

Draft Instructions & Guidelines
For Shariah Compliance
In Islamic Banking Institutions



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DRAFT INSTRUCTIONS FOR SHARIAH COMPLIANCE

IN ISLAMIC BANKING INSTITUTIONS

A. Appointment of Shariah Advisor:

Every Islamic Banking Institution¹ (IBI) shall be required to appoint a Shariah Advisor, the appointment of whom shall be made keeping in view the following instructions:

- i) Appointment of Shariah Advisor, together with its terms and conditions shall be approved by the Board of Directors in case of domestic IBIs and in case of foreign banks having Islamic Banking Branches (IBBs), Shariah advisor shall be appointed by the management.
- ii) Terms of Reference of the Shariah Advisor should be approved by the Board/management, as the case may be.
- iii) Shariah Advisor should meet the 'Fit and Proper Criteria for Shariah Advisors' notified by State Bank of Pakistan.
- iv) Appointment of Shariah Advisor shall require prior written approval from State Bank of Pakistan for which information about Shariah Advisor should be submitted to the Islamic Banking Department of State Bank on Form SAP, attached to the Fit and Proper Criteria for Shariah Advisors.
- v) Shariah Advisor should not be a director or shareholder of the IBI concerned.
- vi) The fatawa and rulings of the Shariah Advisor in all financial matters shall be binding on the IBI. He may, however, advise/issue guidelines on any matter referred to him by BoD/management.
- vii) If the appointment of Shariah Advisors working in domestic IBIs has not been approved by the Board of Directors of the bank before the issuance of these instructions, the same should be ratified within three months from the date this circular becomes effective.

B. Duties and Responsibilities of Shariah Advisor:

1. Shariah Advisor (SA) shall ensure that all products and services and related policies and agreements of IBIs are in compliance with Shariah rules and principles. Before launching any new products and services, the related policies and agreements shall be duly vetted by the SA. SA, in coordination with management, shall also conduct/arrange Shariah training programs for the IBI's staff. SA shall prepare a report on the Bank's annual financial statement in respect of its Shariah compliance the details of which are provided in Para C.

2. Shariah Advisor shall have access to all records, documents and information from all sources including professional advisors and IBI employees. The management shall be responsible to provide him all information relating to the IBI's compliance with Shariah. SA shall review operations of the IBI on a periodical basis in coordination with officials responsible for Shariah compliance to ensure that all the products and services being offered by the IBI conform to the injunctions of Shariah. If any income is declared non-Shariah

¹ Islamic Banking Institution means Islamic commercial banks, Islamic banking subsidiaries and Islamic banking branches of conventional banks licensed by State Bank of Pakistan.

compliant by the Shariah Advisor, the same shall be credited to Charity Account opened for this purpose.

C. Report of Shariah Advisor:

Based on review conducted in terms of aforementioned para B(2), the Shariah Advisor shall prepare a report, which shall be published in the IBI's annual report. The Shariah Advisor shall report that—

- i) whether or not he has examined, on test check basis, each class of transaction, the relevant documentation and procedures adopted by IBI.
- ii) whether or not in his opinion, the IBI has complied with Shariah rules and principles in its contracts, transactions, accounts and dealings and also with specific *fatawa* and rulings issued by the Shariah Advisor from time to time;
- iii) whether or not in his opinion, the allocation of funds, weightages, profit sharing ratios, profits and charging of losses (if any) relating to PLS accounts conform to the basis vetted by Shariah Advisor in accordance with Shariah rules and principles;
- iv) whether or not in his opinion, any earnings that have been realized from sources or by means prohibited by Shariah rules and principles have been credited to charity account.

D. Conflict Resolution in Shariah Rulings:

1. In case any difference of opinion arises between Shariah Advisor of the IBI and the State Bank's Inspection staff or other SBP departments regarding Islamic Banking practices, State Bank may refer the case to SBP Shariah Board and the decision of SBP Shariah Board, notified by State Bank, shall be final.
2. IBIs may refer issues relating to Shariah compliance to State Bank for consideration of SBP Shariah Board. In case management of any IBI has a difference of opinion on any ruling of their Shariah Advisor on the basis of Shariah principles, the management shall produce the ruling and arguments of Shariah Advisor alongwith their views based on Shariah. The decision of the SBP Shariah Board, notified by State Bank, shall be final.
3. Shariah Advisor of any IBI, with the concurrence of management, may also refer issues relating to Shariah compliance to State Bank for consideration of SBP Shariah Board. In that case, the case will be sent to SBP alongwith his arguments based on Shariah. The SBP Shariah Board shall provide guidance in such cases at its earliest convenience.

E. Permissible Modes of Financing and Investment:

1. Islamic Banking Institutions may offer following Shariah-compliant modes of financing and products based on these modes. BCD Circular No.13 dated 20th June, 1984 shall not be applicable on IBIs.

a. Participatory Modes:

- i) Mudaraba
- ii) Musharaka
- iii) Diminishing Musharaka
- iv) Equity Participation in the form of shares in a corporate entity

b. Trading Modes:

- v) Ijara or Ijara wa Iqtina
- vi) Murabaha
- vii) Musawama
- viii) Istijrar
- ix) Salam/ Parallel Salam
- x) Istinsa/Parallel Istisna
- xi) Tawarruq may also be used in exceptional cases requiring specific prior approval of SBP.

c. Debt Based Modes:

- xii) Qard

d. Others:

- xiii) Wakala
- xiv) Assignment of Debt
- xv) Jua'la

2. The above list of modes, however, does not preclude the possibility of developing new products by the IBIs with prior approval of their Shariah Advisor. Further, in addition to above mentioned modes, IBIs may also engage in other businesses as authorized under section 7 of BCO 1962, provided they are Shariah compliant.

3. It shall be ensured that any of the above mentioned permissible modes, which may not require security, will be subject to the usual limits for unsecured financing as mentioned in the various Prudential Regulations issued by State Bank of Pakistan.

4. Any security obtained by IBIs for participatory modes of Islamic financing shall not be applied or utilized to cover losses except those in case of negligence, fraud or misconduct by the customers.

5. It would be prohibited for IBIs to engage in or finance trading of *Haram* goods and services.

F. Essentials of Islamic Modes of Financing:

All IBIs are required to follow essentials of Islamic modes of financing provided in Appendix hereof in the course of their operations as minimum requirements for Shariah compliance in respect of products developed on the basis of such modes. Furthermore, these essentials should be considered *minimum* requirements for Shariah compliance and IBIs may include

additional conditions and controls in their procedures for the sake of more effective Shariah Compliance and prudence.

G. Use of Charity Fund:

1. Every IBI will create a Charity fund in which income of the IBIs from non-Shariah compliant sources or penalties and late payment charges received from clients in default or overdue cases etc. will be credited. The existing Prudential Regulations G-3 for Corporate/Commercial Banking will not be applicable to the Charity Fund created under these instructions related to Shariah Compliance. The amount in this fund will be utilized for charitable and social welfare purposes in accordance with the policy vetted by Shariah Advisor and approved by the Board of Directors, in case of locally incorporated IBIs or management in case of foreign banks having IBBs. A copy of this policy shall be submitted to the Islamic Banking Department of SBP within a period of seven days of its approval by the board. Any modification in this policy shall also be communicated to State Bank within a period of seven days of the change.

2. The IBIs shall maintain proper accounts and records regarding all transactions relating to Charity Fund and disclose in their annual audited financial statements a Statement of Sources and Uses of Charity Fund.

H. Introduction of New Products and Services:

The IBIs shall prepare a full set of documents including agreements, process flows, checklists and manuals pertaining to the deposit, investment and financing products being offered by them, duly vetted by the Shariah Advisor. A certificate from the Shariah Advisor will be submitted to SBP along with structure and salient features of the product before offering it to the customers.

I. Schedule of Service Charges:

In partial modification of BPD Circular 33 of 2003, the IBIs shall be required to provide original copy of the printed schedule of charges to the Islamic Banking Department in addition to the Banking Policy & Regulations Department of the State Bank of Pakistan, at least seven days before the commencement of the related half-year. IBIs shall ensure meticulous compliance of the following instructions while submitting schedule of charges to SBP:

- i) Islamic Banking Branches of Conventional banks shall have a separate set of Schedule of Charges for their business.
- ii) The set of Schedule of Charges submitted by the IBIs shall be signed by the bank's Shariah Advisor as an endorsement of Shariah compliance.
- iii) If IBIs want to fix different rate of charges for various categories of clients (e.g. according to volume of business etc.), then such categories should be clearly defined by the IBI.



DRAFT GUIDELINES FOR SHARIAH COMPLIANCE

IN ISLAMIC BANKING INSTITUTIONS

I. Shariah Compliance:

In order to strengthen the Shariah compliance mechanism within IBIs and to ensure that all relevant Islamic banking regulations are complied with in letter and spirit, IBIs are required to introduce Shariah compliance mechanism as a part of their control structure. Close coordination of Compliance officials with Shariah Advisor of the IBI may further help streamline the process with necessary inputs by the Shariah Advisor. The Shariah Compliance framework may include the following:

- ◆ A system of compliance having special emphasis on Shariah aspects with relevant provisions of existing laws, rules, regulations, policies and procedures related to Islamic Banking need to be embedded in the IBI's processes in such a manner that monitoring and reviewing of issues related to Shariah compliance forms part of internal control structure.
- ◆ Monitoring and reviewing for Shariah Compliance should cover all activities, products and locations of the IBI.
- ◆ The basic purpose of this responsibility is to ascertain whether the transactions, processes and products undertaken by the IBI are Shariah compliant and all related conditions are being met, as approved by Shariah Advisor.
- ◆ All necessary documents should be provided to Shariah compliance officials in performance of their functions.
- ◆ Irregularities, if any, related to Shariah Compliance shall be rectified with the approval of Shariah Advisor.

II. Internal Shariah Audit:

Islamic Banking Institutions should introduce a system of internal Shariah audit, so as to ensure that the goals and objectives of Shariah compliance are achieved, having regard to the following guidelines:

- a) Internal Shariah Audit of IBI may form part of the regular internal audit or as a separate unit depending upon size of operations of the IBI. The primary objective of the Internal Shariah Audit is to ensure that the management of the IBI is discharging its responsibilities in compliance with Shariah rules and principles as prescribed by the State Bank of Pakistan and the Shariah Advisor of the IBI. The purpose of the Internal Shariah Audit is to ensure that the system of internal control for Shariah Compliance is conceptually sound and effective in implementation, so as to ensure that the goals and objectives for Shariah compliance are achieved.
- b) The Internal Shariah Audit shall be carried out in conformity with Shariah rules and principles, guidelines and instructions issued by the State Bank of Pakistan and Shariah advisor of the IBI. The internal Shariah auditors shall have direct and

regular communications with all levels of management and Shariah Advisor. No scope limitation and restriction of access to documents, reports etc. shall be placed on Internal Shariah auditors.

- c) The report of Internal Shariah Audit shall contain observations and assessment of systems and controls in place for Shariah compliance. The Internal Shariah Audit report shall also include recommendations for potential improvements and corrective actions to be taken. Any disputes/difference of opinion between management and Internal Shariah auditors on matters relating to Shariah interpretation shall be referred to the Shariah Advisor of the IBI for decision.
- d) The report of the Internal Shariah Audit shall be placed before the Audit Committee of the IBI for consideration and appropriate remedial action as may be deemed necessary.

III. Investment in Shares:

1. IBIs, in the course of their business, may invest their surplus funds in shares of such companies whose primary business is not prohibited under Shariah. For investment in shares of such companies, a screening process for the selection of shares shall be followed. In this process, companies with acceptable primary business activities should be identified, which should be further evaluated according to several ratio filters as advised by the Shariah Advisor of the IBI in order to eliminate companies with unacceptable levels of non-Shariah compliant debts/non-Shariah compliant income/liquid assets.

2. If the IBI invests in the shares which meet above mentioned criteria for investment, and in the event a portion of non-Shariah compliant income exists in the investee company's accounts, then income of IBIs shall need to be purified and IBI's share of non-Shariah compliant income shall be donated to charity on pro-rata basis for the period of its holding of the share.

3. IBIs shall follow the regulatory limits prescribed by State Bank in Prudential Regulations in terms of their aggregate exposure in shares both in ready/cash and futures market, as amended from time to time.

IV. Policy for Profit Distribution with PLS depositors:

1. IBIs shall have a policy statement in place, vetted by the Shariah Advisor, regarding the policies and procedures to safeguard the interest of the Profit and Loss Sharing based deposit holders (PLS depositors). Following areas may be covered under this policy:

- i) Identification and determination of pools of Assets and related income and the basis of such determination together with method for allocation of profits/losses between the PLS depositors and the IBI (as a Mudarib or as an investment manager), whether or not IBI participates in the investment with its own funds
- ii) Policy for charging provisions against non-performing assets in compliance with Prudential Regulations and Profit Equalization Reserves out of

- income generated from PLS funds and to whom these provisions and reserves revert to, in case of write-back or recovery.
- iii) Policy on the priority for investment of own funds and those of PLS depositors
 - iv) Basis for allocating expenses to equity holders and various classes of depositors for determination and appropriation of profit.
 - v) Profit Sharing Ratio and Weightages for distribution of profit among various categories of deposits and periodicity for changing the same.
2. IBIs shall submit these policy statements to Islamic Banking Department of SBP within 30 days of issuance of these guidelines. Any modification in such policies shall be communicated to SBP within one month of the change.
3. The applicable Profit Sharing Ratios and Weightages for each type of deposits should be displayed in the branches and on the websites of IBIs for information of the general public.

V Financial Reporting and General Disclosure:

1. IBIs shall follow financial reporting standards for Islamic modes of financing issued by the Securities and Exchange Commission of Pakistan (SECP) under the Companies Ordinance, 1984.
2. In the annual report, IBIs are encouraged to disclose detailed working of profit distributed to depositors, break up of their financing by Islamic modes of finance and remuneration of Shariah advisor. In addition, IBIs should also disclose balance sheet and income statement of their Islamic banking operations in the annual report.

Nothing contained in these instructions and guidelines shall or be deemed to permit an IBI to engage in any business, transaction or trading which is contrary to the injunctions of Shariah.

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Appendix**1. Murabaha (Agreed profit margin sale with cash or deferred payment of price)**

i) Murabaha means a sale of goods by a person to another under an arrangement whereby the seller is obliged to disclose to the buyer the cost of goods sold either on cash basis or deferred payment basis and a margin of profit included in the sale price of goods agreed to be sold.

ii) Goods to be traded should be real, but not necessarily tangible goods. Credit documents cannot be the subject of Murabaha.

iii) Being a sale transaction, it is essential that the commodities which are the subject of sale in a Murabaha transaction, must be existing, owned by the seller and in his physical or constructive possession. Therefore, it is necessary that the seller must have assumed the risks of ownership before selling the commodities to the buyer/customer.

iv) Murabaha, like any other sale, requires an offer and acceptance which will include certainty of price, place of delivery, and date on which the price, if deferred, will be paid.

v) In a Murabaha transaction, the appointment of an agent, if any, the purchase of goods by or for and on behalf of the bank and the ultimate sale of such goods to the customer shall all be transactions independent of each other and shall be so separately documented. An agreement to sell, however, may embody all the aforesaid events and transactions and can be entered into at the time of inception of relationship. The agent would first purchase the commodity on behalf of his principal i.e. financier and take its possession as such. Thereafter, the client would purchase the commodity from the financier, through an offer and acceptance. According to Shariah it is sufficient in respect of the condition of 'possession' that the supplier from whom the bank has purchased the item, gives possession to the bank or its agent in such a manner that subject matter of the sale comes under the risk of the bank. In other words, the commodity will remain in the risk of the financier during the period of purchase of the commodity by the agent and its ultimate sale to the client (agent/buyer) and its possession by him.

vi) The invoice issued by the supplier will be in the name of the financier as the commodity would be purchased by an agent on behalf of such financier. It is preferable that the payment for such commodities should be made by the financier directly to the supplier.

vii) Once the sale transaction has been concluded, the selling price determined cannot be changed.

viii) It can be stipulated while entering into the agreement that in case of late payment or default by the client, he shall be liable to pay penalty calculated at percent per day or per annum that will go to the charity fund constituted by the bank. The amount of penalty cannot be taken to be a source of further return to the bank (the seller of the goods) but

shall be used for charitable purposes including the projects intended to ameliorate economic conditions of the sections of the society possessing little or nothing i.e. needy people/peoples without means

ix) The banks can also approach competent courts for award of solatium which shall be determined by the Courts at their discretion, on the basis of direct and indirect costs incurred, other than opportunity cost. Also, security or collateral can be sold by the bank (seller) without intervention of the court.

x) The buyer may be required to furnish security in the form of pledge, hypothecation, lien, mortgage or any other form of encumbrance on asset. However, the mortgagee or the charge-holder shall not derive any financial benefit from such security

xi) *A Murabaha contract cannot be rolled over because the goods once sold by the bank become property of the client and, hence, cannot be resold to the same (or another) financial institution for the purpose of obtaining further credit. The bank can, however, extend the repayment date provided that such extension is not conditional upon an increase in the selling price of goods, originally agreed.*

xii) *Buy-back arrangement is prohibited. Therefore, commodities already owned by the client cannot become the subject of a Murabaha transaction between him and any financier. All Murabaha transactions must be based on the purchase of goods from third party(ies) by the bank for sale to the client.*

xiii) The promissory note or bill of exchange or any evidence of indebtedness cannot be assigned or transferred on a price different from its face value.

2. Musawamah

Musawamah is a general kind of sale in which price of the commodity to be traded is stipulated between seller and the buyer without any reference to the price paid or cost incurred by the former. Thus it is different from Murabaha in respect of pricing formula. Unlike Murabaha, seller in Musawamah is not obliged to reveal his cost. All other conditions relevant to Murabaha are valid for Musawamah as well. Musawamah can be an ideal mode where the seller is not in a position to ascertain precisely the costs of commodities that he is offering to sell.

3. Ijarah (Leasing)

i) In Ijara/leasing, the corpus of leased commodity remains in the ownership of the lessor and only its usufruct is transferred to the lessee. Any thing which cannot be used without consuming the same cannot be leased out like money, edibles, fuel, etc. Only such assets which are owned by the lessor can be leased out except that a sub-lease is effected by the lessee with the express permission of the lessor.

ii) Until such time that assets to be leased are delivered to the lessee, lease rentals do not become due and payable.

iii) During the entire term of the lease, the lessor must retain title to the assets, and bear all risks and rewards pertaining to ownership. However, if any damage or loss is caused to the leased assets due to the fault or negligence of the lessee, the consequences thereof shall be borne by the lessee. The consequences arising from non-customary use of the asset without mutual agreement will also be borne by the lessee. The lessee is also responsible for all risks and consequences in relation to third party liability, arising from or incidental to operation or use of the leased assets.

iv) The insurance of the leased asset should be in the name of lessor and the cost of such insurance borne by him.

(It is hoped that arrangement shall soon be made for Islamic Takaful to replace the existing insurance system)..

v) A lease can be terminated before expiry of the term of the lease but only with the mutual consent of the parties.

vi) Either party can make a unilateral promise to buy/sell the assets upon expiry of the term of lease, or earlier at a price and at such terms and conditions as are agreed, provided that the lease agreement shall not be conditional upon such sale. Alternatively, the lessor may make a promise to gift the asset to the lessee upon termination of the lease, provided the lessee has fulfilled all his obligations. However, there shall not be any stipulation in the lease agreement purporting to transfer of ownership of the leased assets at a future date.

vii) The amount of rental must be agreed in advance in an unambiguous manner either for the full term of the lease or for a specific period in absolute terms.

viii) Assignment of only the lease rentals is not permissible except at par value.

ix) Contract of lease will be considered terminated if the leased asset ceases to give the service for which it was rented. However, if the leased asset is damaged during the period of the contract but is capable of being repaired, the contract will remain valid.

x) A penalty can be agreed ab initio in the lease agreement for delay in payment of rental by the lessee. In that case, lessee shall be liable to pay penalty calculated at the agreed rate in percent per day/annum. However, that penalty shall be used for the purposes of charity. The banks can also approach competent courts for award of damages, at discretion of the courts, which shall be determined on the basis of direct and indirect costs incurred, other than opportunity cost. Also, security or collateral can be sold by the bank (purchaser) without intervention of the court.

4. Salam (Advance payment--Deferred Delivery Sale)

i) Salam (advance payment against deferred delivery of goods) means a kind of sale whereby the seller undertakes to supply specific goods to a buyer at a future date in consideration of a price fully paid in advance at the time the contract of sale is made. .

ii) The buyer shall pay the price in full to the seller at the time of effecting the sale. Otherwise, it will be tantamount to a sale of debt against debt, which is expressly prohibited in Shariah.

iii) The specifications, quality and quantity of the commodity must be determined to avoid any ambiguity which could become a cause of dispute.

iv) Date and place of delivery must be agreed upon but can be changed with mutual consent of the parties.

v) Salam can be effected in respect of 'Dhawatul-Amthal' which represent such commodities the units of which are homogenous in characteristics and which are traded by counting, measuring or weighing according to usage and customs of trade. Therefore, other things such as precious stones, cattle heads etc. cannot be sold through the contract of Salam because every stone or individual animal is normally different from the others.

vi) It is necessary that the commodity which is the subject of Salam contract is normally expected to be available at the time of delivery.

vii) Salam cannot be effected in respect of things which must be delivered on spot. Examples are exchange of gold with silver or wheat with barley where it is necessary according to Shariah that the delivery of both be simultaneous.

viii) Salam cannot be tied to the produce of a particular farm, field or tree.

ix) In a Salam transaction, the buyer cannot contractually bind the seller to buy-back the commodity that will be delivered by the seller to the buyer. However, after the delivery is effected, the buyer and the seller can enter into a transaction of sale, independently, with their free will.

x) In Salam transactions the buyer shall not, before taking possession (actual or constructive) of the goods sell or transfer ownership in the goods to any person.

xi) The bank (buyer in Salam) can enter into a Parallel Salam contract without any condition or linkage with the original Salam contract. In one of them, the bank will be the buyer and in the second the seller. Each one of the two contracts shall be independent of the other. They cannot be tied up in a manner that the rights and obligations of original contract are dependant on the rights and obligations of the parallel contract. Further, Parallel Salam is allowed with a third party only.

xii) In order to ensure that the seller shall deliver the commodity on the agreed date, the bank can ask him to furnish a security.

xiii) In case of multiple commodities, the quantity and period of delivery for each of them should be separately fixed.

xiv) A penalty can be agreed ab initio in the Salam contract for delay in delivery of the concerned commodity by the client i.e. seller of the commodity. In that case, the client shall be liable to pay penalty calculated at the agreed rate in percent per day/annum. However, that penalty shall be used for the purposes of charity. The banks can also approach competent courts for award of damages, at discretion of the courts, which shall be determined on the basis of direct and indirect costs incurred, other than opportunity cost. Also, security or collateral can be sold by the bank (purchaser) without intervention of the court.

5. Musharaka

i) Musharaka means relationship established under a contract by the mutual consent of the parties for sharing of profits and losses arising from a joint enterprise or venture.

ii) Investments come from all partners/shareholders hereinafter referred to as partners.

iii) Profits shall be distributed in the proportion mutually agreed in the contract.

iv) If one or more partners choose to become non-working or silent partners, the ratio of their profit cannot exceed the ratio which their capital investment bears to the total capital investment in Musharaka.

v) If Mudarib in a Shirkah arrangement also contributes his own capital to the business, he will be entitled to share the profit in proportion to his own capital in addition to his share as Mudarib according to the agreed proportion.

vi) It is not allowed to fix a lump sum amount for any of the partners, or any rate of profit tied up with his capital. A management fee however, can be paid to the partner managing the Musharaka provided the agreement for the payment of such fee is independent of the Musharaka agreement.

vii) Losses are shared by all partners in proportion to their capital.

viii) All assets of Musharaka are jointly owned in proportion to the capital of each partner.

ix) All partners must contribute their capital in terms of money or species at an agreed valuation.

6. Mudaraba

i) Mudaraba means an arrangement in which a person participates with his money and another with his efforts and shall include banks, unit trusts, mutual funds or any other institutions or persons by whatever name called.

ii) A Mudarib who runs the business can be a natural person, a group of persons, or a legal entity and a corporate body.

iii) Rabbulmal shall provide his investment in money or species, other than receivables, at a mutually agreed valuation which shall be placed under the absolute disposal of the Mudarib.

iv) The conduct of business of Mudaraba shall be carried out exclusively by the Mudarib within the framework of mandate given in the Mudaraba agreement.

v) The profit shall be divided in strict proportion agreed at the time of contract and no party shall be entitled to a predetermined amount of return or remuneration.

vi) Financial losses of the Mudaraba shall be borne solely by the Rabbulmal, unless it is proved that the Mudarib has been guilty of fraud, negligence or willful misconduct or has acted in contravention of the mandate.

vii) The liability of Rabbulmal is limited to his investment unless otherwise specified in the Mudaraba contract.

viii) Mudaraba may be of various types which may be multi purpose or specific purpose, perpetual or for a fixed period, restricted or unrestricted and close or open-ended in accordance with the conditions respective to each of them.

ix) The Mudarib can invest his funds in the business of the Mudaraba with the permission of Rabbulmal. The condition is that in such situation, the Rabbulmal shall not be entitled to a proportion of profit in excess of the ratio that his investment bears to the total investment of the enterprise. The loss, if any, shall be shared in proportion to the capital of the parties.

7. Istisna

i) Istisna'a is an exceptional mode of sale, at an agreed price, whereby the buyer places an order to manufacture, assemble or construct, or cause so to do anything to be delivered at a future date.

ii) The commodity must be known and specified to the extent of removing any ambiguity regarding its specifications including kind, type, quality and quantity.

iii) Price of the goods to be manufactured must be fixed in absolute and unambiguous

terms. The agreed price may be paid in lump sum or in installments in the matter mutually agreed by the parties.

iv) Providing of material required for manufacture of commodity is not the responsibility of the buyer.

v) Unless otherwise mutually agreed, any party may cancel the contract unilaterally if the seller has not incurred any direct or indirect cost in relation thereto.

vi) If goods manufactured conform to the specifications agreed between the parties, the orderer (purchaser) cannot decline to accept them except if there is an obvious defect in such goods. However, the agreement can stipulate that if the delivery is not made within the mutually agreed time period, then the buyer can refuse to accept the goods.

vii) The bank (buyer in Istisna) can enter into a Parallel Istisna contract without any condition or linkage with the original Istisna contract. In one of them, the bank will be the buyer and in the second the seller. Each of the two contracts shall be independent of the other. They cannot be tied up in a manner that the rights and obligations of one contract are dependant on the rights and obligations of the parallel contract. Further, Parallel Istisna is allowed with a third party only.

viii) In Istisna transactions the buyer shall not, before taking possession (actual or constructive) of the goods sell or transfer ownership in the goods to any other person.

ix) If the seller fails to deliver the goods within the stipulated period, the price of the commodity can be reduced by a specified amount per day as per the agreement.

x) The agreement can provide for payment for penalty calculated at the agreed rate in percent per day/annum that shall be used for the purposes of charity. The banks can also approach competent courts for award of solatium, at discretion of the courts, which shall be determined on the basis of direct and indirect costs incurred, other than opportunity cost. Also, security or collateral can be sold by the bank (purchaser) without intervention of the court.

xi) In case of default by the client, the banks can also approach competent courts for award of damages, at discretion of the courts, which shall be determined on the basis of direct and indirect costs incurred, other than opportunity cost.

8. Diminishing Musharaka (*Newly Approved Essential by the SBP Shariah Board*)

Diminishing Musharaka (DM) is a form of co-ownership in which two or more persons share the ownership of a tangible asset in an agreed proportion and one of the co-owners undertakes to buy in periodic installments the proportionate share of the other co-owner until the title to such tangible asset is completely transferred to the purchasing co-owner.

- i) Diminishing Musharaka can be created only in tangible assets. Diminishing Musharaka shall be limited to the specified Asset(s) and not to the whole enterprise or business.
- ii) A DM arrangement would consist of following three steps, i.e.
 - a. Creation of joint ownership between the co-owners.
 - b. Renting out by one co-owner the undivided share in the asset owned to the other co-owner; and
 - c. Selling in periodic installments by one co-owner his share to the other co-owner(s)
- iii) All other terms and conditions as are essential to co-ownership, Ijarah and sale shall be fulfilled in respect of different stages in the process of DM arrangement.
- iv) Proportionate share of each co-owner must be known and defined in terms of investment.
- v) Expenses incidental to ownership shall be borne jointly by the co-owners in the proportion of their co-ownership.
- vi) Loss, if any, shall be borne by the co-owners in the proportion of their respective investments.
- vii) Risk and Reward shall be shared by the co-owners in proportion to their investment. Any other ratio, even if mutually agreed, shall be void.
- viii) The amount of periodic payment would go on decreasing with purchase of ownership units by the purchasing co-owner.
- ix) Each periodic payment shall constitute a separate transaction of Sale.
- x)
 - (i) Separate agreements/contracts shall be entered into at different times in such manner and in such sequence so that each agreement/contract is independent of the other in order to ensure that each agreement is a separate transaction.
 - (ii) The sequencing of the agreements in a DM shall be as follows:
 - a. There shall be an Agreement of co-ownership between the parties.
 - b. There shall be an agreement of Lease between the co owners to lease out one's share in such property to another for an agreed rental in consideration of the use of the former's share by the latter.
 - c. An undertaking by one of the co-owners to the effect to purchase the units of other co owner at a mutually agreed price until the entire ownership of the asset is transferred to the purchasing co-owner. Additionally, an undertaking shall be given by the other owner to the effect that he will sell the units owned by him to the first co-owner in the event the latter desires to purchase the units earlier than the agreed schedule on such price as may be mutually agreed.
 - d. The sale of units by one co-owner to the other co-owner as aforesaid shall be documented in such a manner as the parties may mutually agree.
- xi)
 - (i) In case a co owner fails to honour his undertaking, as aforesaid with regard to the periodic payment and purchase or sale of units as the case may be, the asset shall be sold in the open market and the co-owner aggrieved by such failure shall be entitled to recover:
 - a. Actual loss defined as the difference between the market price and price mentioned in the undertaking, if any, not being the opportunity cost.

- b. Any gain on sale of property, shall be shared by the co-owners in proportion of their respective investment at the time of such sale.
- (ii) In addition to the above, the co-owner shall be entitled to recover outstanding rental in respect of the period for which the other co-owner has actually used or possessed the asset which shall be payable to such co-owner.

DEFINITIONS:

9. Istijrar:

Istijrar is a contract between a client and a supplier, whereby the supplier agrees to supply a particular product from time to time (each time there is no offer or acceptance or bargain), on the basis of an agreed mode of payment. The sale price or its basis should be determined in advance. All other conditions relevant to Murabaha are valid for Istijrar as well.

10. Qard:

Qard is a contract of loan between two parties in which borrower is required to pay back only the amount borrowed. Any excess over the principle amount cannot be demanded and Qard is repayable on demand.

11. Wakala:

Wakala is a contract of agency in which one person appoints someone else to perform a certain task on his behalf on agreed terms and conditions, usually against a certain fee. Only such acts can be delegated which the principle is permitted to perform himself and the act permits delegation.

12. Assignment of Debt:

It is the transfer of the liability for a debt from the debtor to the liable person named in the contract. In other words, in this transaction the transfer of debt takes place from the transferer (Muheel) to the payer (Muha Alaihi). The transfer of debt differs from transfer of right as in transfer of debt a debtor is replaced by another debtor whereas in a transfer of right a creditor is replaced by another creditor.

13. Jua'la:

Jua'la is a contract in which one party (the Ja'il) undertakes to give a specific reward (the Jua'l) to *anyone* who may be able to realize a specific or uncertain required result (the Aa'mil). This mode may be used for recovery of financing, brokerage services, etc.

14. Tawarruq (Reverse Murabaha):

Tawarruq is an arrangement in which one party sells commodities to the other party on deferred payment at cost plus profit. The other party then sells the commodities to a third party on spot basis and gets instant cash.

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