RISK & PROFIT

in Islamic Financial Instruments

by

MAHOMED SHOAIB OMAR

Bcomm (Dbn Westville) LLB (Univ of Natal)
Certificate in Tax Law & Estate Planning (UNISA)
Certificate in Islamic Law (Darul Uloom Karachi)
Practising Attorney of the High Court of South Africa
Author of Various Islamic Law Texts

P.O. Box 48050, Qualbert 4078
Durban, South Africa

Tel: +27 31 306 3282
Fax: +27 31 305 3539
email: msolaw@mweb.co.za

11 November 2008

CONTENTS

PREFACE

The enclosed notes on risk and profit relating to the contemporary application of Islamic Financial Instruments were written to assist participants at the 4th Southern African Islamic Economics Banking and Finance Seminar (15 -17 November 2008).

Because the bulk of the notes were written over a weekend, constraints of time did not permit further elaboration or detail. It is hoped that these notes will benefit interested persons including practitioners in the field.

In compiling this booklet, I had the benefit of a host of authentic classical arabic authorities, across the recognised Mazaaib. I also referred to certain valuable opinions of contemporary Shariah experts, including the incisive contemporary applications of my revered teacher Mufti Muhammad Taqi Usmani, a leading authority in the field of Islamic Finance. I remain eternally grateful for his ongoing valuable guidance. May Allah Almighty accept this humble endeavour from a student of the lowest class but rendered only for his Divine Pleasure.

M S OMAR
DURBAN
11 NOVEMBER 2008

RELEVANT GENERAL PRINCIPLES GOVERNING RISK

The first general rule of the Shariah is that the sale of a non-existent thing ("madoum") is null and void. Such contract is rendered void because of the absolute prohibition against Garar in commercial contracts : the sale of a chance or hazard, in the sense that the purchaser does not know whether he or she will receive the commodity or not. (see Ibn Qayyim, Zad Ul Maad, vol 6). Such a contract resembles a wager ("Qimar"), in terms of which one party with certainty, gains absolutely, and the other parties' potential hope of gain is dependent on a contingent chance event (which may or may not occur). In this case, the seller receives or appropriates the full price but the purchaser labours under the hazard of receiving the thing purchased.

There are two exceptions to this general rule prohibiting the sale of non-existent commodities. The first is a contract of salam in terms of which, although non-existent at the time of sale, the commodity must be generally existing in the relevant market on the agreed future date of delivery. The second exception is the manufacturing contract of istisna in terms of which the manufacturer agrees to manufacture or produce a clearly described commodity, with agreed specifications, upon mutually agreed terms.

The second general rule is that the seller must not sell a thing (in existence) but belonging to a third party. The corollary of this rule is that the seller must own the thing sold, and must have taken the risk thereof, through actual or constructive possession, at the time of the relevant sale.

For example, a purchaser informs a seller that he or she requires 1000 metres of fabric of a certain category and quality. The seller is prohibited from selling the commodity at an agreed price, unless the seller had first (prior to the sale) acquired ownership and risk in the required commodity. The seller's profit is dependent on the corresponding risk ("damaan") in the commodity.

The third general rule is the prohibition against the conditionality of different contracts: the performance or validity of one contract is conditional or suspended upon another contract. For example, the sale of a commodity by the institution to the client is subject to the due performance of another contract of sale between the institution and a third party. In such a case, the validity of the one contract is suspensively dependent upon the operation of the other. This is known as Taaliq which is prohibited in commercial contracts of profit (such as sale and lease).

The fourth general rule is that the sale of future reciprocal debts, arising from a contract, is prohibited. For example, in the contract of salam, the obligation of the seller is to deliver the described commodity (with agreed specifications) at the agreed future date. This obligation is a debt ("Dain"). Similarly, if the purchaser undertakes to pay the agreed price on a future date, this obligation is also a debt. ("Dain"). In the result, there is an exchange or sale of mutual or reciprocal future debts which by consensus is prohibited. For this reason, the validity of the contract of salam is conditional upon the purchaser paying the price upfront at spot.

Finally, the risk in a contract of sale is transferred from the seller to the purchaser upon actual or constructive possession of the commodity by the purchaser. Once the purchaser takes possession of the commodity, the burden of loss is shifted to the purchaser, with the result that the purchaser is entitled to onsell the commodity for a legitimate profit : Entitlement to profit is therefore the result of assuming a risk in the commodity consequent upon possession, actual or constructive. The nature of possession, and consequent transfer of risk, depends on prevailing usage and the circumstances of each case. For example, if the commodity is placed at the disposal of the purchaser or his agent, so that he can deal with it as he wishes, then there is a valid transfer of possession. ("Takliyah ").In the case of bulky commodities such as wheat, which are stored in a warehouse or silo, there must be a separate identified appropriation or setting aside, supported by an appropriate waybill or covering note evidencing this.

MURABAHA

The murabaha financing arrangement in essence involves two separate contracts of sale, which are unrelated to each other, and which are concluded consecutively in time, each contract is concluded separately at the relevant time.

The first contract of sale ("the first sale") is concluded between the supplier of defined goods, as seller, and the bank, as the buyer, for an agreed price which is normally payable upfront, or as mutually agreed. The price is paid by the bank directly to the supplier under the first sale.

The second contract of sale ("the second sale") is the special contract of murabaha itself in terms of which the bank (as seller), sells the defined goods (subject matter of the first sale) to the client for the disclosed cost price (the price under the first sale plus direct expenses which enhance the value of the goods) plus a disclosed agreed mark-up or profit. The total price (cost price plus profit) is normally paid by the client to the bank in agreed future instalments over a fixed future period. The price is converted to a debt owing to the bank upon conclusion of the murabaha. This debt cannot be traded except at par or face value (without increase or decrease).

The main points which entitle the bank to charge a profit, and which distinguish both the transactions from a conventional interest-bearing loan are as follows:

1. The bank must under the first sale take actual or constructive possession of the goods which form the subject matter thereof. It does this through an agent who in many cases is the client. When the agent takes actual or constructive possession of the goods under the first sale, then the risk (of destruction or deterioration) passes to the bank, with effect as from the date of the agent's possession. It is precisely for this risk that the bank is entitled to charge a profit on the murabaha (the second sale), which is thereafter separately concluded by way of offer and acceptance.

2. The first sale and the second sale are separate, and cannot be concluded simultaneously. There must be an interval of time between both sales to ensure that the bank is assuming a risk for which it is entitled to charge a disclosed profit under the murabaha (the second sale).

3. If the agent of the bank under the first sale utilizes or disposes of the goods upon or after taking possession thereof, then such agent has acted negligently or in material breach of mandate. In such a case, the murabaha is impossible, with the result that the agent must pay the bank (the principal) the market value of the goods at the relevant material time of the misappropriation.

4. Once the agent takes possession of the goods on behalf of the bank and for its benefit, the risk therein passes to the bank. Thereafter, the bank may enter into the murabaha (second sale) with the client by way of separate offer and acceptance. Upon conclusion thereof, and delivery of the goods to the client, ownership and risk in the goods pass to the client.

5.In short, therefore, in the context of murabaha financing, there must be a clear separation of risks ("Damaan"), through the interposition of a period of time, between the first sale and the second sale (the murabaha). The bank will obviously assume the risk in the goods, after taking ownership and possession of the goods under the first sale, and prior to the conclusion of the murabaha (second sale).

ISTISNA

Istisna is a special manufacturing contract of sale in terms of which the manufacturer (as seller) manufactures or produces, with his own material, a clearly described non-existing commodity, with agreed specifications, ("Al Mawsufah fi Dhimmah") for an agreed price, payable upon mutually agreed terms.

In the context of an istisna financing arrangement the bank enters into two separate independent contracts, namely:

(a) an istisna contract between the bank (as purchaser) and the manufacturer (as seller) for the manufacture or production of a clearly described commodity, for a specific price, upon mutually agreed terms. ("the first istisna");

(b) a parallel independent separate istisna contract between the bank (as seller) and the client (as purchaser) for the manufacture of a clearly described commodity (which is the subject matter of the first istisna) for a specific price and upon mutually agreed terms. ("the second istisna")

The bank's profit is represented by the difference in price between the first istisna and the second istisna. The bank's entitlement to such profit is dependent upon compliance with the following:

(i) the operation of the second istisna must not be conditional on the first istisna, each contract being separate and independent of each other, and each contract must be concluded at the relevant time;

(ii) the bank (as purchaser) becomes the owner of the manufactured commodity, under the first istisna, upon completion and delivery of the commodity by the seller to the bank in accordance with the contractual specifications;

(iii) The bank is prohibited from transferring the risk to the client in any manner prior to taking possession and delivery of the manufactured or produced commodity. If it purports to do so, then both transactions would simply constitute a stratagem (hilah) to charge interest.

SALAM

Salam is a special contract of sale of a clearly described commodity, with agreed specifications, which does not exist at the time of sale, but which the seller agrees to deliver on an agreed future date. The commodity must generally exist in the relevant market on the agreed future date of delivery. Unlike istisna, an essential requirement of salam is that the agreed price must be paid upfront at spot, upon conclusion of the contract of salam.

A financing arrangement relating to salam comprises two independent contracts:

(a) a salam contract between the institution in its capacity as purchaser and a third party as seller, in terms of which the third party agrees to deliver the described commodity (say 100 tons of steel of a specified category and quality) at a future date ("the first salam");

(b) a parallel independent separate salam contract between the institution in its capacity as seller, and the client as purchaser, in terms of which the client agrees to purchase the described commodity (the subject matter of the first salam) from the institution at an agreed price to be payable upfront at spot.

The institution's entitlement to profit (the net difference in the price between the first salam and the second salam) is based on the following:

(i) the operation of the second salam must not be suspended upon the timeous and proper fulfilment of the first salam (the one contract must not be suspensively conditional upon the other);

(ii) the risk in the commodity under the first salam will only pass to the institution (as purchaser) upon delivery thereof;

(iii) the institution, as purchaser under the first salam is not permitted to sell the debt (the right to receive delivery of the commodity on the agreed future date) prior to actual or constructive possession of the commodity.

DIMINISHING MUSHARAKAH ARRANGEMENT

Diminishing Musharakah is a financing arrangement comprising three independent and separate contracts:

(a) the relevant contract of partnership, in respect of the underlying property, in terms of which the client and the institution own the property in proportionate undivided shares (pro rata to their respective contributions).

(b) the contract of lease in terms of which the institution leases (as landlord) its proportionate undivided share in the property to the client (as tenant) for a specified agreed rental. ("the lease");

(c) the relevant contract of sale in terms of which the institution sells its undivided share to the client for an agreed price. ("the sale").

The following important requirements must be observed from the standpoint of risk and profit:

(i) Each contract is per se valid, and independent of the other, and must be concluded at the appropriate time. One contract cannot be made conditional upon the operation of the other. For example, the lease cannot be made conditional upon the sale, and vice versa.

(ii) The sale by the institution of its proportionate share to the client is a separate sale which must be concluded by way of offer and acceptance at the relevant time of sale. Each sale of a portion of the institution's proportionate share in the property is a separate consensual contract evidenced by offer and acceptance at the material time of sale. The client cannot be compelled to purchase the institution's pro rata undivided share in the property.

(iii) All liabilities flowing from joint ownership of the property must be paid by both co-owners (institution and client) in proportion to their pro rata shares in the property. Such liabilities include structural maintenance, renovations, and rates and taxes.

(iv) All losses, which are not attributable to the negligence or misconduct of a co-owner, ("Taaddiy ") must be borne by the co-owners, pro rata to ownership.

IJARAH (Leasing)

A financing arrangement involving Ijarah comprises the following transactions:

(a) the institution purchases an asset, and takes actual or constructive possession thereof, and the consequent risk therein;

(b) thereafter, the institution enters into a separate contract of lease in terms of which the institution (as lessor) leases such asset to the client (as lessee) for a specified rental and for a fixed period.

The following must be strictly adhered to, from the standpoint of risk and profit:

(i) the institution's entitlement to rental will only commence after the delivery of the leased asset to the client (as lessee), and not from date of conclusion of the lease (unless this coincides with delivery);

(ii) the lessee's possession of the leased asset is that of Amanah ("holding of trust"). It follows that the lessee is not liable for damage or destruction of the leased asset, unless the same is caused by the lessee's negligence or misconduct. Hence, a clause in the contract imposing strict liability on the lessee is not permitted. The risk remains with the institution for the duration of the lease (for which it is entitled to profit);

(iii) all liabilities arising from the ownership of the asset, such as taxes and takaful insurance contributions, must be borne by the institution (as owner and lessor);

(iv) the institution as lessor is obliged to effect necessary maintenance to the leased asset, so as to keep it in a condition reasonably fit to be used for the purposes for which it was let;

(v) if the lessor (institution) prematurely cancels the lease by reason of the client's default, and elects to take back the leased asset, then, in such event, the institution is not entitled to claim the outstanding rental for the remaining period of the lease. The institution may however claim damages representing the difference between the total outstanding rental (as from date of cancellation) and the lower rental it receives as a result of leasing the asset to a third party for the outstanding period (of the original cancelled lease).

LEASING OF DESCRIBED SERVICES (MAWSUFAH FI DHIMMAH)

1. The leasing of services described in the contract (as non-specific) Al Ijaarah Al Mawsufah fi Dhimmah is permissible according to the preferred views of the Maliki, Shafei and Hanbali schools (of interpretation).

2. In relation to the time of payment of rent, there are two juristic approaches: According to the Hanbali school, and a group of Shafei jurists, the rent may be paid upfront or at future dates, as the contracting parties may agree. On the other hand, the Maliki jurists are of the view that the rent must be paid upfront, upon conclusion of the contract of lease, in order to avoid falling within the prohibition of the sale of future reciprocal debts.

3. In relation to the contemporary application of this category of leasing of described services (Al Ijaarah Al Mawsufah fi Dhimmah), there are two separate contractual relationships, namely: The first contract is between the service provider, and the financial institution (as the recipient of services). The second contract is between the financial institution (as lessor) and the client, as lessee of the described services. Each contract is independent of the other, and must be concluded separately at the appropriate stage. The profit of the financial institution is represented by the net difference in rentals between the first and the second leasing contract.

4. At the outset, it is permissible for the financial institution concerned and the client to enter into an overriding arrangement, in terms of which the client promises to conclude (in the future) the second contract of lease (as stated above). Thereafter, at the appropriate stage, the second contract between the institution (as lessor) and the client (as lessee) would be concluded, without preconditions.

5. It is obligatory to ensure that each contract contains the material terms relevant thereto.

6. It is permissible to finance maintenance services through a financial institution by way of Ijaarah Al Mawsufah fi Dhimmah. Similarly, the financial institution concerned may hire all permissible described services by way of this category of leasing, in order to re-lease such services to those clients who wish to benefit therefrom.

SUKUK

The sukuk is essentially a share certificate which confers upon the holder thereof a proportionate share in the underlying tangible assets of the relevant portfolio. The holder of a sukuk is accordingly entitled to a proportionate share of the actual profits generated by he underlying assets of the relevant portfolio. This distinguishes a sukuk from a conventional debenture (which represents an interest-bearing loan).

A hybrid sukuk confers upon the holder thereof a right to the income but not a pro rata undivided share in the underlying assets, and is accordingly impermissible. It is simply a right to purchase income or an income stream.

The holder of a sukuk cannot be guaranteed the return of his or her capital in any manner, directly or indirectly, at the time of redemption or maturity. The general principle is that the return of capital cannot be guaranteed under any circumstances. It follows that a sukuk can only be redeemed or sold at the market value thereof on the date of sale.

In summary therefore:

(i) Sukuk may be issued in respect of commercial projects, but they must confer on the holders thereof complete proportional undivided ownership in the underlying assets.

(ii) The profits generated by the project, after deducting operating expenses (including the mudarib's share, where applicable) and management incentives based on actual performance, must be distributed proportionally amongst the sukuk holders.

(iii) Sukuk must at maturity be redeemed at market value (based on the value of the underlying assets) or otherwise at a price mutually agreed at the relevant time of purchase (and not on historical face value).

(iv) An undertaking by the manager of the portfolio to advance a loan in the situation where the actual profit falls below the expected profit is not permissible.

(v) If the underlying assets of the relevant portfolio are mainly constituted by cash, debts or receivables, then it is not permissible to trade in the relevant sukuk, except at par or face value (any increase or decrease from one side is prohibited interest). On the other hand, if the majority assets (51% or more) in the portfolio are constituted by tangible assets or property or benefits (rentals) or a combination thereof, then it is permitted to trade in such sukuk at fair market value at time of sale.

MUDARABAH

Mudarabah is a special unique contract of partnership in terms of which only the investor (Rabbul Maal) provides the capital, and the mudarib, as the exclusive working partner, provides his expertise and labour, with the object of making a profit. The contracting parties agree to share profits in a pre-agreed ratio as stated in the contract.

The mudarabah fund or portfolio is a separate entity, in the sense that the assets therein are at all times owned by the investors, pro rata to their capital contributions, but they (the investors) have no right of disposal or dealing with the assets. On the other hand, the mudarib has the sole power to deal with the assets in accordance with his mandate. The contracting parties are thereby in a sense treated as strangers unto each other, the relationship being one of arm's length, with the result that the parties may buy and sell from each other. (see: Al Khasani, Badai, on Mudarabah).

The critical points from a risk perspective are the following:

(i) The mudarib manages the portfolio in the ordinary course in his capacity as a trustee.

(ii) The mudarib is not liable to compensate the investors for loss of capital unless the same was caused by the mudarib's negligence, misconduct, or material breach of contract.

(iii) The capital of the investors cannot be guaranteed in any manner whatsoever. The burden of loss falls on the investors in the ordinary course. Losses are first offset against profits, and thereafter against capital.

(iv) Where the mudarib is a financial institution or bank, it will be liable to perform the obligations imposed upon it in the contract of mudarabah, and shall be liable to bear all indirect expenses connected with its activities in its capacity as a mudarib.

(v) If the underlying assets in the mudarabah portfolio consists only of cash and debts, then an investor cannot withdraw his investment prematurely.

There must be a final accounting at the end of the relevant period and any advance payment on account must be adjusted. On the other hand, if the majority assets in the portfolio are tangible assets then in such event an investor may prematurely withdraw by selling to the portfolio his pro rata share at the fair market value or at a mutually agreed price.

(vi) If the mudarib has been given blanket authority (and there is no stipulation to the contrary) the mudarib may contribute his own funds to the mudarabah portfolio. In such event, a partnership will be created between the mudarib (in his personal capacity as partner), and the mudarabah portfolio (as a separate entity). The resultant profits will be shared proportionately (with the mudarib receiving his share as a partner, and a separate share in the mudarabah portfolio in his capacity as mudarib).