TRADE-BASED CONTRACTS

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Our only interest is you.

Trade-based Contracts

Outline

Murabahah (Cost plus financing)

Bai Muajjal (Deferred sale)

Salam (Forward sale)

Istisna' (Manufacturing/construction)

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Trade-based Contracts

Murabaha (Cost plus financing)

- The origin of Murabaha is the word 'Rabaha' (i.e. to make a profit (from a deal). It is one of the trust sales contracts, which requires a seller to fully disclose the cost price of a good or asset and his profit margin, which could be a lump sum or a percentage of the cost price.
- A Murabaha is a sale in which the seller's cost of acquiring the asset and the profit earned from it are disclosed to the client or buyer.
- The Murabaha operated by NIFIs is referred to as Murabaha To Purchase Orderer (MTPO)

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Features of Murabaha (Cost plus financing)

SUBJECT MATTER	PRICE	DEFAULT	REPRICING
The subject matter/asset must exist at the time of contract execution. The bank must own the asset and have either physical or constructive possession. The asset must be a tangible good, clearly identified, quantified and Shariah compliant	✓ The Murabaha asset cost, including all expenses involved in the asset's acquisition, must be declared to the client ✓ Parties to the contract establish a profit rate by mutual consent or in relation to a specific and known benchmark which must be disclosed. ✓ The Murabaha price may be charged at spot or be deferred and paid as a lump sum at the end of the contract or in installments on fixed dates during the term.	There is no concept of a late payment penalty in a Murabaha contract, however, a charity clause is established at contract execution to serve as a deterrent to default. Based on the charity clause, the client is obliged to pay a predetermined amount to a designated charity account, which shall not be benefited from by the Bank, its staff or ACE members, and which disbursement is to be supervised by the ACE.	This is prohibited because the Shariah does not permit an increase in debt once it is fixed. Rescheduling is only permissible when the creditor provides an extension to ease the burden of a debtor, so a roll-over where the bank increases the debt in return for an extension is impermissible as the resulting amount of debt is analogous to riba or interest.

Steps of Murabaha Execution

PRU

The client's submission of a purchase requisition for Murabaha goods.

EARNEST MONEY

The client's unilateral promise to purchase the Murabaha goods and the financial institution's acceptance of collateral. The Bank requests the client to furnish a security or earnest money called Haamish Jiddiah. In case the client backs out from entering into a Murabaha, the bank makes up for the actual loss from it and returns the remainder to the client.

AGENCY

The agency agreement between the financial institution and the client or a third party. During the Agency stage the bank's exposure to asset risk. The Bank must also ensure that the asset to be purchased is not already in the client's possession by paying to the supplier before the agent/customer purchases the goods. The Bank can equally procure Murabaha goods directly or establish a third party agency.

POSSESSION

The possession of the Murabaha goods by the agent on behalf of the financial institution

ACTUAL SALE

The exchange of an offer and acceptance between the client and the financial institution to implement the Murabaha sale.

Murabaha – Varying Nature of Relationships

CLIENT'S PROMISE TO PURCHASE, NOT AN ACTUAL SALE

BANK– PRINCIPAL
CLIENT - AGENT

BANK– BUYER
VENDOR- SELLER

BANK– SELLER/CREDITOR
CLIENT- BUYER/DEBTOR

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Bai' Muajjal (Deferred/Credit Sale)

- ❖ Bai' Muajjal is a contract between a Buyer and a Seller for the sale of a specific asset to the Buyer at an agreed fixed price payable at a fixed future date in lump sum or by fixed instalments.
- ❖ As a Sale contract, the buyer must have ownership of the asset before the sale of same. The ownership may be actual or constructive

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Differences Between Murabaha and Bai' Muajjal

	MURABAHAH	BAI' MUAJJAL
1.	Sale on an agreed mark-up which may be at the spot or deferred	Sale on credit or deferred payment basis
2.	Key objective of a Murabahah is to make profit, the profit mark-up is thus an essential part of the contract	The key objective of a Bai' Muajjal is deferred payment of a sale which may be at discount, par, or premium of the cost price of the asset.
3.	As one of the Trust Sale contracts, the actual purchase price of the asset and the mark-up must be transparently disclosed in the contract document	The Vendor/Seller is not bound to disclose the actual purchase price to the customer orally or in the contract documents.
4.	Murabahah purchase may be effected either in cash or on credit	Bai' Muajjal sale must always be on credit. Payment is deferred.

Salam (Forward sale)

- ❖ Salam is one of the exceptions to the general rule of sale, i.e. tangibility, availability and ownership of the asset to be sold.

- ❖ Salam is a sale where the price of the subject matter is paid in full at the time of the contract's execution while the delivery of the subject matter is deferred to a future date.

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Salam (Forward sale)

- It is not necessary that the subject matter exist, and be owned and possessed by the seller at the time of the Salam's execution as is the customary requirement of a standard sale, provided it meets the other criteria specific to it.

- Salam allows the buyer to purchase commodities for a price lower than the spot market price, while providing capital for the vendor at the point when he needs it most, thus creating a win-win situation. The vendor wins and the purchaser wins.

Features of Salam (Forward sale)

HOMOGENEITY	NO AMBIGUITY	PRICE	DELIVERY
Salam may be executed for homogeneous commodities but not for specific commodities and mediums of exchange	The quantity and quality of Salam goods must be specified in order to avoid any ambiguity that may lead to dispute between contracting parties	Salam price must be paid at spot. The price is fixed and cannot be increased due to an increase in the price of Salam goods in the market during the contract's term	The place of delivery of Salam goods must be specified and they must be delivered in their entirety on a fixed future date or in installments on predetermined dates

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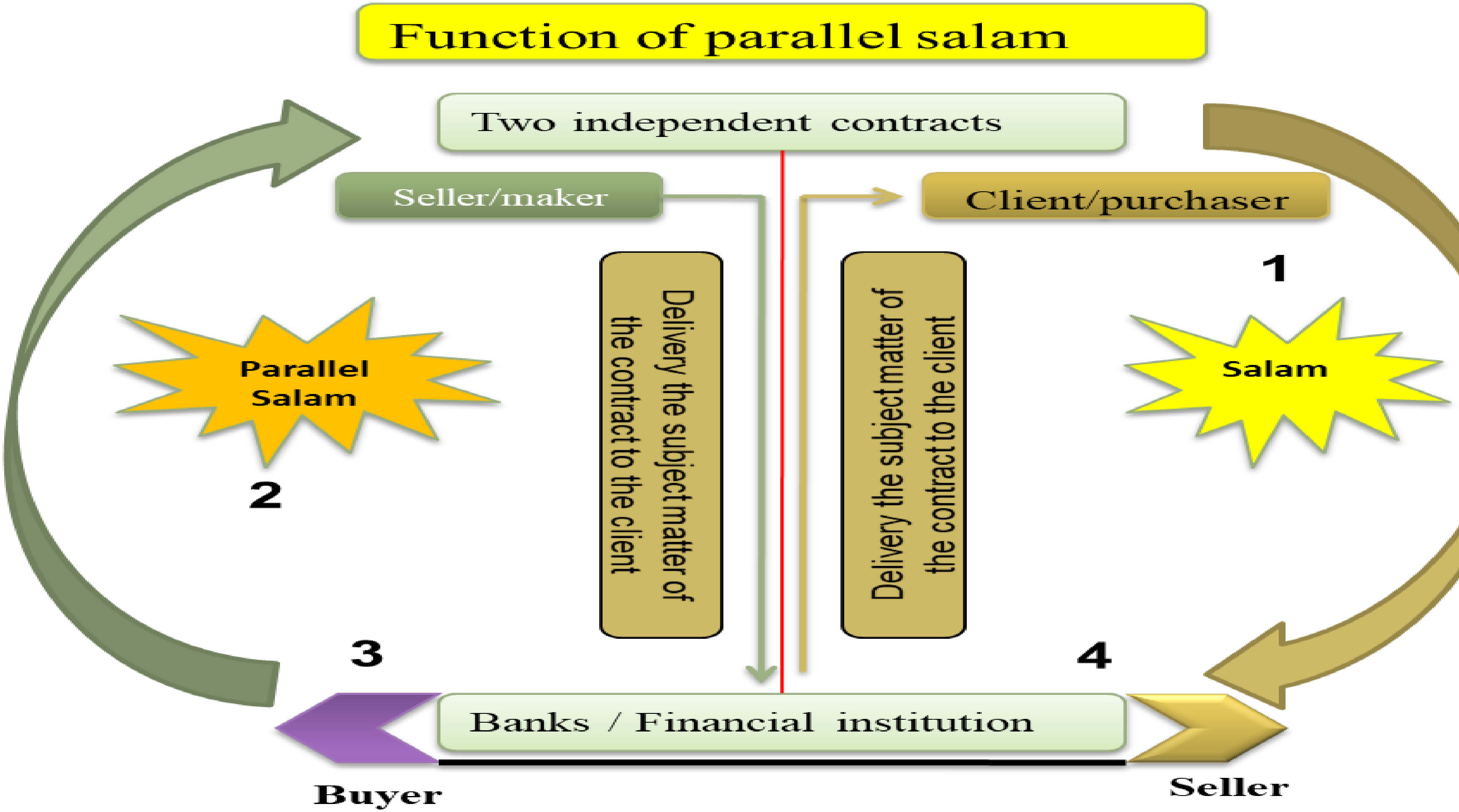
Features of Salam (Forward sale)

PARALLEL SALAM	OPTIONS	SALAM TERMINATION
Salam goods cannot be sold to a third party before receiving possession however a parallel Salam may be executed for them. A Parallel Salam is a transaction executed simultaneously with the original Salam. The buyer of goods in the first Salam is the seller of goods in the second or Parallel Salam. It is permitted with a third party only.	The Khiyar al 'Aib (option of defect) may be exercised for Salam subject matter, however, not the Khiyar al Rooyat (option of refusal).	Once executed, a Salam may not be revoked unilaterally by either party. It is a sale contract binding on both parties and may be terminated completely or partially by mutual consent by returning the actual or proportionate amount of the price paid

Process Flow of Salam (Forward sale)



Istisna' (Manufacturing/Construction Financing)

- Istisna, like Salam, is the second exception to the general rule of sale.
- An Istisna is a transaction used to acquire an asset manufactured on order. It may be executed directly with the supplier or any other party that undertakes to have the asset manufactured.
- There are usually two parties involved in an Istisna contract; the Istisna requestor, or orderer, and the manufacturer.
- An Istisna takes place when one party agrees to manufacture a product for another party at a specific price. This agreement involves an exchange of an offer and an acceptance which completes the contract.

Features of Istisna

SUBJECT MATTER	SUBJECT MATTER	SUBJECT MATTER	PRICE
The subject matter of an Istisna need not exist, be owned or possessed by the manufacturer at the time of contract execution	It must be an item that is manufactured as customary market practice and undergoes processing to convert from one form to another	The quantity or quality of Istisna subject matter can be changed by mutual consent of the contracting parties	The Istisna price, agreed at the time of contracting between the istisna requestor and the manufacturer, may be paid at the time of contract execution, in fixed instalments over the contract's term or as a lump sum at the end of the contract's term

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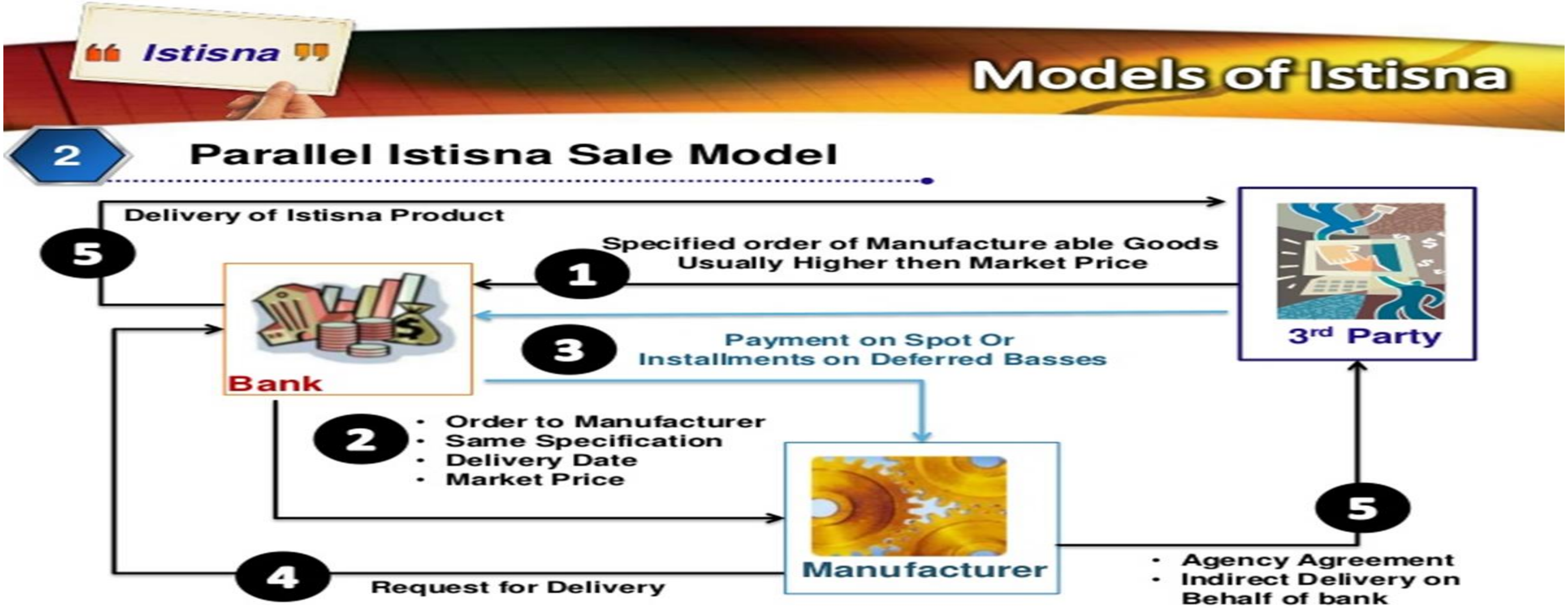
Features of Istisna

PARALLEL ISTISNA	ARBUN	NO BUY-BACK	ISTISNA TERMINATION
A parallel Istisna is a second Istisna contract executed alongside the first Istisna. The manufacturer in the original contract serves as the Istisna requestor in the parallel contract and profits from a difference in price. The parallel Istisna is completely separate and independent of the original Istisna contract	The Islamic bank may demand security in its capacity as requestor or manufacturer. Such a security is called Arbun. Arbun is a non-refundable down payment that the seller/manufacturer receives from the buyer/requestor, in order to secure the purchase of goods	The Istisna must not involve a buy-back at any stage. Before the Istisna is executed it is important to ensure that the contracting parties are separate and independent legal entities	Either of the two contracting parties may terminate the Istisna unilaterally provided the manufacturing process has not commenced. If manufacturing has begun then the contract is binding on both parties and can only be terminated by mutual consent

Process Flow of Istisna



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Differences Between Salam and Istisna'

	Salam	Istisna
Subject Commodity	Agricultural produce or existing and off the shelf goods or assets	Items not in existence or not fully developed or assembled to be fit for purpose
Price	Paid in full in advance	Flexible; may be in advance, at milestones or upon project delivery
Time of Delivery	Must be fixed at the contracting stage	May be reviewed, especially in the case of project delivery
Cancellation of Contract	Can not be unilaterally cancelled once concluded	Can be cancelled unilaterally even after concluding the contract, but must be before manufacturer or developer commence the project

Thank You!

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