

COMMERCIAL CONTRACTS IN ISLAMIC FINANCE

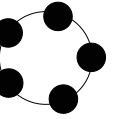
Inspired by tradition, adapted to modern times



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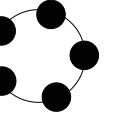


COMMERCIAL CONTRACTS IN ISLAMIC FINANCE



Contract		Characteristics
Musharaka	Partnership	Joint Venture: several investors combine funds for a project
Mudarabah	Partnership	Limited Partnership where Investor (Rabb Ul Maal) appoints a manager (Mudarib)
Musawana	Sale Contract	Sale of an Asset
Murabaha	Sale Contract	Sale of an Asset where the cost is disclosed
Salam	Differed Sale	Pay now an Asset delivered in the future
Istisna	Sale/Manufacturing	Project Financing, flexible payment terms
Ijara	Leasing	Rental contract

Partnership Agreements



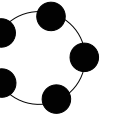
Active Partnership

Musharaka

Passive* Partnership

Mudharabah

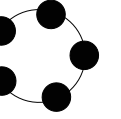
*from investor's point of view



MUSHARAKA - ACTIVE PARTNERSHIP



The term "Musharakah" originates from Arabic and literally translates to "sharing." In a business and trade context, it refers to a joint enterprise where all partners mutually share the profits and losses of the joint venture.



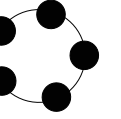
MUSHARAKA – ACTIVE PARTNERSHIP

Based on AAOIFI standards: Musharaka, or Shariqat Al Aqd (contractual partnership) means an agreement between two or more parties to combine their assets, labour or liabilities for the purpose of making profit.

- each partner contributes a specific amount of money
- each one has a right to deal in the assets of the partnership
- profit is distributed according to the partnership agreement,
 - if not proportionate to capital contribution, the additional percentage cannot be in favor of a sleeping partner
- losses are born in accordance with the contribution to capital

It is permissible, with the agreement of all partners, to provide tangible assets as capital after the monetary values of these assets are determined and expressed in currency in order to calculate the appropriate share in the capital.

It is permitted for the managers to agree that the management of the partnership will be restricted to certain partners or to a single partner. It is also permitted for the partners to appoint a manager other than the partners and pay him a fixed remuneration that will be included in the expenses of the Sharika.



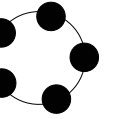
MUSHARAKA – ACTIVE PARTNERSHIP

Diminishing Musharaka

Form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him. It is necessary that his buying and selling is not stipulated in the partnership contract, the partner is only allowed to give a promise to buy. The promise to buy should be independant from the partnership contract.

It is permissible for the partners to maintain the ratio of profit already determined even if the ratio of equity shares has changed, or to agree on amending the ratio of profit sharing due to the change in the ratio of equity shares. In doing so, they must ensure that the principle of allocation of losses in accordance with the ratio of equity share of ownership is maintained.

It is permissible for one of the partners to give a binding promise that entitles the other partner to acquire, on the basis of a sale contract, his equity share gradually, according to the market value or a price agreed at the time of acquisition. It is not permitted to stipulate that the equity share be acquired at their original or face value.

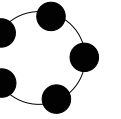


MUDARABAH - PASSIVE PARTNERSHIP



Mudarabah is a partnership in profit whereby one party provides capital (Rab al-Mal) and the other party provides labour (Mudarib).

Financial Loss is supported by Rab Al Maal, unless caused by negligence or violation of terms of the contract by the Mudarib



MUDARABAH - PASSIVE PARTNERSHIP

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A mudarabah contract is a trust-based contract. The Mudarib is not liable for losses except in case of breach of the requirements of trust, such as misconduct in respect to the Mudarabah fund, negligence and breach of the terms of Mudarabah contract.

For a mudarabah contract to be valid and for the mudarib to be considered as having control over the capital, the capital must be, wholly or partially, put at the disposal of the mudarib, or the mudarib must have free access to the capital.

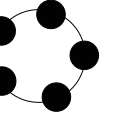
The mechanism for distributing profit must be clearly known in a manner that eliminates uncertainty and any possibility of dispute. Distribution of profit must be made on the basis of an agreed percentage of the profit and not on the basis of a lump sum or a percentage of the capital.

There are two types of Mudarabah

Unrestricted Mudarabah, in which the capital provider permits the mudarib to administer a mudarabah fund without any restrictions. In this case, the mudarib has a wide range of trade or business freedom on the basis of trust and the business expertise he has acquired. An example is when the capital provider says, “Do business according to your expertise”

Restricted Mudarabah, in which the capital provider restricts the actions of the mudarib to a particular location or to a particular type of investment as the capital provider considers appropriate, but not in a manner that would unduly constrain the mudarib in his operations.

Sale & Leasing contracts



Sale

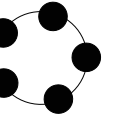
Murabaha, Musawana

Sale with differed delivery

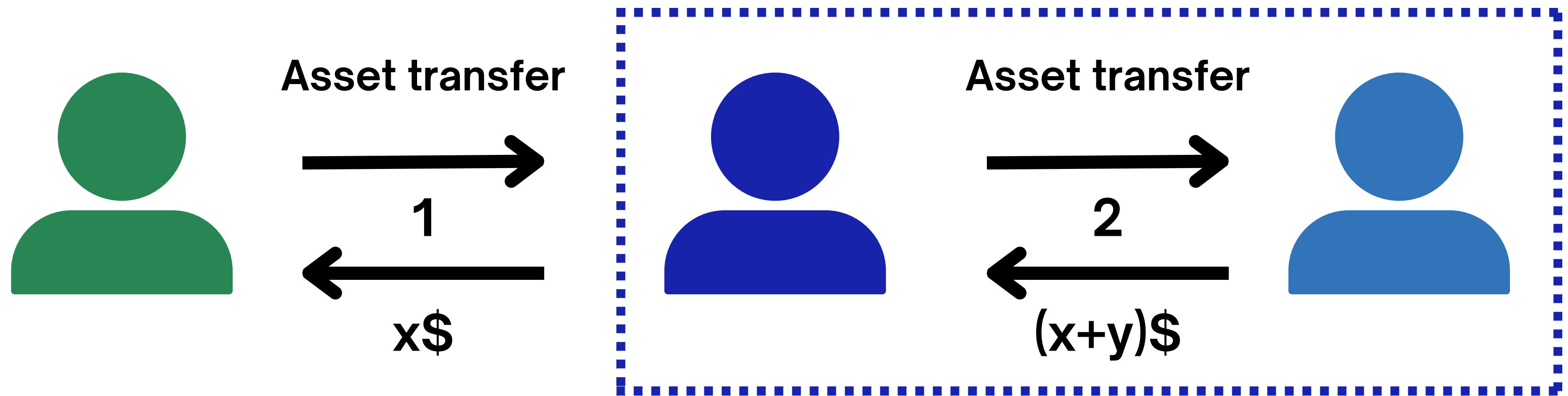
Salam & Istisna

Leasing

Ijara



MURABAHA

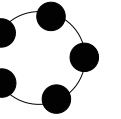


A seller agrees with his purchaser to provide him a specific commodity on a certain profit added to his cost

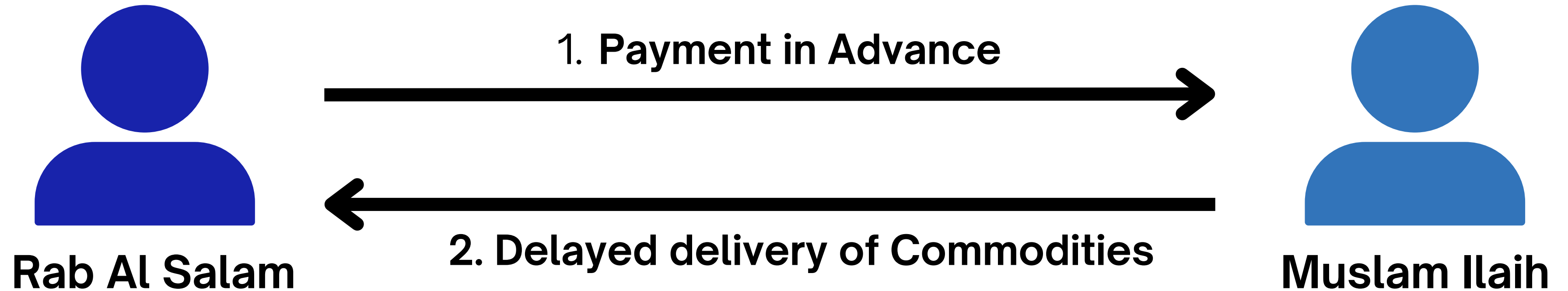
x = original cost of the asset or commodity

y = pre-determined and fixed margin

Cost (x) and Margin (y) are known by the final buyer, otherwise it is a Musawana (simple sale)



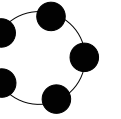
SALAM



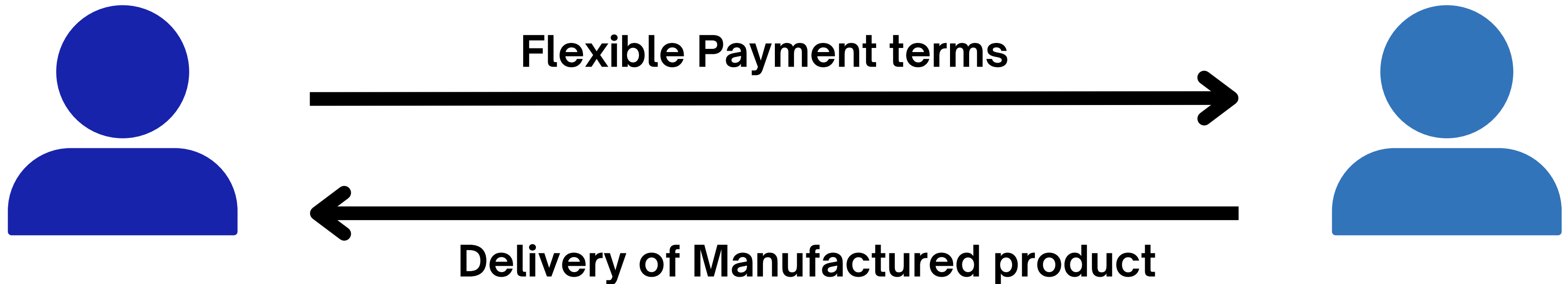
Salam operates as a forward sales contract where the buyer pays in advance for buying specified assets.

Parties agree on delivery date, exact quantity and quality, and pre-determined specifications for the commodity to avoid gharar.

Note: A sale contract is valid in shari'a only when the asset/commodity is in the physical or constructive possession of the seller. Salam and Istisna' are the only exceptions to this rule

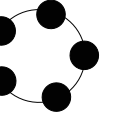


ISTISNA - Manufacturing Contract

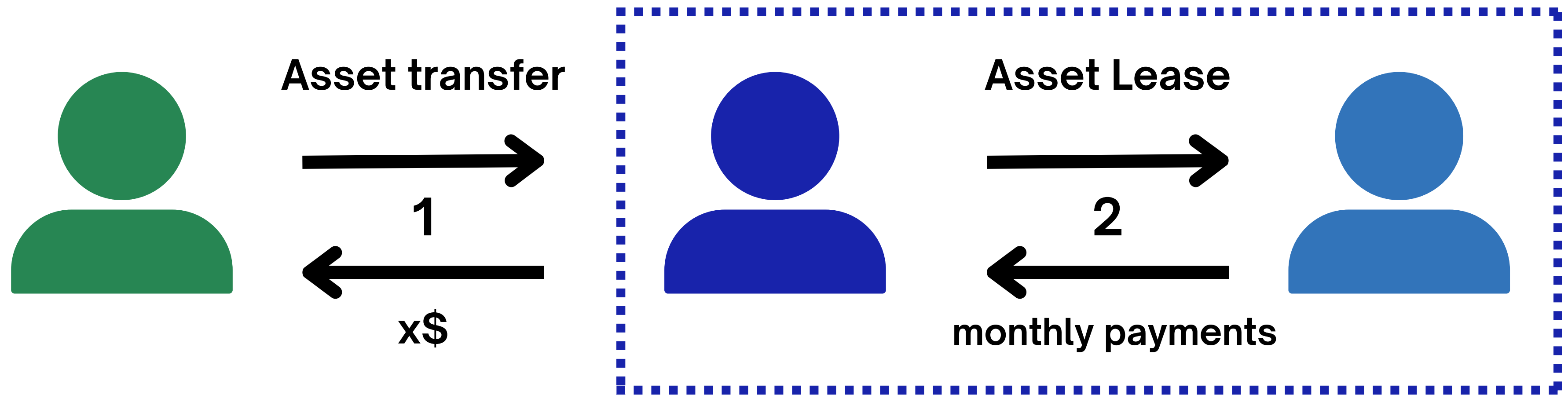


An Istisna'a contract is permissible only for raw materials that can be transformed from their natural state by a manufacturing or construction process involving labour. Therefore, Istisna'a is valid only in so far as the supplier has agreed to provide a subject-matter that is manufactured or constructed.

Conditions to be fulfilled are: specification of the type, kind, quality and quantity of the subject-matter to be produced. Moreover, the price of the subject-matter must be known and, if necessary, the delivery date must be determined.



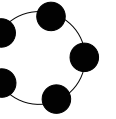
IJARAH



Ijarah means “to give something on rent”. It is used for 2 situations:

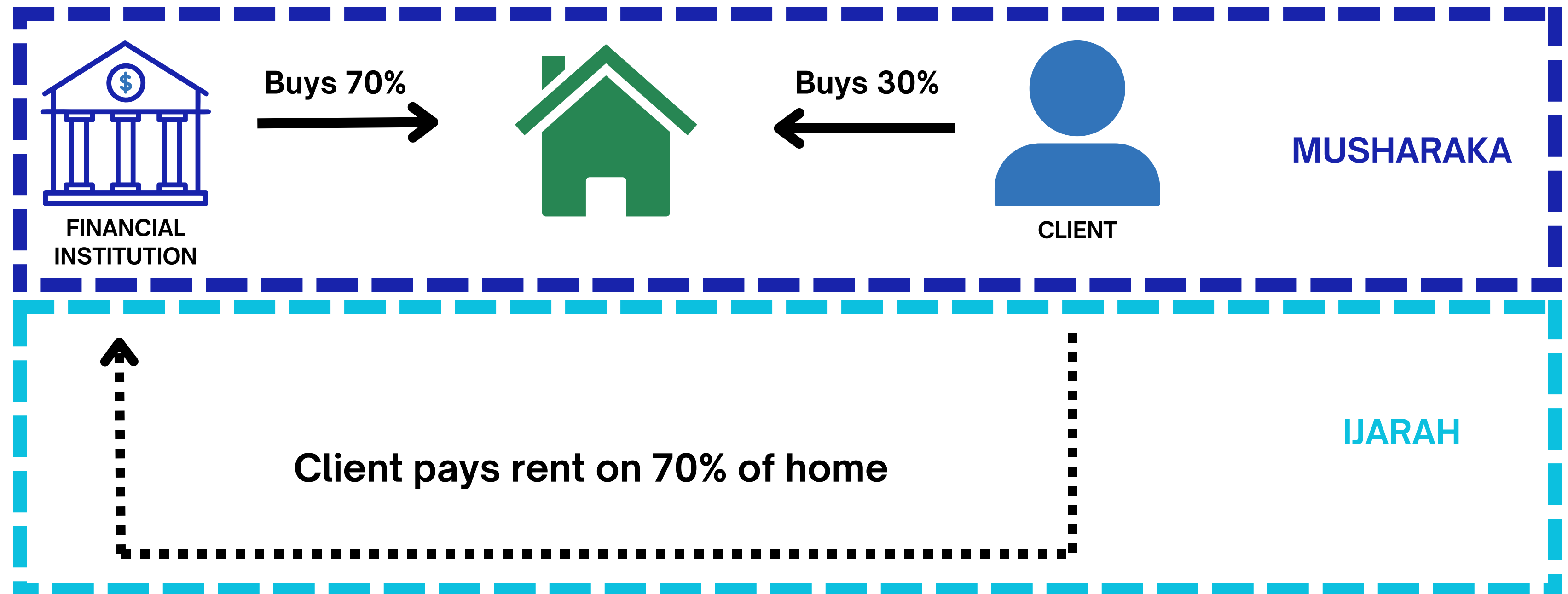
- to employ services of a person on wages
- to rent the usufruct of assets and properties (leasing)

In Banking/Finance, an Ijarah contract is executed for an asset owned by the lessor or an usufruct owned by the sub-lessor.

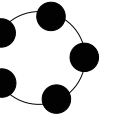


Combining contracts for Home Financing

Combining contracts is an essential mechanism of islamic finance practices, allowing product developers to design and structure shari'a compliant products and services

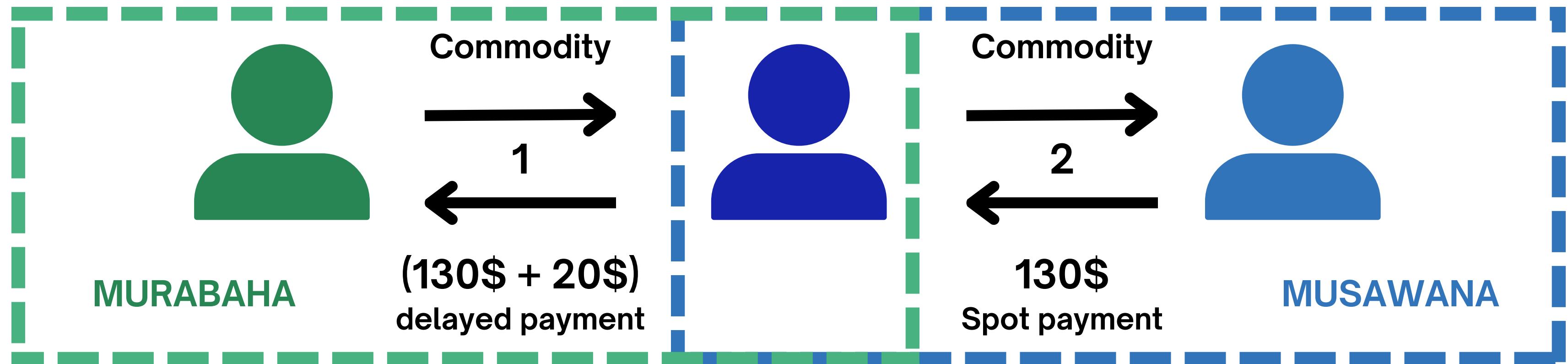


The client can regularly buy back shares from the financial institution. in that case, we would call it a Diminishing Musharakah



Combining contracts for Liquidity

Combining contracts is an essential mechanism of islamic finance practices, allowing product developers to design and structure shari'a compliant products and services



Called Commodity Murabaha, or Tawarruq, this operation is highly controversial, but commonly used in the industry



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