Shari'ah Standard No. (37)

Credit Agreement

Contents

IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

This Standard aims to indicate the various types of credit facilities and their most important applications as well as the returns and commissions which result from them. The Standard also covers the Shari'ah rulings pertaining to credit facilities so as to be observed by Islamic financial institutions (Institution/Institutions).[1]

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This standard covers credit facilities and the returns and commissions arising from them, whether such facilities are practiced between the Institution and its clients or between the institution and other institutions.

2. Definition of Credit Facilities

2/1 The term credit refers to the financial transaction according to which one of the two parties becomes indebted to the other. Indebtedness in such transactions can arise at the beginning of the transaction, and this is known as direct cash credit such as loans and discounting of commercial papers. Instead, indebtedness could be only probable at the end of the transaction, and that is incidental credit, such as bank suretyship, letters of guarantee, bills of acceptance, and letters of documentary credit. The term "credit facilities" is used to denote credit in both cases. The concepts of credit and credit facilities are more comprehensive than the concept of financing which relates to the case of actual deferment of one of the two transacted objects.

2/2 According to this standard, credit facilities in institutions can be divided into the following types:

2/2/1 Cash facilities: This type includes the transactions in which the Institution presents funds, whether in the form of cash - as is the case in *Qard Hasan* (benevolent loan), Musharakah and Mudarabah; or in the form of an asset or usufruct - as is the case in Murabahah and lease financing. It should be noticed here that Musharakah and Mudarabah do not result in a debt owed by the client except in case of transgression or negligence.

2/2/2 Incidental facilities: This type includes the transactions which result in an incidental commitment owed by the Institution such as suretyship and letters of guarantee.

2/3 Transactions that entail instant delivery of the transacted objects are not considered as part of credit facilities.

2/4 The decision of granting credit facilities:

It refers to the approval of the Institution to enter into a credit facility with a specific client. The approved facility will be subject to a specific financial limit that can be used during a specific period of validity and subject to a certain date of maturity. The credit facility would also comprise specific conditions relating to guarantees, method of repayment and regulatory requirements. The decision of granting the facility is usually issued in the form of a letter addressed from the Institution to the client, indicating that the letter does not constitute any commitment from the part of the Institution unless transactions are actually commenced. Similar to letters of granting facilities, letters for renewal or extension of the period of already approved facilities also carry the same conditions.

2/5 Using credit facilities

It refers to commencement of the client to utilize the facility by submitting a request for a letter of guarantee or a letter of credit, or making a pledge to purchase a commodity or hire an asset through the Institution.

3. Types of Credit Facilities

3/1 Types of traditional credit facilities used by banks:

3/1/1 Loans

Loans refer to facilities payable on a specific date agreed upon between the traditional financial Institution and the client. Loans can be extended directly to the client, or through participation with other traditional financial Institutions, or through acquisition of bonds issued by the client.

3/1/2 Overdraft

Overdraft is a facility which the traditional financial institution puts at the disposal of the client to draw from it on need, up to a specific limit and within a given period.

3/1/3 Discounted papers

Discounted papers comprise commercial papers and bonds to order discounted in the traditional financial institution.

3/1/4 Issued credit cards

In this traditional form of credit facility, the indebtedness which can arise from using the credit card is determined for each client within a certain limit, and he can repay it in installments along with the interest.

3/1/5 Documentary credits

Documentary credits are among the facilities which traditional financial Institutions extend to their clients. In this case the Institution assumes the commitment to pay to beneficiaries the value of the credits opened for its client, whether the value of such credits is due on sight of the documents or on a date thereafter.

3/1/6 Bank acceptances

This type of facilities which traditional financial Institutions offer to their clients entails a commitment from the Institution, for the benefit of a client or for its own benefit, to pay to beneficiaries the value of the accepted papers when they are due.

3/1/7 Bank guarantees

Traditional financial Institutions offer this type of facility to their clients. In such facility the bank, upon request of its client, undertakes to pay to a third party the amounts indicated in the guarantees, on request and within a specific period.

3/1/8 Foreign exchange operations

Foreign exchange operations constitute a traditional facility offered to clients in deferred contracts of buying and selling foreign currency.

3/2 Types of Islamic credit facilities used by institutions

3/2/1 Murabahah and Musawamah

Murabahah and Musawamah are two types of sale transactions which constitute methods of financing used by Islamic financial institutions to cater for client needs for owning moveable as well as immovable assets. Contrary to Musawamah, in Murabahah the cost incurred by the Institution for obtaining the good must be indicated. [see Shari'ah Standard No. (8) on Murabahah]

3/2/2 Mudarabah

Mudarabah is a method of financing which institutions use for financing various economic activities. According to this method the institution enters the deal as the partner who subscribes the funds (Rab al-Mal) while the other partner (Mudarib) subscribes the work and performs the managerial duties. The two parties agree, within the contract, on a specific method for profit sharing, while the entire loss has to be borne by Rab al-Mal, unless it is due to transgression or negligence of the Mudarib. [see Shari'ah Standard No. (21) on Financial Papers: Shares and Bonds]

3/2/3 Permanent Musharakah and diminishing Musharakah

Musharakah is a method of financing in which the institution joins the client as a shareholder in the capital of a certain project or operation. In this case the two parties share the profits and losses according to a predetermined method specified in the contract.

3/2/4 Operational-cum-financing Ijarah

It is a method used for financing clients' needs for usufructs and assets. According to this method the institution purchases the assets and rents them to clients for specific periods, against periodical amounts of rent stipulated in the contract. [see Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek]

3/2/5 Istisna'a

Istisna'a is a method through which the institutions provide finance to their clients. In this case the institution assumes the commitment of manufacturing the equipment or the good, or constructing the buildings or the different types of capital assets according to the specifications agreed upon. The institution which provides finance in this manner has the right to sign a Parallel Istisna'a contract with another party to manufacture the asset in question.

3/2/6 Salam

Salam is a method of financing which institutions use for extending finance to owners of farms and merchants who want to spend on their business as well as on their personal needs. Under this mode of financing the Institution has the right to arrange Salam with another party through a parallel Salam contract.

3/2/7 Other financing operations

Finance can also be extended to clients through other financing operations which include among others: *Qard Hasan*, customer overdraft balances, letters of guarantee and letters of credit.

4. Shari'ah Status of Offering Credit Facilities

The decision to offer a credit facility and the facility agreement are considered as means of mutual understanding and exchange of non-binding promises for entering into transactions. The Shari'ah status of actual utilization of the facilities depends on the type of contract to be used.

5. Shari'ah Rulings on Credit Facilities

5/1 It is impermissible to use any of the traditional facilities mentioned in item 3/1 if it involves interest or would lead to an interest-bearing loan as is the case in guarantees and uncovered credits, or it would result in deferment of one of the two transacted objects as is the case in currency exchange contracts. [see Shari'ah Standard No.

(14) on Documentary Credit; Shari'ah Standard No. (2) on Debit, Charge and Credit Cards; and Shari'ah Standard No. (1) on Trading in Currencies]

5/2 The institution is not committed to pay any compensation to the client on rejection of his application to utilize the approved facilities, whereas the client also is free to use the facilities within the specified period or not. When the client refrains from using the facilities, he is not committed to pay any compensation to the Institution.

5/3 Returns and commission on credit facilities

5/3/1 First type: Commissions and returns which arise before contracting

5/3/1/1 Commission for credit study

The institution is permitted to take commission for the credit study it prepares internally or through an external party, so as to know the credit worthiness of the client and his ability to honor his commitments within the period agreed upon. Entitlement of the Institution to such commission is due to fact that the client has benefited from the study regardless of whether the study has led to acceptance or rejection of his request. The study shall become the property of the client who has the right to take it.

5/3/1/2 Commission for offering credit facilities

This commission refers to the amount which the Institution charges against allocating and specifying the limit of the facility. The institution usually charges such commission whether the deal is finalized or not. However, it is impermissible for the Institution to obtain commission for offering credit facilities, because the mere indication of willingness to enter into a lending and borrowing transaction does not justify remuneration. [see item 2/4/2 of Shari'ah Standard No. (8) on Murabahah]

5/3/1/3 Commission for renewal or extension of credit facilities

This type of commission should be treated in the same way like commission for offering credit facilities. [see item 5/3/1/2 above and Shari'ah Standard No. (8) on Murabahah]

5/3/1/4 Cost of preparing the contracts and forms pertaining to the transaction

5/3/1/4/1 The cost of preparing the contracts to be signed between the Institution and the client should be shared between the two parties, unless the contract indicates otherwise. Such charge should be fair and commensurate with the actual work load so as not to comprise an implicit fee for commitment or for offering the credit facility.

5/3/1/4/2 When Murabahah (or any other mode of financing) is used through syndicated financing the arranging Institution has the right to charge arrangement fees which has to be borne by the participants of the syndication. [see items 2/4/3 and 2/4/4 of Shari'ah Standard No. (8) on Murabahah]

5/3/1/5 Cost of the feasibility study of the project

The institution has the right to charge the cost of the feasibility study it prepares, when the client requests such a study for his own interest, and the cost of the study is agreed upon beforehand. [see item 2/4/5 of Shari'ah Standard No. (8) on Murabahah]

5/3/1/6 *Hamish Jiddiyyah* (security deposit)

The institution may charge the seriousness margin which refers to an amount of earnest money forwarded by the client at the stage of offering his binding pledge in Murabahah. In case of retreatment of the client from concluding the contract the amount of actual harm caused to the institution shall be deducted from the seriousness margin. [see item 7/8/2 of Shari'ah Standard No. (5) on Guarantees]

5/3/2 Second type: Commissions and returns which arise on signing of the contract

5/3/2/1 Commitment fee

The institution should not charge the commitment fee which relates to traditional facilities of interest-bearing loans, whether in the case of direct loans or the indebted-current (overdraft) loans. Such fee which traditional institutions charge to the client even if he has not used the facility, is also known as the "loan fee", or the "indebted-current facility fee", or the "financing fee". [see item 2/4/1 of Shari'ah Standard No. (8) on Murabahah]

5/3/2/2 'Arboun (Earnest Money)

It is permissible for the institution to charge such earnest money which constitutes part of the price paid in advance in sale and lease contracts. Such amount is owned by the seller or the landlord when the buyer or the tenant uses his right of terminating the contract. [see item 7/8/3 of Shari'ah Standard No. (5) on Guarantees]

5/3/2/3 Guarantee return

The institution should not obtain any returns on the guarantee relating to documentary credits, letters of guarantee, and bank suretyship, except actual expenses, whereas it can obtain returns for agency in documentary credits. [see item 7 of Shari'ah Standard No. (5) on Guarantees; and item 3/3 of Shari'ah Standard No. (14) on Documentary Credit]

5/3/2/4 Return on debt rescheduling

5/3/2/4/1 The institution should not obtain returns against extending the date of repayment of debts in all credit facilities. It should charge only the actual expenses of the rescheduling transaction. [see item 5/7 of Shari’ah Standard No. (8) on Murabahah; Shari’ah Standard No. (3) on Procrastinating Debtor, and item 3/3/1 of Shari’ah Standard No. (14) on Documentary Credit]

5/3/2/4/2 Renewal and extension of facilities should be done by entering into new contracts, rather than by extending the duration of the ongoing ones.

6. Obtaining Guarantees on Credit Facilities

The institution has the right to use permissible forms of guarantee in order to ascertain the fulfillment of the commitments of its client. [see item 3/4/1 of Shari’ah Standard No. (14) on Documentary Credits, and item 4/1/1 of Shari’ah Standard No. (5) on Guarantees]

7. Date of Issuance of the Standard

This Standard was issued on 17 Rabi’ I, 1430 A.H., corresponding to 15 March 2009 A.D.

Adoption of the Standard

The Shari'ah Board adopted the Standard on Credit Agreement in its meeting No. (23), held in the Kingdom of Bahrain, on Thursday – Saturday 15–17 Rabi' I, 1430 A.H., corresponding to 12-15 March 2009 A.D.

Appendix (A)
Brief History of the Preparation of the Standard

In its meeting No. (14) held on 21–23 Rabi' I, 1426 A.H., corresponding to 30 April – 2 May 2005 A.D., in Dubai (U. A. E.), the Shari'ah Board decided to issue a Shari'ah Standard on Credit Agreement.

On 24 Jumada I, 1427 A.H., corresponding to 20 June 2006 A.D., the Secretariat General decided to commission a consultant to prepare a study on Credit Agreement.

The study was discussed in a joint meeting of the Shari'ah Standards Committees (1) and (2), held in the Kingdom of Bahrain, on 19 Shawwal 1427 A.H., corresponding to 10 November 2006 A.D. The Joint Committee then advised the consultant to introduce the necessary changes in the Standard, in the light of the discussions and observations of the meeting.

The revised draft of the Standard was discussed in another joint meeting of the Shari'ah Standards Committees (1) and (2), held in the Kingdom of Bahrain, on 15 Jumada I, 1428 A.H., corresponding to 31 May 2007 A.D. The consultant was again advised to introduce changes in the standard as per the discussions and observations of the meeting.

The draft of the standard was discussed once again in a joint meeting of the Shari'ah Standards Committees (1) and (2), held in the State of Kuwait, on 21 Jumada I, 1428 A.H., corresponding to 7 June 2007 A.D. Further changes were introduced in the document in the light of the discussions and observations of the meeting.

In its meeting No. (19) held in Makkah Al-Mukarramah, on 26-30 Sha'ban 1428 A.H., corresponding to 8-12 September 2007 A.D., the Shari'ah Board discussed the changes in the standard which had been made by the consultant and introduced changes that it deemed necessary.

In its meeting No. (20), held in the Kingdom of Bahrain, on 4-8 Safar 1429 A.H., correponding to 11-15 February 2008 A.D., the Shari'ah Board discussed the changes introduced by the joint meeting of the Shari'ah Standard Committees (1) and (2), and introduced the changes which it deemed necessary.

The Secretarial General of AAOIFI held a public hearing in the Kingdom of Bahrain on 34 Safar 1430 A.H., corresponding to 19 February 2009 A.D. More than 30 participants attended the session as representatives of central banks, institutions, and accounting firms. Shari'ah scholars, university teachers and other interested parties also attended the session. Several observations were made and duly responded to by the members of the Shari'ah Standards Committees (1) and (2).

In its meeting No. (23) held in the Kingdom of Bahrain, on Thursday – Saturday 15–17 Rabi' I, 1430 A.H., corresponding to 12-15 March 2009 A.D., the Shari'ah Board discussed the amendments that had been suggested in the public hearing, introduced changes which it deemed necessary and adopted the Standard.

Appendix (B)
The Shari'ah Basis for the Standard

Shari'ah Basis for Charging a Fee for Preparation of the Credit Study

The credit study is a detailed study on the financial and credit position of the client so as to facilitate assessment of his credit worthiness and ability to honor commitments. According to Shari'ah, this task as such can constitute a remunerable service apart from the financing contract. The institution can even stipulate a condition that the study should be prepared by a third party. Charging the client for the credit study is also justified by the fact that the benefit from the study is shared between the financier and the financed party, rather than confined to the former only. The fee for the study should not necessarily be equal to the actual cost of its preparation, since it is a service which can be performed independently within the contract. Therefore, the credit agreement fee is considered as a fee payable for the effort exerted in preparation of the study as an independent service, irrespective of its results.

In this regard, the Shari'ah Board of Aayan Company for Leasing and Finance issued a Fatwa (Fatawa Aayan: 189), indicating permissibility of charging such fees. The text of that Fatwa runs as follows:

> "When the clients of Aayan Company wish to sign with Aayan Company permissible investment or financing contracts through Mudarabah, Musharakah or any other mode of financing, and if Aayan Company, for that purpose, needs to conduct a study on the financial status of these clients and their legal eligibility for concluding such contracts, it is permissible for Aayan Company to sign special contracts with these clients so that Aayan Company prepares the required study. For preparation of the study, Aayan Company may charge a fee to be paid by the clients on the basis of

the special contracts which should be completely separate from the financing and legal contracts pertaining to the deals in question. The prepared study should become the property of the client once he pays the cost of its preparation, and therefore Aayan Company should not deprive him the right of obtaining it. Aayan Company should handover the study to the client so that he can be able to use it in his deals with Aayan Company or with any other party".

Appendix (C)
Definitions

Financing

Financing takes place only when one of the two objects of the transaction is deferred such as loan, discounting of bills, simple credit, Murabahah, Salam and Istisna'a. Financing may not take place in suretyships, letters of guarantee, letters of documentary credits and bank acceptances. Therefore, the term financing is more special than the term credit. That is to say, any financing is credit, but any credit does not always lead to financing.

Indebted-Current

This is one of the traditional forms of extending loans to customers. In this case the customer (borrower) is given access to draw from an account opened for this purpose (the indebted-current account) up to a certain maximum limit which constitutes the amount of the loan, and within a specific period. A maximum date will also be specified for repayment of the drawn amounts. Such account is usually made subject to the following terms:

- The customer has to pay interest on the amounts he draws actually.
- The customer should pay a commitment fee calculable as a percentage of the total amount of the loan. Such amount is paid in addition to interest and is considered as Riba (usury).

The indebted-current account differs from the direct loan in that interest in the case of the former is paid at the end of the transaction's period. In the indebted-current account also interest is calculable on the basis of the amounts that have been actually used by the customer (the debit balance).

Facility Limits

The maximum limit of the facility is the total amount of the facility that has been approved by the institution. Such amount is extended through a specific mode of financing (Murabahah, Ijarah, letter of guarantee, documentary credit ….etc.). It constitutes the maximum exposure limit for the institution with regard to the specific client.

Credit Policy

Credit policy refers to the precautionary measures adopted by the Institution with the aim of safeguarding its funds in the light of rules and regulations and in view of the resolutions of its Shari'ah Supervisory Board and the prevailing principles and traditions in the field of its activities.

Credit Study

The credit study is the process of identifying the credit worthiness of the client and his ability to honor his commitments within the specified period. It also aims to assess the suitability of the type, size and currency of the requested financing to the activity to be financed, and to what extent the financing is commensurate with the resources and capabilities of the client in general. Moreover, the credit study indicates - subject to the nature of financing operations - the suitable guarantees to be requested from the client, whether for the debts and entitlements stemming from the operations or against transgression and negligence from his part. The final result of the study presents a clear recommendation on whether the client is to be offered the facility subject to certain conditions, or his application should be rejected on the basis of specific reasons.

The credit study covers the financial standing, cash flow, activity results, income, and expenses of the client. It also covers other various aspects such as past experience of the institution with the same client, image of the client, and his ability to manage his activity and stand any difficulties he may encounter while practicing such activity.

Facility Agreement

This agreement is signed between the client who applies for the facility and the institution when the decision to offer the facility is issued. The agreement indicates the type and amount of the facility as well as the guarantees and profit margin, or profit sharing ratio in case of Musharakah in Islamic transactions. Such agreement is not considered to be binding for the client before entering into the actual contracts.