

BANKING PRODUCTS

PRINCIPLES OF ISLAMIC BANKING

- Absence of interest-based (*riba*) transactions. Islamic banks cannot charge any fixed return in advance. Depositors share in the profits according to predetermined ratio and are rewarded with returns for assuming risk.
- Islamic banks are partners to their clients and undertake operations on the basis of Profit and Loss Sharing (PLS) arrangements and other acceptable modes of financing.
- Avoidance of economic activities involving speculation (*gharar*).
- Do not fund production of goods and services considered *haram*.
- Every Islamic bank has to establish a *zakat* fund for collecting the tax and distributing it exclusively to the poor directly or through other religious institutions. This tax is imposed on the initial capital of the bank, on the reserves, and on the profits as described in the Handbook of Islamic Banking, and on penalties levied.
- *Mudaraba* and *murabaha* are the two profit sharing arrangements practised by Islamic banks.
- Have an additional layer of governance as the suitability of their investments and financing must conform strictly Islamic to *fiqh* and the expectations of the Muslim community.
- Are expected to establish Shari'ah Supervisory Boards consisting of Muslim jurisprudence employed as advisers to ensure that the practices and activities of the institutions conform to Islamic ethical standards.
- Islamic banks are conceived as financial intermediary mobilising savings from the public on a *mudaraba* basis and advancing capital to entrepreneurs on the same basis. Banks receive funds from the public on the basis of unrestricted *mudaraba*.
- There are no restrictions imposed on the banks concerning the kind of activity, duration, and location of the enterprise. However, the funds cannot be applied to activities considered *haram*.
- Banks have the right to aggregate and pool the profit from different investments and share the net profit (after deducting administrative costs, capital depreciation and Islamic tax (*Zakat*) with depositors according to a specified formula.
- In the event of losses, the depositors lose a proportional share or the entire amount of their funds.
- Banks apply the restricted form of *mudaraba* when funds are provided to entrepreneurs. They have the right to determine the kind of activities, the duration, and location of the projects and monitor the investments. However, these restrictions may not be formulated in a way which harms the performance of the entrepreneur.
- The banks cannot interfere with the management of the investment.

- Loan covenants and other such constraints of pertaining to commercial banks' lending are allowed. However, Islamic banks cannot require guarantees such as security and collateral from borrowers in order to secure their capital against the possibility of eventual loss.
- The liabilities of financiers are limited to the capital provided while that of the entrepreneurs are also restricted solely to labour and effort employed.
- If negligence or mismanagement can be proven, entrepreneurs may be liable for the financial loss and be obliged to remunerate financiers accordingly.
- Entrepreneurs share the profit with banks according to previously agreed ratio.
- Until the investment yields a profit, an Islamic bank is only liable to pay a salary to the entrepreneur based on the ruling market rate.
- In *musharaka* financing the losses are borne proportionately to the capital amounts contributed.
- Under these two Islamic modes of financing, projects are managed by clients and not by the banks, even though the latter share the risk.
- Certain major decisions such as changes in the existing lines of business and the disposition of profits may be subject to the banks consent.
- The banks, as partner, have the right to full access to the books and records of the business they fund, and can exercise monitoring and follow-up supervision.
- Directors and management of the companies retain independence in conducting the affairs of the businesses.
- The banks are not allowed to foreclose on the debt in case of losses by borrowers.

ACCOUNTS

Current accounts

- Current accounts are based on the principle of al-wadiah, whereby the depositors are guaranteed repayment of their funds.
- The depositor does not receive remuneration for depositing funds in a current account as the guaranteed funds are not used for PLS ventures.
- The funds accumulating in these accounts can only be used to balance the liquidity needs of the bank and for short-term transactions.

Savings accounts

- Savings accounts operate under the al-wadiah principle.
- The Islamic bank may pay a premium, *hiba*, at its discretion, to the holders of savings accounts.

Investment accounts

- An investment account operates under the mudaraba al-mutlaqa principle, in which the mudarib (active partner) must have absolute freedom in the management of the investment of the subscribed capital.
- The conditions of this account differ from those of the savings accounts by virtue of:
 - a) A higher fixed minimum amount,
 - b) A longer duration of deposits, and
 - c) Depositors may lose some of or all of their funds in the event of the bank making losses.

Special investment accounts

- Special investment accounts also operate under the mudaraba principle
- Usually directed towards larger investors and institutions.
- The difference between these accounts and the investment account is that the special investment account is related to a specified project, and the investor has the choice to invest directly in a preferred project carried out by the bank.

METHODS OF FINANCING

Mudaraba

- A mudaraba can be defined as contract between two or more parties whereby one party, the financier (sahib al-mal), entrusts funds to another party, the entrepreneur (mudarib), to undertake an activity or venture.
- In mudaraba, the financier is not allowed a role in management of the enterprise. Consequently, mudaraba represents a PLS contract where the return to lenders is a specified share in the profit/loss outcome of the project in which they have a stake, but no voice.
- Under mudaraba, the yield is not guaranteed in profit-sharing and financial losses are borne completely by the lender. The entrepreneur as such losses only the time and effort invested in the enterprise. This distribution effectively treats human capital and financial capital as equal.

Musharaka

- Under musharaka, the entrepreneur adds some of his own capital to that supplied by the investors, so exposing themselves to the risk of capital loss.
- Profits and losses are shared according to pre-fixed proportion
- These proportions need not coincide with the ratio of financing input.
- The bank sometimes participates in the execution of the projects in which it has financed by providing managerial expertise.

Two-tiered mudaraba

- For banking operations, the *mudaraba* concept has been extended to include three parties: the depositors as financiers, the bank as an intermediary, and the entrepreneur who requires funds.
- Banks act as entrepreneurs when they receive funds from depositors and as financiers when they provide funds to entrepreneurs.

FINANCING

Though *mudaraba* and *musharaka* are the main modes used by Islamic banks to finance their customers, other methods are also used:

- *Murabaha* (mark up) – This is the most commonly used mode of financing. In *murabaha* transactions, banks finance the purchase of goods or assets by buying them on behalf of their clients and then add mark-up before reselling them to the clients on ‘cost-plus’ contracts.
- *Bai’ Mu’ajjal* (deferred payment) – It is considered lawful in *Fiqh* (jurisprudence) to charge a higher price for goods if payments are to be made at a later date as this is considered to be a trading transaction.
- *Bai’ Salam* (prepaid purchase) – The bank pays the money first and receives the commodity later. This is a common mode normally used to finance agricultural products.
- *Istisna* (manufacturing) – This is a contract to acquire goods on behalf of a third party where the price is paid to the manufacturer in advance and the goods produced and delivered at a later date.
- *Ijara* and *ijara wa iqtina* (leasing) – Under this mode, banks buy equipment or machinery and lease it out to their clients who may opt to buy the items eventually. Monthly payments constitute two components: rental for the use of the equipment and instalment towards the purchases price.
- *Qard Hasan* (beneficence loans) – This is the zero return type of loan that the Holy Qur’an urges Muslims to make available to those who need them. The borrower is obliged to repay only the principal amount of the loan but is allowed to add a margin at his own discretion.
- Islamic securities – Islamic financial institutions often maintain an international Islamic equity portfolio where the underlying assets comprise ordinary shares in well run halal businesses.

LEASING

Leasing is, in essence, an agreement between two parties for the rental of property (land or asset). It allows one party, the Lessee, to use an asset or property owned by another party, the Lessor. In this regard, leasing is equivalent to an *Ijara*, an Islamic mode of acquiring property. The lessee makes the economic use of the lessor’s assets and pays in the form of a rental for this privilege.

Basic rules governing Leasing under Islamic Law

- Lease is a contract whereby the owner of an asset transfers its benefits to another person for an agreed period, at an agreed consideration.
- The object being leased must have a valuable use.
- It is necessary for a valid lease contract that the leased asset remains in the ownership of the seller, and only its usage is transferred to the lessee. A lease cannot be effected in respect of consumables, fuel, ammunition, etc. because their use is not possible unless they are consumed.
- As the leased property remains in the ownership of the lessor, all the liabilities emerging from the ownership shall be borne by the lessor, but the liabilities arising from the use of the property shall be borne by the lessee.
- The period of lease must be defined.
- The lessee cannot use the leased asset for any purpose other than the purpose specified in the lease agreement.
- The lessee is liable to compensate the lessor for any damage to the leased asset caused by any misuse or negligence on the part of the lessee.
- Any harm or loss incurred during the lease period and caused by factors beyond the control of the lessee shall be borne by the lessor.
- A property jointly owned by two or more persons can be leased out, and the rental shall be distributed between all the joint owners according to the proportion of their respective shares in the property.
- It is necessary for a valid lease that the leased asset is fully identified by the parties.

Basic Principles of Leasing

Types of Leases

Leases can be conducted in several different ways by varying the terms and conditions of the contract. However, these can be divided in two broad categories -Finance Leases and Operating Leases.

Operating Lease

An Operating Lease is a pure rental agreement with three distinctive features:

- (i) the cost of the asset is not fully amortized over the lease period,
- (ii) the lessor provides maintenance of the asset, and
- (iii) the asset is usually returned to the lessor. Therefore, the lessee has the advantage of procuring an asset, utilizing it for its benefit and returning the same when it has served its purpose.

Finance Lease

A Finance Lease is in essence similar to a loan because substantially all risks and rewards related to the leased assets pass on to the lessee. It is mainly characterized by the:

- asset being fully amortized over the lease period,

- lessee is responsible for maintenance costs, and
- ownership is usually transferred to the lessee at the end of the lease. In this respect, the involvement of the lessor is restricted to financier.

Components of a Lease

These components are essential to a lease contract. By varying these, the type of the lease is determined. In order to analyze any lease, the following elements should be carefully studied:

Adjusted Lease Amount or Adjusted Capitalized Cost

Security Deposit /Down Payment Lease Term Rental Residual Value Termination
These elements are explored in detail below.

Adjusted Lease Amount or Adjusted Capitalized Cost

The starting point in the calculation of any lease payment is the capitalized cost. This cost is equivalent to the "purchase price" of the asset and generally known as the lease amount. It is reduced by the amount of any security deposit /down payment, and miscellaneous charges. These adjustments are called capitalized cost reductions. After all adjustments are made, the final amount is referred to as the adjusted lease amount or adjusted capitalized cost. This is the amount of financing provided by the lessor to the lessee.

Security Deposit /Down Payment

The security deposit, often termed as a Down Payment or Equity Contribution, is the amount most Lessors obtain at the onset of a lease. This amount serves as a security for the lessor (apart from the asset itself) and is refunded to the lessee at the end of the lease provided the terms and conditions of the lease contract have been met. For the lessee, a higher amount yields a lower adjusted lease amount resulting in reduced rentals. Therefore, the lessee has to make a trade-off between a higher security deposit and higher rentals.

Lease Term

The lease term can vary considerably from lease to lease. However, in Pakistan, it is usually between three to five years. The length of the lease term has a vital role in determining the payments. In a fully amortized lease, a longer lease period can reduce the payments while a shorter period has the opposite effect.

Rental

The rental represents periodic payments of agreed rent over the lease term. It represents a charge for the depreciating asset as well as a rent charge. The rent charge includes the cost of funds, overheads and services being provided by the lessor. It is the compensation that a lessor claims for providing the lessee the economic use of the asset.

Residual Value

The residual value is the amount the asset is considered to be worth at the end of the lease. It is generally expressed as a percentage of the lease amount. In cases where the ownership is transferred to the lessee, the residual value forms the sale price. Like the security deposit, a higher residual value can lower the rental payments.

Termination

Most leases cannot be terminated before the end of the lease by design. Terminations are possible if the lessee wants to payoff the lessors or when a forced termination is undertaken in the event that the underlying assets are destroyed, i.e. stolen or made unproductive. If one terminates the lease early, he has to pay for the privilege. For the lessor, an early termination results in generating an unexpected cash inflow. The lessor loses the expected income from the lease until the terminated amount is redeployed in another investment. Generally, lessors charge a penalty for early termination to avoid this loss of income.

Benefits of Leasing

Leasing offers many substantial benefits both for the lessee and the lessor:

- Leasing is acceptable within the Islamic modes of finance as fixed rental payments are made and interest is not involved.
- Large lease payments are fully tax deductible at the time of payment. An incentive may exist to load payments into a particular tax year.
- Lower present value of after-tax leasing costs compared to purchase costs.
- Leasing provides long-term lending at fixed rentals.
- Leasing assures maximum conservation of capital as it makes large investments in fixed assets unnecessary. The lessee can use this for other purposes such as working capital, trade debts, and seasonal expenditures.
- Leasing permits conservation of existing lines of credit that can be used for other purposes.
- Leasing guards against technological obsolescence.
- The terms and conditions are flexible and can be customized for the lessee.
- Lease rentals can be structured in accordance with the Lessee's cash flow requirements.
- Leasing being long-term provides a hedge against inflation.
- Facilitates capital budgeting as rental payments are fixed.
- Off balance sheet financing may enhance ability to borrow by improving apparent liquidity and enhancing return on investment.

Lease vs. Buy

The primary difference between Leasing and Buying is the ownership of the asset. A straight purchase gives a person an immediate ownership of the asset. However, in a lease, the ownership of the asset vests with lessor. The lessee benefits from the economic use of an asset that does not belong to him. A closer look reveals that it is

the usage of the asset that is important rather than its ownership. The economic benefit of the asset lies with a person whether he leases or buys the asset. For personal usage, it is the pleasure of say, driving a new car. For business purposes, it's the usage that translates into profits.

Another difference is the initial cash outlay requirement. When buying, a person pays the cost of the asset as a lump-sum amount at the onset. However, leasing enables a person to pay only a part of the cost (down payment) and begin utilization of the asset before repaying the full amount. The remaining amount is repaid with fixed payments over a period of time.