracts:

This type of contracts is based on sale and exchange-based activities. Such contracts create assets and form the core of an extended financial system. They can be categorized into two broad categories:

- Contracts of exchange and sale (sale of ownership): they include a variety of contracts relevant to property transfer, debt transfer and currency exchange.
- Contracts of sale of usufruct (sale of right to use):

Contracts of exchange and sale can be classified into five types in terms of subject of sale

- Bay' (sale of property for a price)
- Sarf (sale of currency on the spot)
- Barter sale (exchange of goods for goods)
- Bay' al-Dayn (sale of debt or liability)
- Bay' al-Salam (immediate payment against future delivery) and Bay' al-Istisnaa' (sale on order of a manufactured commodity). The subject of sale in these two contracts is yet to come.

In terms of mode of payment, contracts of sale can be categorized into:

- Spot cash sale (payment has to be made at the contract conclusion time)
- Installment sale (payment is deferred in installments)
- Future lump sum payment (date of payment to be pre-determined)
- Bay' al-Arbun (earnest sale)

Bay' al-Muajjil (Deferred payment): this includes sale of a commodity for a deferred payment (in installment or lump sum). The price has to be determined at the time of contract conclusion.

Bay' al-Salam (sale with deferred delivery): this type of sale is like forward contracts, but different in terms of payment arrangements. Here, the purchaser pays at spot the full price in exchange for a future specific date delivery of the commodity. This is beneficial for both the seller who gets paid in full in order to invest in the production process, and the buyer who eliminates uncertainty in the future price.

This type of sale was permitted by prophet Mohamed (pbuh) upon prohibition of riba, when farmers could not get cash to get involved into the production process, thus they were allowed to sell in advance their agricultural products. Traders as well were allowed to sell their goods in advance to dispose of cash to finance their trade activities.

Such type of sale is subject to some restrictions:

- Only products that can be fully specified in terms of quality and quantity can be subject sale of Salam. Precious stones such as diamonds cannot qualify for such a sale since every piece is different from the other.

- Full payment has to be made in advance at the time of contract conclusion. Otherwise it is considered as sale of debt against debt which is prohibited in Islam.
- The exact date and place of delivery must be specified in the contract
- It is permissible to take a mortgage or collaterals on such a sale.
- The subject of sale must be in the physical or constructive possession of the seller.

Salam contracts can be used to finance agricultural activities. Islamic banks make a valuable contribution to the production process through providing cash financing and hedging against price volatility. This can be very beneficial to SMEs in the commercial and industrial sector.
Istisna' (manufacturing contract): is a contract whereby a manufacturer undertakes to manufacture an asset or property to the buyer. The price and asset specifications are agreed upon in advance. On delivery time, the property should conform to the pre-determined specifications. However, in contrast to Salam, there's much flexibility in terms of payment process. Both parties can agree that the payment be in advance or in installment.
This is another contract, along with Salam, whereby the subject matter of the contract is sold before its existence. However, the main differences between Salam and Istina' contracts are:

- The underlying asset in Istisna' has to be manufactured or constructed.
- In Istisna' the price does not have to be paid in full at the contract conclusion. In Salam contract it has.
- Istisna' can be cancelled unilaterally before the manufacturer undertakes manufacturing, whereas Salam cannot.
- Istisna' is more flexible in terms of delivery time.
- Istisna' can broadly be used in project financing in different industry sectors such as machinery manufacture and infrastructure projects.
- Contracts of sale of usufruct (sale of right to use)

Ijarah (Lease): It is a sale contract whereby the first party sells the usufruct of a tangible asset for a specified period of time. The term Ijarah denotes leasing assets and hiring people and services for a fee.
Contrary to the conventional financing mode, that is in the form of debt, ijarah results in financing against an asset which combines financing and collateral since the ownership of the asset serves as collateral in the case of Ijarah Muntahia Bittamlik.
Ijarah resembles the conventional lease contracts. However, the leasing cmpany has to own the asset during the lease agreement. The absence of interest and the late payment fees represent also a major difference between both modes of finance, Islamic and conventional.
The main features of Ijarah contracts can be summarized as follows:

- The lessor must own the asset. He is required to maintain it and bear any insurance costs.
- The terms of the contract should be stipulated including the asset being leased, the rental fees, schedule of payment, and the purpose of the contract.
- The leased asset is treated as a trust in the hands of the lessee
- The leased object must not be perishable or consumable
- In case of default of payment, the lessor may revoke the contract and claim the remaining amount.
- The lessor may claim any damage caused to the leased asset as an act of negligence from the lessee.

Another form of contract similar to the conventional hire-purchase contract has been created by jurists. In addition to the original lease contract, another contract is concluded including a promise by the seller to sell the asset after the lease period with the residual value of the asset. The lessee is given an option either to purchase or to return back the leased asset.
Leasing represents a major portion in the financial portfolios of Islamic banks. However, Islamic banks avoid dealing much in ijarah in order not to take on additional administrative responsibilities in maintaining the assets.

Financing contracts:

They are meant at financing transactional contracts or providing capital through equity partnership.

Murabahah (Cost plus sale): is the most popular contract of sale on credit. The financier purchases a product to supply an entrepreneur with a profit margin called "mark-up".

Murabahah, in origin, was practiced by traders who bought products to sell them to end-users with a mark-up on the original price.

Murabahah, as practiced in banks, takes place between three parties: the Islamic bank as financier, the original seller of the product, and the end-user of the product. Such a process goes through the following steps:

- The bank's client requests a quote from the vendor of the product he is seeking for.
- The client contacts the Islamic bank to buy the product and promises to purchase it from the bank at a cost plus fee.
- The bank purchases the product and pays in full the commodity.
- The bank may appoint the client as agent to accept delivery on its behalf
- A Murabahah contract is concluded between the bank and the client determining the original cost and the mark-up.
- The parties agree on the mode of payment: either lump sum or in installments
- The bank may require collaterals against the credit risk.

Murabaha is valid from a Shariah point of view only if the product is really purchased by the financier.

In the event of default payment by the end user, it is not permissible for the bank to receive late payment fees and it is only entitled to acquire the financed item. If two due installments are not paid, the bank is entitled to declare the remaining installments as due.

The mark-up is affected by the type of product financed, the security required, the client creditworthiness and the financing period.

Murabahah is different from conventional loan in many aspects. Murabahah is not money lending, it is a real sale of an asset. Moreover, there is no interest in Murabahah, but a pre-agreed upon mark-up on the real cost.

While engaging in Murabahah, the bank exposes itself, in addition to the credit risk, to price risk which may fluctuate during the commodity ownership period.

Bay' Bithaman Ajil: this kind of sale is used in Malaysia and South East Asian countries. The only difference with Murabahah is that the cost price and the mark-up are not necessarily disclosed.

Tawarruq: (known as reverse Murabahah): such a sale underlies two transactions. A person buys a commodity for deferred payment, and sells it at spot with a lower price. Such a practice has not received wide acceptance by scholars since it does not create any economic value or activity.

Musharakah (partnership): It is a versatile contract combining many variations. It includes investment and management. It is a contract whereby two or more people combine their capital or / and labor to share profits and losses generated. It can be in the form of Mudarabah (partnership of capital and labor) whereby partners share profits on a pre-determined basis, where losses are borne by the capital provider (Rab al-mal) except in cases of misconduct where the Mudarib is liable for loss.

In Musharakah profits per partner are predetermined as proportions and no fixed amount is determined. Losses should be borne proportionate to each partner's share in the capital.

A new form of partnership called consecutive partnership has been created by Islamic banks. Such a partnership considers depositors as partners during the financial year and entitles them to proceeds of that period.

Another form is diminishing Musharakah used to provide housing mortgages whereby ownership of the asset remains in the possession of both partners proportionate to their shares. The client purchases shares through every monthly payment, and the share of the financier diminishes gradually. At the end, the client acquires the financier's shares completely.

Social welfare contracts:

They are contracts between individuals and the society. They are meant to promote the welfare of the society.

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