SPECIFICS OF MANAGING FINANCIAL INSTRUMENTS IN ISLAMIC BANKS

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Abstract

This professional paper aims to bring closer to readers the basic characteristics and business features of Islamic banks as well as islamic financial instruments. Islamic banking has proven to be a potential and, above all, ethical, alternative method of banking worldwide. The transactional prohibition of collecting and earning interest is the most important prominent feature of Islamic banks. In other words, it is inadmissible that ‘money create money’ without the labor and the real sector effort. Islamic banks consider ethical responsibility on the supply side and thereby supply the market with an offer-based on trust. The most important characteristics of Islamic banks are participation and guarantees. Islamic banks perform with two major types of contracts: non-participatory or asset-based (murabahah, ijarah, istishna and salam) and risk-sharing/participatory or equity-based (musharakah, mudarabah).

Keywords: Islamic banking, Islamic banks, Ethics, Financial instruments

Sažetak

Ovaj stručni rad ima za cilj približiti čitaocima osnovne karakteristike i načine poslovanja Islamskih banaka kao i islamske financijske instrumente. Islamsko bankarstvo se širom svijeta pokazalo kao potencijalan i nadasve etičan, alternativan, metod bankarskog poslovanja. Transakciona zabrana ubiranja i zarade od kamate najvažnija je istaknuta karakteristika islamskih banaka. Drugim riječima, nedopustivo je da novac stvara novac bez uloženog rada i napora realnog sektora. Islamske banke uzimaju u obzir etičku odgovornost na strani ponude i na taj način opskrbljuju tržište ponudom temeljenom na povjerenju. Najvažnije karakteristike islamskih banaka su učešća i garancije. Islamske banke posluju sa dvije glavne vrste ugovora: neparticipatorni ili temeljen na imovini (murabahah, ijarah, istishna i salam) i podjelom rizika/participatorni ili temeljen na kapitalu (musharakah, mudarabah).

Ključne riječi: Islamsko bankarstvo, islamske banke, etika, finansijski instrumenti
1. INTRODUCTION

1.1. Conventional vs Islamic banking - main features

Unlike conventional banks, Islamic banks do not consider an interest as a price of money. Islamic banks reject interest rate mechanism and interest as the price of capital and seek profits by promoting investment in ethical projects with a social impact. The Islamic bank’s depositors return is connected to the assets return due to the ‘pass-through’ nature of an Islamic bank balance sheet, which removes the typical asset-liability mismatch exposure of a conventional bank.

Table 1: Major Differences between Conventional and Islamic Banking

<table>
<thead>
<tr>
<th>Conventional banking</th>
<th>Ethical banking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Un-ethical, Profit-oriented</td>
<td>Shariah Law</td>
</tr>
<tr>
<td>Central Bank</td>
<td>Central Bank, Shariah Bank Board</td>
</tr>
<tr>
<td>Interest bearing loan (‘Time-value of money’)</td>
<td>Asset based financing</td>
</tr>
<tr>
<td>No backing of real assets for expanded money</td>
<td>Balance budget, no expansion of money</td>
</tr>
<tr>
<td>Loss not shared by the bank</td>
<td>Loss shared through investment partnership</td>
</tr>
<tr>
<td>No agreement for exchange of goods and services</td>
<td>Agreements <em>per must</em> for disbursing funds</td>
</tr>
<tr>
<td>Inflation creates by expansion of money</td>
<td>No inflation</td>
</tr>
<tr>
<td>Individual welfare</td>
<td>Society welfare</td>
</tr>
<tr>
<td>Maximize taxes/decreases real GDP</td>
<td>Minimize taxes/increases savings/increases real GDP</td>
</tr>
</tbody>
</table>

2. ISLAMIC BANKING FINANCIAL PRODUCTS

2.1. Financing in Islamic banks

Assets and liabilities side of an Islamic bank balance sheet contain Shari’ah compatible financial instruments. Depositors in Islamic banks (investment account holders) deposit their money into special accounts on the liability side and the Islamic bank, with their approval, invests further on the assets side. The asset side of the balance sheet consists of commodity trading, leasing, partnerships, equity based partnerships and trade financing.
2.2. Islamic financial instruments (IFI’s) and their characteristics

Financing instruments in Islamic banks (il tabarru’-form of social-based contracts) are contracts of exchange (murabahah, musawamah, mu’ajjal, salam), investment contracts or equity placement (musyarakah, mudharabah), ijarah, agency contracts (wakalah), production contracts (istishna’) and guarantees (kafalah, rahn). IFIs could be also divided into participatory (mudarabah and musharakah) and non-participatory (trade-based) forms (murabahah, ijarah, salam, istishna’, bai muajjal, jo’alah and qard hasan) (Khan, 2010). Further, one can classify tools into two groups: cost-plus tools (murabahah, ijara, istishna’, salam...) and investment tools (mudarabah and musharakah) (Boumediene, 2011).

2.2.1. Role of collateral (rahn) and guarantee (kafalah)

Unequivocally, the prohibition of ribā proscribes any interest or increase to money loans, and rejects the notion that money is, of itself, productive, or that the time factor alone justifies a charge (Haneef, 2007). Collateral (rahn) represents the real assets deposited in the bank as a guarantee of payment by the debtor while the third-party (kafalah) guarantees payment if it is required and at a specified time (will pay debtor’s debt if debtor defaults due to the loss of ability to pay or reluctance or avoidance to pay).

2.3. Islamic financial products

2.3.1. Benevolent loan (Qard Hasan)

Literally, qard means cutting off (Saleem, 2009). It is based on goodwill, riba-free and it falls under the category of pure assistance (il-tabarru’). This lending, which, of course, is interest-free, is an aspect of the bank’s social activities (Boumediene, 2011).

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4 Saleem, M.Y. (2009), Islamic Commercial Law, Willey Finance.
2.3.2. Debt - based models

2.3.2.1. Deffered sale (Bay’ul Mu’ajjal – Murabahah)

*Murabahah* (cost-plus sale) presents a short-term leasing contract for asset acquisition. Islamic bank purchases a good on behalf of the client and later resells it to the client at a marked-up price (Oxford Dictionary of Islam, 2003). It is a sale contract through which bank sells goods to its customer on profit revealing the original cost and profit charged in the contract (Ul Hassan, et. al. 2012). Profit (mark-up) is adjusted in advance with a client/buyer and usually does not exceed 10% of the purchase price of goods. As long as it is a sale contract it is *halal*, regardless of the percentage mark-up (Usmani, 2002). Islamic bank and buyer must sign two separate contracts, one for the purchase of exactly specified goods by the bank (accoding to *Shari‘ah* law, Islamic bank must first become the owner of such good) and other for the sale of purchased goods to the buyer. When buying goods (in a form of promise/ *wa‘ad* or requesting assistance from a third party through an agency/ *wakalah*), the bank must take good care of the purchasing price because it can be in loss at the time of sale to the debtor. This contract is called *murabaha purchase order* (MPO). *Murabahah* could be prompt (the buyer immediately pays the full price to the bank), delayed (the buyer pays in deferred payment as agreed with the bank in the contract), open (the buyer is familiar with the purchase price and negotiates with the bank mark-up) and closed (the buyer is not familiar with any details of the goods purchase). Buyer may default in paying the debts in full and on time. The bank may face the risk of losing or damaging goods (after purchase and before delivery to the final consumer), in which case the buyer will refuse the purchase and the bank will be at loss, and costs that may arise from delivery delay in the first contract (when purchasing exactly specified goods), inventory costs, the costs of securing the goods or storing goods costs. One of the important differences is that the mark-up in *murabahah* contract consists of the costs for the services the bank provides for the buyer and do not increase if the buyer fails to make a deferred payment on time. In the interest-based lending, the bank provides a loan and its risks are smaller and purely financial.

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2.3.2.2. Advanced purchase/Purchase with deferred delivery (*Bay‘al Salam*)

*Salām* is an agreement to pay now for goods delivered later; A contract for the purchase of goods to be delivered at a specified time in the future; Payment for the goods is made in advance (QFinance, 2014)\(^8\). All specifics must be precisely defined and specified on the day of signing the contract in order to avoid any possible ambiguities and misunderstandings. The seller will receive money earlier and the buyer will pay a spot price for goods (surely, lower price than the one he would pay on the day of delivery). Some kind of guarantee can be demanded to ensure payment. Types of risks may occur. Firstly, counterparty risk may arise in transaction period when the supplier does not provide and deliver the goods on time (or at all) and as defined by the contract. In that case the Islamic bank just extend the delivery time and it is not allowed to charge any penalties. Secondly, commodity price risk could be successfully overcome with parallel *salām*. Parallel *salām* consists of two separate contracts, independent from each other. The first *salām* contract is between Islamic bank and the seller of goods (requesting for an early redemption of its products/goods) and second/parallel *salām* is between contract and before the delivery where a third-party promise (*wa‘ad*) to buy the specified commodity. If the supplier of goods, for some reason, does not deliver precisely specified goods accurately and at the delivery date (this is important for the bank in order to fulfill the obligation from the second/parallel *salām* contract) then the bank is exposed to an additional cost for buying goods at its own expense. However, the supplier of goods (from the first *salām* contract) is required to submit to bank agreed goods (no matter how – whether by producing/raising or buying). The default probability could also arise from the buyer (counterparty) to buy the commodity at the agreed price.

2.3.2.3. Partnership in manufacturing/commissioned manufacture (*Istishna’*)

*Istishna’* is a pre-production sale contract (medium to long-term, usually) used when an item, equipment, building or project needs to be constructed, manufactured or assembled according to specification (ISRA, 2011)\(^9\). It is a sale contract between *al-mustasni* (the ultimate purchaser) and *al-musania’a* (the seller) (Kettell, 2007)\(^10\). Specifics of the goods being sold must be indicated during the contract signing which also includes, before agreed, profit margin. Payment can be made at the moment of signing the contract, in instalments or at the time of delivery in lump sum. The subject of sale must not exist at the time of signing the contract (not built/

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\(^9\) International Shari’ah Research Academy for Islamic Finance (ISRA).

manufactured yet). Usually, Islamic bank is a financier or an intermediary between seller and buyer. Probability of default occurs as a counterparty risk (delivering the commodity or constructed asset at the time or the failure of the goods to fulfil the requested specifications) as well as a market/business risk (arises if the costs of production increases or not receiving the agreed selling price from the buyer or user).

2.3.2.4. Lease (Ijarah)

*Ijarah* (Arabic *ajara ujeru* mening ‘renting’) represents a model of financing in which the bank buys items of future renting and leases them to the clients (Hadžić, 2005, p.176)\(^{11}\). It involves one party (the lessor) allowing another (the lessee) to utilize the benefits on a tangible asset for a rental consideration (Zafar, 2012)\(^{12}\). It is a lease where the leased object is either returned to the owner (operational *ijarah*) or transferred to permanent ownership (at a certain fee) to the client (financial *ijarah*). There are operating lease of *ijarah* (after the expiration of the lease period the object is returned to the owner; short term in nature) and financial/*ijarah mumtahiah bi tamlik* (the client is paying the periodic price of the lease payment and also part of the cost price of the object and after the expiry of the *ijarah* contract an object is transferred into his/her ownership respecting the promise/*wa′ad* of the bank to sell or grant). Financing risk is faced in cases where there is a danger of non-fulfillment of obligations.

2.3.3. Intermediation contracts (Partnership, PLS models)

Mudaraba and musharaka are very popular types of financial contracts. Both types have been used to mobilize the entire reservoir of monetary resources of the medieval Islamic world for financing agriculture, crafts, manufacturing and long distance trade (El-Hawary et. al. 2007)\(^{13}\). When utilized, these two instruments do not create debt in the society at a whole, and the profit is shared more equally between capital and labor (Boumediene, 2011)\(^{14}\). In the case of profit-sharing modes of financing (like *mudarabah* and *musharakah*) the financing/credit risk

\(^{11}\) Hadžić, F. (2005), *Islamsko bankarstvo i ekonomski razvoj*, Ekonomski fakultet Sarajevo.


will be non-payment of the share of the bank by the entrepreneur when it is due (Ahmed & Khan, 2007). This problem may arise for banks in such cases due to the asymmetric information problem whereby they do not have sufficient information on the actual profit of the firm (ISRA, 2011).

2.3.3.1. Trustee finance contracts/finance by way of trust (Mudarabah)

Most dominant Islamic financing instrument is *Mudarabah*. It is the best financing model in zero-interest banking. The PLS system is no doubt a just system since it fairly distributes the risk between lender and borrower (Atmeh, Ramadan, 2012). *Mudarabah* may be concluded between Islamic bank, as provider of funds, on behalf of itself or on behalf of its depositors as a trustee of their funds, and its business-owner clients (in this case the bank act as a *mudarib* for a fee) (Mirakhor & Zaidi, 2007). It is about the business arrangement of the bank (financier – *Rabb al-mal*) and manager (*mudarib* – manages the project, invests knowledge, ideas, working time, effort, equipment etc.). *Mudarib* is completely independent in running the project (Hadžić, 2008). *Rabb al-mal* and *mudarib* arrange the ratio of eventual profit sharing. In the case of loss all financial consequences are endured by bank as investor. The financier cannot ask for a guarantee of the capital nor claim a fixed amount of profit or percentage of capital (ISRA, 2011).

2.3.3.2. Equity Partnership/Joint Venture (Musharakah)

Derived model of financing is called *musharakah* (participation, sharing). In practice, it is not applicable (non-flexible and relatively risky for Islamic banks). It is a type of a joint venture between both partners (the Islamic bank and its client/partner). There are two types of *musharakah*: permanent and diminishing equity partnership.

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3. CONCLUSION

At the end of the last century, the banking system went through the processes of consolidation, regulation and privatization (Efendić, 2011)20. All of them work according to the same regulatory framework.

Bosnia Bank International (BBI) is the first bank in BaH and Southeast Europe to operate in accordance with Islamic finance principles and it began its operations on 19th October 2000 in Sarajevo headquarters. The BBI Shari‘ah Board is responsible for respecting Shari‘ah regulations.

In Bosnia and Herzegovina, Islamic banking is not regulated by existing legislation at any level of government. It is necessary to adopt amendments (Article 39) to the existing Banking Act and thus enable the entire operation of BBI Bank in full compliance with Islamic principles.

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