Islamic Financing Contracts

Siraj Khan

University of Gloucestershire

United Kingdom

Email. serajbest@gmail.com

Abstract

Islamic finance has been expanding strongly all over the world during the past few years and shows significant product innovation and sophistication. Shariah-compliant products have proven to be attractive and offer many opportunities - even for non-Islamic institutions. The contribution of this research is to investigate Islamic financing contracts. The findings of this research show that up to 50% of the total savings of the Muslim population worldwide are projected to be invested in a Shariah-compliant way within the next five years, making it an extremely fast-growing business worldwide and offering significant potential to traditional Islamic institutions and new entrants.

1. Introduction

The Islamic capital market is reaching an important peak of sophistication: almost all conventional products can be readily replicated in a Shariah-compliant way, even the most complex structured products, which is not always desirable according to many experts in the industry. (Kumar 2009) Therefore it holds importance to carry out a detailed study of the risk management practices/processes being carried out by an Islamic bank.

In an Islamic system, banks, although constrained by the rules of the Shari'a, essentially perform the
same functions as those in conventional system; that is, they act as administrators of the economy’s payments system and as financial intermediaries. They are needed in both systems for the same reason for the exploitation of imperfections in financial markets. This imperfection includes imperfect divisibility of financial claims, imperfect information, transaction costs of search and acquisition, diversification by the surplus and deficit units, and existence of expertise and economies of scale in monitoring transactions. Financial intermediaries in an Islamic system can reasonably be expected to exhibit economies of scale with respect to these costs, as do their counterparts in a conventional system. Just as in the latter system, the Islamic depository financial intermediaries transform the liabilities of business into a variety of obligations to suit the tastes and circumstances of the surplus units.

Prohibition of interest and the fact that the banks have to rely primarily on profit sharing leads to a major difference between the two systems: Islamic banks have to offer their asset portfolio of primary securities in the form of risky open ended "mutual funds" type packages for sale to investor depositors, while banks in conventional system keep title to the assets portfolios they originate. Banks fund these assets by issuing deposit contracts, a practice that results in solvency and liquidity risks, because the asset portfolio entail risky payoffs and costs of liquidation prior to maturity, while deposit contracts are liabilities that are often put able instantaneously at par (Iqbal and Mirakhor, 1987). More important for participants, Islamic finance represents part of a divinely sanctioned economic gestalt into which they fit. In this context, this work focuses on analysing Islamic financing contracts. Rest of this work has been organized as follows. In
section 2, literature review is presented. The focus of section 3 is to analyse Islamic financing contracts whilst conclusion and future work is given in section 4.

2. Literature Review

Islamic finance was practiced predominantly in the Muslim world throughout the middle ages. European financiers and businessmen later adopted many Concepts, techniques, and instruments of Islamic finance. In contrast, the term “Islamic financial system” is relatively new, appearing only in the mid 1980s. In fact, all earlier references to commercial or mercantile activities conforming to Islamic principles were made under the umbrella of either “interest free” or “Islamic” banking. This, no doubt, prohibits the receipt or payment of interest as the nucleus of the system, but is supported by other principles of Islamic Doctrine advocating risk sharing, individuals’ rights and duties, property rights, and the sanctity of contracts.

Similarly, the Islamic financial system is not limited to banking, but covers financial instruments, financial markets, and all Types of financial intermediation (Khan and Mirakhor, 1990).

There is a debate among the Islamic community over the effectiveness of an interest based banking system. While it is acknowledged that banks play a pivotal role in the development of a country through their role as financial intermediaries, the question is how efficient an interest-based system is in performing this function. In fact, there is even some debate as to whether or not an interest based system actually contributes to cyclical fluctuations. A new system of banking has emerged known as Profit Loss Sharing PLS most likely in response to the interest based banking system debate, but more due to religious beliefs in the Islamic community. Currently, this banking system is integrated into
over 60 countries throughout the world with over 250 Islamic financial institutions in operation (Al-Iqtisadiyah, 2005).

Aside from the economic debate, the main contributing factor in the emergence of a profit loss sharing (PLS) banking system is the prohibition of 'riba' (interest) in the holy Quran. The basic intention behind establishing Islamic banks was the desire of Muslims to reorganize their financial activities to complement the principles of the Shariah (or the Islamic Law) and enable them to conduct their financial transactions without indulging in 'riba'. The term riba is used in the Shariah in two senses. First is riba al-nasiah, which is the fixing in advance of a positive return on a loan as a reward for waiting to be repaid. Second, riba al-fadl is encountered in a hand to hand purchase and sale of commodities. The Shariah prohibits both forms of 'riba' (Suleiman, 2000).

3. Islamic Financing Contracts

These deals may contain elements of more than one of the basic Islamic contracts. In this section discuss the basic features of these Islamic financing contracts.

3.3.1 Murabaha

A Murabaha transaction is basically a cost-plus profit financing transaction in which a tangible asset is purchased by an Islamic institution at the request of its customer from a supplier. The Islamic institution then sells the asset to its customer on a deferred sale basis with a mark-up reflecting the institution’s profit. The customer takes the responsibility of negotiating all of the key commercial terms with the seller of the asset. The mark up on the asset cannot be altered during the life of the contract. The size of the mark up is determined in relation to an interest rate index such as the LIBOR.
(London Inter-Bank Offered Rate) or US- short T-bills rate, and is also a function of the client's credit rating, the transaction’s size and the type of goods being financed (Geneva, 2009). The Murabaha deals offer enough flexibility to be used in real estate and project financing, but historically it has been used primarily for trade finance.

3.3.2 Ijara and Ijara Wa-Iqtina (Islamic Leasing)

Ijara and Ijara wa-Iqtina are Islamic leasing concepts similar to western operating and finance leases. Ijara is similar to a conventional operating lease, where in an Islamic bank (lessor) leases the asset to a client (lessee) for agreed on lease payments for a specified period of time, but with no option of ownership for the lessee. The maintenance and insurance of the leased asset is the lessor’s responsibility. On the other hand, Ijara Wa-Iqtina is comparable to the Western financial or capital lease, where the lessee has the option of owning the asset at the termination of the lease. In this case, the bank (lessor) purchases the asset such as a building, piece of equipment or even an entire project and leases it to the clients for an agreed on lease rental, together with client agreement to make lease payments towards the purchase of the asset from the lessor (Abdullah, 2007). The conditions governing both types of leasing are that assets must have a long secure productive life, and must not be handled in an un-Islamic way, meaning that the lease payments must be agreed on in advance to avoid any speculation.

3.3.3 Istisna

Istisna is a pre delivery financing and leasing structured mode that is used mostly to finance long-term large-scale facilities involving, for example, the construction of a power plant. The Islamic institution could own the plant, charge the lessee (Project Company) a fee based on
profits, or sell the plant to the project company on a deferred basis with a profit mark up similar to a Murabaha transaction. Unlike a Murabaha transaction, however, certain expenses that cannot easily be reflected in a sale and purchase agreement can be included in the fees to be paid to the Islamic institution by the project company (Geneva, 2009).

Although the Islamic marks up contracts (Murabaha, Ijara, Ijara Wa-Iqtina, and Istisna) are widely used, their acceptability under Islamic law is disputed because they can imply a fixed return on investment for the financing financial institutions. Many Islamic scholars have suggested that mark up contracts, while permissible, should still be restricted or avoided out of fear that these mark up contracts may open a "back door" to interest.

3.3.4 Mudaraba

Mudaraba is a trust based financing agreement whereby an investor (Islamic bank), entrusts capital to an agent (Mudarib) for a project. Profits are based on a pre-arranged and agreed on ratio. Mudaraba agreement is akin to Western style limited partnership, with one party contributing capital while the other runs the business, and profit is distributed based on a negotiated percentage of ownership. In case of a loss, the bank earns no return or a negative return on its investment and the agent receives no compensation for his/her effort (Hassan & Lewis 2007).

3.3.5 Musharaka

Musharaka is similar to a joint venture, whereby two parties (an Islamic Financial institution and a client) provide capital for a project which both may manage. Profits are shared in pre-agreed ratios but losses are borne in proportion to equity participation. It conforms to the principle of profit and loss
sharing and it is suitable for long-term project financing; hence, it is considered to be the purest form of Islamic finance. Musaraka financing is closer to a traditional equity stake with rights of control (Hassan & Lewis, 2007).

In addition to mark up and profit sharing instruments, two more Islamic instruments are used in futures trading, Bai-Salam and Bai-Muajjal. In a Bai-Salam contract the buyer pays an agreed on price in advance for commodities that will be delivered at a future date, while in a Bai-Muajjal deal, the seller allows the buyer to pay at a future price in either lump sum or instalments. The fixed price can be the same or higher or lower as the spot price (Hassan and Lewis, 2007).

Recently a new Islamic mutual insurance type of fund (Takaful) has been introduced. Participants pay instalments into a fund and the bank acts as managing trustee. In addition, a new Islamic banking product was tested in the European market at the end of 2000. The product is an equity Repo, which is similar to a Murabaha or cost plus profit transaction. The typical maturity of the Islamic equity Repo is three months. The equity Repo is the product of collaboration between Cedel bank (a leading provider of global Repo services) and a major European bank in London (Brooks et al, 1999).

4. Conclusion and Future Work
There are five basic Islamic Financing contracts. The underlying concept for each technique is simple and can be compared to an existing Western financial instrument. However, actual financing deals can become very complicated as some banks modify the structure to suit the requirements of specific investors. Future research will focus on comparing risk associated with Islamic against those related to conventional banking. We are committed to share future findings
with the ongoing research in this area.

References


3. AL-Iqtisadiyah, A. H, (2005), The Total Deposits of Two Hundred and Eighty Islamic Banks in Forty Eight Countries Reach Four Hundred Billion Dollars, Issue No. 3567.


