

ECONOMIC EMPOWERMENT FOR FINANCIAL INSTITUTIONS



ISLAMIC FINANCIAL PRODUCT IMPLEMENTATION TOOLKIT

ECONOMIC EMPOWERMENT DEPARTMENT (EED)

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IMPLEMENTATION TOOLKIT**

Foreword from H.E the IsDB President



We find ourselves in a period of remarkable economic and social transformation. The developing and developed countries are evolving, shifting towards changing trends, norms, and realities. Civilization is on the threshold of a fourth technology-driven industrial revolution involving a digital transformation accelerated and galvanized by the Covid-19 pandemic. A new era has dawned upon us, and there is no turning back. The way we live, work, and interact has been intrinsically and profoundly altered. Navigating through this new reality necessitates that we reformulate traditional approaches to tackling poverty, sustainable growth, and development.

Under this new model, our 57 member countries—mainly developing nations—face unprecedented socioeconomic challenges and financial constraints. If left unchecked, these challenges threaten to plunge the global economy into economic malaise and secular stagnation, pushing millions more into poverty traps, which the IsDB and the international development community need to tackle.

Thus, the need to introduce innovative and unorthodox approaches/solutions to effectively provide lasting remedies and deliver impact has become exceptionally important. Achieving sustainable growth and development in the modern context demands a shift in the global development discourse, from a short-term (band-aid) mindset to a longer-term approach that seeks to address the root causes of growth stagnation and development degradation.

Therefore, under the President's Five-Year Program, the Islamic Development Bank has heralded a new paradigm to address development, the economic empowerment approach. Spearheaded by our newly formed Economic Empowerment Department, it is a neo-impact investment philosophy that aims to transform aid recipients and destitute, poverty-stricken individuals into empowered, productive members of society with the ability to take control of their economic destiny.

Traditional access to finance solutions provided by financial and microfinance institutions is not enough. To empower the poor, integrated, comprehensive, and customized solutions that enable the poor to

participate in highly competitive economic landscapes - thereby leveling the playing field - must be adopted.

Consequently, the Islamic Development Bank's economic empowerment approach emphasizes business engineering and design, i.e., the quality at the inception of projects, programs, and initiatives. By combining access to finance and (i) access to markets, (ii) capacity building, (iii) supporting regulatory environment, and (iv) supporting infrastructure, this innovative approach endeavors to ensure that the poor are economically included and assimilated into the mainstream economy as active participants and contributors to sustainable growth and development.

As part of its mandate to mainstream the economic empowerment approach into IsDB member countries, the Economic Empowerment Department has developed a comprehensive toolkit. It is a step-by-step guide for financial institutions and microfinance institutions on structuring and implementing commonly used Islamic modes of financing.

It provides practical examples and templates that can be adapted to various regulatory regimes or jurisdictions. Hence, this toolkit serves as an instrument to promote Islamic finance and economic empowerment. It simplifies adopting sharia-compliant financing for existing and prospective Islamic financial institutions interested in practicing economic empowerment.

Along with the other two complementing toolkits, the Economic Empowerment Design Toolkit and

Monitoring and Evaluation Toolkit, this Islamic Financial Products Implementation Toolkit promises to significantly mainstream the Islamic Development Bank's economic empowerment approach underpinned by Sharia-compliant financing mechanisms.

In keeping with the multifaceted commitment to our member countries and the development community to contribute to the Sustainable Development Goals, tackle poverty, and promote Islamic finance, I present an economic empowerment approach and a toolkit. It has the immense potential to concurrently address some of the world's toughest contemporary development challenges and play the role of *Catalyst for Making the Markets Work for Development*.

Dr. Bandar M. H. Hajjar

President, Islamic Development Bank Group



Acknowledgement

The Islamic Financial Institution Product Implementation Toolkit is the byproduct/outcome of the Islamic Development Bank's efforts to leverage over four decades of experience in structuring, investing, and implementing shariah-compliant financial institutions, products, and processes in member countries and Muslim communities. It draws on lessons learned, success stories, and especially on the expertise of IsDB staff and network of partners.

Ultimately, by developing the toolkit, the IsDB aims to provide accessible and easy-to-understand resources that simplify the processes leading to the adoption of the Islamic modes of finance and shariah-compliant banking, spurring the growth of Islamic finance ecosystem. Moreover, through the promulgation of this toolkit, the ethical and equitable principles that underpin Islamic finance and shariah-compliant banking will increase the share of Islamic financial assets beyond its current tiny percentage of total global financial assets.

Developing the toolkit would not have been possible without the dedication of the Economic Empowerment Department staff, particularly the Programs Team, led by Syed Hassan Alsagoff¹, with invaluable contributions from Mohamed Mazen Dakhli² and Mehmet Fehmi Eken³, as well as the critical support provided by Smail Haddad⁴ and Hazem Hamdy Hassan⁵ for the editorial review and Aboubacar Kante⁶ and Elhadi Elnahoui⁷ for the Sharia review.

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INTRODUCTION

1. CONCEPTUAL FRAMEWORK OF ISLAMIC FINANCE

The principles of Islamic finance and the prohibition of interest, or Riba, are based on principles of social justice and equity. Islam encourages earning of profits but forbids charging of interest because profits, realized ex-post, are legitimate socially (fulfilling justice) and economically (creating economic activity/assets). In contrast, interest, determined ex-ante, is a cost that is accrued irrespective of the outcome of the business operation. Social justice demands that financiers and their clients share rewards as well as losses in an equitable manner, and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

Based on the concepts of fairness and socioeconomic justice, the Islamic financial theory is fundamentally driven by the ultimate objective of achieving welfare of the societies we live in.

2. FUNDAMENTALS OF THE ISLAMIC FINANCIAL SYSTEM

The basic framework for the Islamic financial system is provided by a set of Sharia-prescribed rules and laws governing the financial and economic aspects of Islamic societies. While Islamic finance is widely understood to be interest-free banking, its principles go well beyond that. The fundamental principles of how Islamic financing is structured include the following:

- ▶ **Prohibition of “Riba al-Fadhl” and “Riba Al-Naseea”:** Riba is derived from the derivative word “raba-wa” it has certain meanings as “to increase; to grow; to grow up, to exceed, be more than. In the specific sense, Riba is generally translated into English as usury or interest but in fact it has a much broader sense under Shari’ah. Usurious transactions were classified into two categories: a) Riba al-fadl, the excess over and above the loan paid in kind. It lies in the payment of an addition by the debtor to the creditor in exchange

of commodities of the same kind and b) Riba al-nasi’ah, refers to the interest on loans; its prohibition essentially implies that the fixing in advance of a positive return on a loan as a reward for waiting is not permitted in Islam. Some scholars added a third category of Riba named Riba al-jahiliyah or pre-Islamic Riba, often manifested by the lender asking the borrower at maturity date if he will settle the debt or increase it.

On Riba, the direct Quranic references are to be found in four surahs or chapters. These verse are an ascending scale which starts with a mere judgment of value, followed by an implicit prohibition, then a limited one and finally, a total and conclusive prohibition (Al-Rum, 30:39; Al-Nisa, 4:161; Ali-Imran, 3:130 and Al-Bakarah, 2:275-9).

Moreover, the detailed varieties of usurious transactions as well as such prohibition have explained and elaborated by the Sunnah. For example, the Messenger of Allah (s.a.w.) has cursed the one who accepted Riba, the one who paid it, the one who recorded it, and the two witness of it, saying they were all alike. It is also reported that the Prophet (s.a.w.) has said to the effect: “(Exchange) gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, measure for measure and hand to hand. If the (exchanged) articles belong to different general, the exchange is without restraint provided it takes place in a hand to hand transaction.” It is more than evident from the above discussion that Riba i.e., interest in the modern world is categorically prohibited in the Holy Quran and practices of the Prophet (s.a.w.). Riba arises with loan: car loan, home loan, term loan or overdraft, hire purchase loan and personal loan; Riba in savings and fixed deposit account; Riba in credit card. More often than not Riba is intertwined with modern banking and finance¹.

- ▶ **Prohibition of “Excessive Gharar” (ambiguity) and “Maysir” (speculation/gambling):** Gharar refers to uncertainty or ambiguity that may lead to

¹ Principles of Islamic Finance: Prohibition of Riba, Gharar and Maysir, Md Akther Uddin, INCEIF, Malaysia

dispute between contracting parties. For instance, executing a contract before the price, subject matter, or transacting parties are definitively known. More specifically, the prohibition refers to excessive risk in a business transaction as a result of uncertainty about the existence or description of an object due to lack of information on the ultimate outcome of the contract or the nature or quality of its subject matter. More precisely, significant ambiguity in a deal from the initial establishment of the contract would be termed as *Gharar* and, hence, prohibited. All Islamic financial transactions must be based on transparency, accuracy and disclosure of all information necessary to restrict one party from gaining undue advantage at the cost of other party. *Maysir* broadly refers to speculative activities or acquiring unearned income and, as such, is prohibited. Sharia categorically prohibits easy acquisition of wealth by chance. Therefore, one is required to abstain from effortless gain and engage in realizing profit through trading, and not through dishonest appropriation of another party's property. Typically, financial products such as derivatives or other products that entail excessive uncertainty may be prohibited if excessive uncertainty is not addressed.

- ▶ **Asset-backed financing:** A financial transaction needs to result in asset creation linking directly or indirectly to a real economic activity. The asset-based aspect is considered one of the most important characteristics of Islamic finance. Profit is generated when something having intrinsic utility is sold for money. Therefore, financing in Islam is always related to real assets; either in trading, manufacturing or leasing, i.e. transforming monetary resources into goods and services. Islamic finance is focused on value generation as a result of conducting activities within the value chain.
- ▶ **Sharing risk:** The application of risk-sharing is most noticeable in profit-and-loss-sharing arrangements. In a *Mudaraba* arrangement, for example, profit is shared between the capital provider and the entrepreneur based on a contractual agreement, whereas losses under normal circumstances would be charged to

the capital. Similarly, in the case of *Musharaka* agreements profits are distributed according to a contractually-agreed ratio, whereas the liability of loss is proportionate to the capital contribution. In the case of underprivileged classes, sharing risk with counterparts brings confidence and encourages them to purchase new technology and innovate for higher profits. For this and other reasons, profit-and-loss-sharing contracts are known to promote greater stability in financial markets. Islamic financial contracting encourages financing institutions to focus on their relationships with client in the long run. Even in trading arrangements, such as *Murabaha* and *Salam*, the involvement of the economic empowerment institution (MFI/FI) in the value chain means that some of the risk initially borne by the client is transferred and shared with the MFI/FI. In any financial arrangement, the MFI/FI must go beyond its role as a financial intermediary. Being an arm's length lender to its clients, leaving them with all the burden of handling all business risks, is unacceptable.

- ▶ **Sanctity of contracts and exclusive permissibility of Sharia-approved activities:** Only those business activities that do not violate the rules of Sharia qualify for financing. For example, any investment in businesses dealing in alcohol, gambling or casinos would be prohibited. This is in line with the ethical principles of only financing activities that do not have negative effects on society.

3. MODES OF ISLAMIC FINANCE

Islamic financial institutions (IFIs) differ in operations from their conventional counterparts in many respects. Based on the Sharia fundamentals discussed above, IFIs source funds through investments from other parties under three main categories of financing modes, namely (a) benevolence-oriented financing; (b) trade-oriented financing; and (c) Investment-oriented financing.

Based on the expertise of the IFI, the type of clients it serves and its specific mandate, the most appropriate

mode of financing to fit the need of its clients is selected.

Benevolence-oriented financing

Qard Hasan

Qard Hasan is the main direct interest-free loan instrument. Qard Hasan loans are benevolent by definition, as they are meant to help the poor to either cover their emergency expenses or to benefit from an opportunity to generate income. This mode is also a dignified means of financing, providing the poor with an alternative to being a recipient of charity. Providing a Qard Hasan is a demonstration of solidarity with fellow humans, providing succour at times of dire need. If used to purchase medicine, the loan would help the recipient to recover, avoid further medical expenses and regain productivity. If used to purchase inputs, it would ensure that all income generated from the inputs would benefit the poor. It is strictly prohibited for financiers to gain any form of benefit from providing such a loan, although it could be allowed to charge the maximum actual expenses incurred in administering the loan under specific circumstances.

Trade-oriented financing

Murabaha

Murabaha is the sale of a commodity by an institution to its client as per the purchase price/cost with a defined and agreed profit mark-up.

Salam

Salam is the sale of a predefined commodity with deferred delivery and immediate payment of price.

Ijara

Ijara is the leasing of property pursuant to a contract under which a specified permissible benefit in the form of usufruct is obtained for a specific period in return for a specific permissible consideration (i.e. rent).

General Guidelines

The details of each financing mode will be described in subsequent sections. However, IFIs should generally take note of the following when performing trade with their clients:

- ▶ **Avoiding *Bai al-Inah*** (buyback arrangement): it is important to note that Murabaha cannot be used in cases where the goods to be financed have already been purchased by the end client. This is because in such cases the transaction would become an instance of *Bai al-Inah*, i.e. buyback agreement, which is impermissible.
- ▶ **Long-term Murabaha financing:** Murabaha is recommended for short-term financing (less than a year). However, it could also be used for longer maturity. Since there is a risk of Sharia non-compliance in the order of process flow, close monitoring of how commodities are transacted should be ensured. If the payment period is too long due to high capital expenditure, Ijara transaction would be preferred.
- ▶ **Salam is restricted to homogenous commodities:** Salam is also a useful product, but it can only be used where the client can deliver homogenous products (e.g. fruits and vegetables etc.) that can be described with precision.
- ▶ **Income accrual in Salam:** In Salam transactions, there should not be any accrual of income upon execution of the Salam. This skews the income of the institution using Salam transaction. In the absence of accruals, there will be no Salam income in the months prior to delivery and it will suddenly shoot up in the month of delivery when the subject of Salam is received and is disposed-off.
- ▶ **Murabaha vs. Ijara:** If an asset is tangible and is not yet purchased at the time of application by the client for financing and at the time of disbursement, then Ijara would be a better option than Murabaha. Moreover, if maximizing tax advantage is a major consideration, then Ijara would suit the client much better, as all Ijara transactions are supposed to be treated as operational and the component invested by the lessor, along with the rental component, are considered tax deductible.

expenses. It is pertinent to note that in the case of Ijara, the income on the Ijara portfolio is relatively “understated” in the first half of the Ijara tenure and gets relatively “overstated” in the second half due to the impact of depreciation, which has to be reflected in the books of the lessor (the MFI/FI in this case).

- ▶ **Diminishing Musharaka vs. Ijara:** As far as income leakage is concerned (costs associated with obtaining rental income), in relative terms, Diminishing Musharaka (business partnership) remains a better option, as it has no income leakage at all. However, repossession of a jointly owned DM asset in case of default makes DM a relatively weaker security to repossess and sell than an Ijara asset.

the entrepreneur.

The following chapters provide details on each mode of financing.

Investment-oriented financing

Musharaka

Musharaka is a business partnership where both parties provide a share of capital.

Mudaraba

Mudaraba is a business partnership where one party provides capital while the other contributes effort.

Diminishing Musharaka

Diminishing Musharaka (DM) is a business partnership where one of the partners agrees to buy the equity share of the other partner gradually until the title of the equity is completely transferred.

Both Musharaka and Mudaraba are Sharia-nominated contracts that promote economic activity. However, these modes are exposed to the risks of asymmetric information and moral hazard. Keeping such risks in view, preference should be given to Musharaka, where all parties share risk of loss.

Overall, both modes should preferably be offered to relatively larger businesses whose cash flows and audited accounts would be available to verify the business results. The main difference is that in Mudaraba the financier puts up 100% of the financing, while in Musharaka part of the capital is provided by



Qard Hasan

Qard Hasan is defined as the transfer of ownership in fungible wealth to a person on whom it is binding to return wealth like it [Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)]. The concept is akin to conventional loans but without the element of interest. However, the institution can charge for services rendered in loans equivalent to the actual amount directly spent on such services.

1. USES OF QARD

Qard Hasan (ie Interest-free Loan) can be used to finance working capital needs of very poor people. The clients should be selected very carefully (preferably using the poverty scorecard) to help target only those in dire need.

2. QARD VS. SHORT-TERM LOAN

Qard is the only strictly debt-based product among the various financial instruments available in Islamic Finance. Any benefit gained by the provider above the borrowed principle is strictly prohibited. However, charges are allowed on the loan strictly to recover the costs involved in providing it. In addition, borrowers are allowed to repay more than what they borrowed on their own free will as an expression of appreciation towards the lender. Any additional benefit above the principle and costs incurred is purely at the discretion of the borrower and may not be part of a contractual arrangement.

3. IMPACTFUL QARD HASAN THROUGH ECONOMIC EMPOWERMENT

Qard Hasan is typically provided to those in dire need to advance their future earnings towards meeting current obligations. Instead of receiving handouts, which is strongly discouraged, a more dignified approach would be to receive an interest-free loan. However, this loan would be more effective if it were

coupled with training and capacity building activities to foster a better livelihood. Penalty fees collected by the institution, which must be given to charity, may be used for such purposes. These efforts are aimed at lifting the client out of the cycle of poverty towards having a commercial relationship (using other modes of financing).

4. RULES AND STAGES OF QARD HASAN FINANCING

- ▶ The client applies for financing.
- ▶ The MFI/FI (through its financing officer) helps the client develop the project description, details of costs and total value of investment required.
- ▶ The application is then forwarded to the MFI/FI financing committee. Once the committee approves the request, it is entered into the list of applicants for the financing facility. The list is then forwarded to the respective Regional/Head Office, which arranges all necessary approvals and disbursement.
- ▶ The MFI/FI concludes a Qard Hasan agreement with the client and disburses the approved amount through the adopted standard procedure.
- ▶ The Qard Hasan agreement sets out the terms and conditions given below, whereby the MFI/FI and client agree:
 - ✓ The Qard Hasan amount and rate of service charge based on actual cost incurred in disbursing and administering this Qard.
 - ✓ The client's undertaking to repay the loan along with the service charge on the dates stated in the schedule of repayment incorporated in the agreement.
 - ✓ Detail of securities as required by the MFI/FI, in addition to a standard demand promissory note (Appendix-2)
 - ✓ The client agrees to submit the purchase

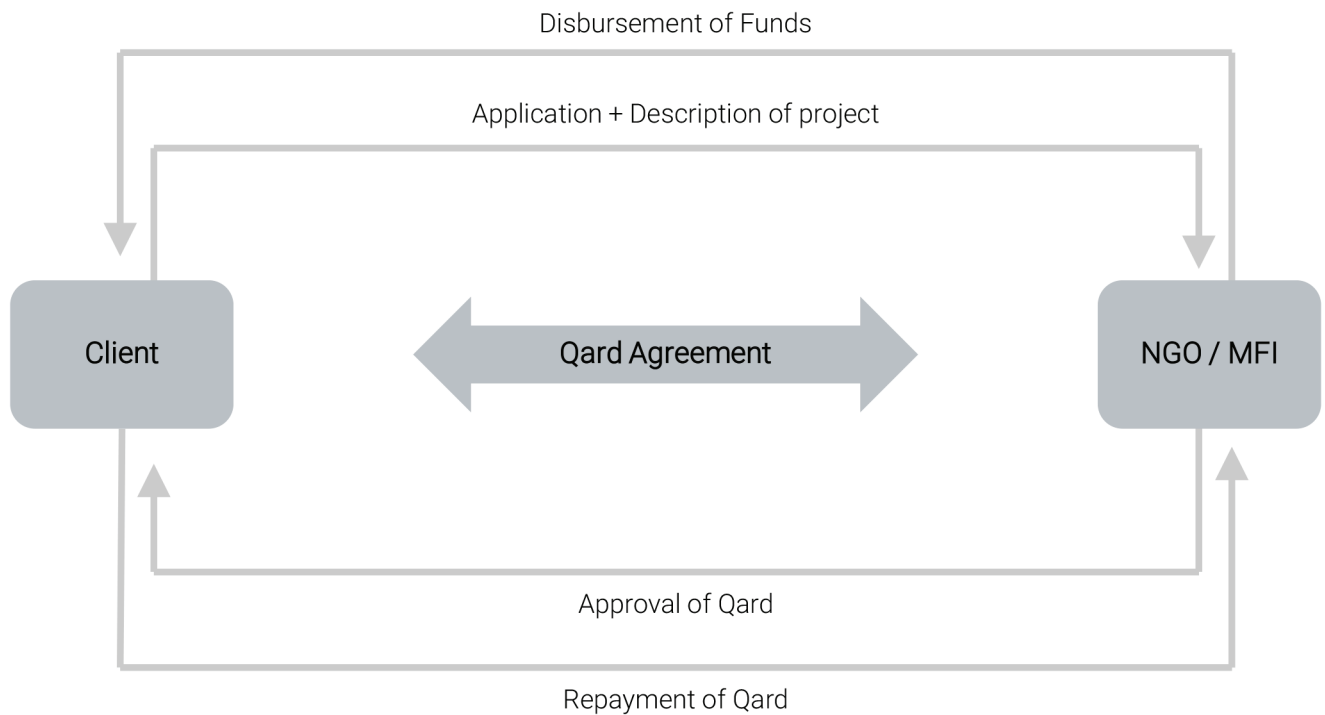
receipts and other proof of utilization documents to the MFI/FI.

MFI/FI to cover the expenses incurred in the recovery of its dues.

✓ In case of client default requiring litigation, the court may also award compensation to the

▶ Once the Qard, along with service charge, are fully recovered in full and no outstanding amounts remain in respect of the Qard or any other liability on the client, a No Demand Certificate is issued.

Figure 1. Qard Hasan Process Flow



5. QARD ACCOUNTING/BOOKKEEPING

The accounting treatment and bookkeeping of Qard is not different from conventional loans, except that the actual service charge is recovered as income instead of interest amount, as shown in the following example.

Table 1. Qard Hasan Accounting Example

Qard Instalment Plan						
Microenterprise - Working Capital Financing Qard						
Enterprise description	New microenterprise - village store					
Asset specification	Singer automatic sewing machine					
Description of project	The MFI/FI screens the client and classifies him as very poor using the poverty score card. A Qard of \$2,000 is approved, to be repaid over a period of 12 months in monthly instalments. The service charge is set at 2.5% based on the MFI/FI's administrative expenses in respect of this transaction. Procurement of supplies for the grocery store is planned on monthly basis. However, to provide sufficient time for the client to repay the Qard, a one-year period is allowed for repayment.					
Amount of Qard disbursed						\$2,000
Date of disbursement						1-Jan-2014
Tenor						12 Months
Service Charge (SC)						2.50%
Date of First Instalment						1-Feb-14
Instalment Payment						
#	Due Date	Balance	Amount of instalment	Amount of SC		
1	1-Feb-14	2,000	168.93	4.17	Rate of SC	2.50%
2	1-Mar-2014	1,835.23	168.93	3.82	Tenure (months)	12
3	1-Apr-2014	1,670.13	168.93	3.48	Periodic Rate	0.21%
4	1-May-2014	1,504.67	168.93	3.13	Monthly Payment	168.93
5	1-Jun-2014	1,338.88	168.93	2.79		
6	1-Jul-2014	1,172.73	168.93	2.44		
7	1-Aug-2014	1,006.24	168.93	2.10		
8	1-Sep-2014	839.41	168.93	1.75		
9	1-Oct-2014	672.22	168.93	1.40		
10	1-Nov-2014	504.69	168.93	1.05		
11	1-Dec-2014	336.81	168.93	0.70		
12	1-Jan-2015	168.58	168.93	0.35		
Total			2,027.19	27.19		

Processing charges:

instalments are paid on other than monthly schedule.

Dr. Part A/C xxxxx

Payment of Instalments

Cr. Processing charges A/C xxxxx

Each instalment is scheduled for receipt on the first day of the month following the instalment due date as follows:

At the time of disbursing Qard, the following entries will be passed:

February 1, 2014

January 1, 2014

Dr Qard A/C 2,000

Dr Party A/C 168.93

Cr Party A/C 2,000

Cr Qard A/C 164.77

January 31, 2014

Cr Service charge receivable 4.17

Dr Service charge receivable 4.17

(Entries will repeat at the time of payment of each instalment but with different amounts of principal and service charge).

Cr Income A/C 4.17

Note: Accrual will be posted every month, even if the

6. QARD HASAN COMPLIANCE CHECKLIST- GUIDANCE FOR SHARIA CONTROLLER/AUDITOR

#	Item	Remarks
	General	
1	Obtain a list of all Qard Hasan transactions entered into by the MFI/FI during the period under review.	
2	Select a sample of the transactions and obtain their respective agreements/ supporting documents and amounts disbursed from the account books.	
3	Compare the sampled agreements with the standard agreement as approved by the Sharia Governance Committee (SGC).	
4	Document the transaction flow.	
5	Ensure that the documented transaction flow is in agreement with the standard of Qard Hasan transaction flow.	
	Internal Controls	
6	Does the MFI/FI ensure that there are no form of charges or fees incurred by the client?	
7	If there are any costs that are transferred to the client in administration of the Qard, do the charges/fees reflect the true costs incurred? Any charges incurred by the client should not be higher than the true cost of administration of the loan.	
8	Does the MFI/FI ensure that the subject matter of the transaction is of a permissible type?	
9	Are there adequate measures to ensure that the Qard provided is for the wellbeing of the client?	
10	Ensure that the terms of the agreement are not amended except with the specific approval of the SGC.	

#	Item	Remarks
11	Ensure that in case of default by the client, additional amounts paid to the MFI/FI is collected in a charity account and donated to a charitable institution approved by the SGC.	
12	Ensure that the agreement is properly signed and witnessed.	
	Donation Undertaking	
13	Inquire about clients in default.	
14	Obtain a list of those clients.	
15	Obtain list of charitable institutions approved by the Sharia Governance Committee (SGC).	

7. QARD CONTRACTS AND DOCUMENTATION

Qard application form

Date: _____

To: _____ [Insert name and address of the Institution]

We would like to request a financing facility as follows

1.	Recommended facility type (Murabaha/Salam/DM/Qard)*	
2.	Amount required (\$)	
3.	Tenor/Period (months)	
4.	Purpose (e.g. purchase of raw material)	
5	Proposed business activity (e.g. manufacturing of plastic bottles)	
6	Proposed total investment required for business (\$)	
7	Of which applicant's contribution (if applicable) is	_____%
8	Experience in business	_____years
9	Professional training received	YES <input type="checkbox"/> NO <input type="checkbox"/>
10	Proposed business commencement date	
11	Business address	Owned <input type="checkbox"/> Old Lease <input type="checkbox"/> New Lease <input type="checkbox"/>
12	Business premises	
13	Proposed legal form of business	
14	Taxation status	
15	Protest status	
16	No. of employees	
17	Expected no. of new employees	
18	Applicant's name	
19	Address (residence)	
20	Mobile phone	

21	Telephone Work / Home		
22	Gender	Male	Female
23	National No.		
24	ID card status	(Personal/Family) with No:	Dated:
25	Office of issue		
26	Date of birth		
27	Qualification		
* Provided by the MFI/FI. The officer responsible for filling up the information provides a recommended type based on information gathered from the applicant			

We would like to request a financing facility as follows

For and on behalf of

_____ [Insert name(s) of applicant(s)]

Qard facility offer letter

Qard Date:

To: _____ [Insert name and address of the applicant(s)]

Dear Sirs,

We refer to your application dated _____ and are pleased to advise you of the facility approval as per the terms given below:

1	Facility	Qard
2	Limit approved (\$)	
3	Service charges (if applicable, maximum is stated, but actual is charged)	
4	Facility tenor (months)	
5	Payment (in case of Qard)/Repayment (in case of Murabaha/Salam/DM) frequency [delete as appropriate]	
6	Security: (promissory note, personal surety, direct debit authority/post-dated cheques, other securities as agreed, etc.)	
7	Comprehensive Takaful/insurance (for default and assets)	
8	Other requirements, if any	

For and on behalf of

_____ [Insert name of Institution]

Acceptance of facility offer letter and terms and conditions

Date: _____

To: _____ [Insert name and address of the Institution]

Reference your approval of our request dated _____, we hereby accept the facility and terms and conditions of the approval provided and request to proceed with the facility. We undertake to abide by the terms of approval. We shall provide a promissory note, surety and also furnish collateral, if required. We also undertake to avail the facilities and meet all documentation, customary and other requirements, in form and substance acceptable to the Institution wherever required.

Accepted, as above.

For and on behalf of

_____ [Insert name(s) of applicant(s)]

Qard (interest-free loan) agreement

This Qard (interest-free loan) agreement ('the Agreement') is made on this _____ day of _____. Between _____, incorporated under the laws of (Country name), having its registered offices at _____, through its _____ (hereinafter referred to as the "Institution" which expression shall, where the context so permits, mean and include its successors-in-interest and assigns), of the one part; and _____ (hereinafter referred to as the "Client" which expression shall, where the context so permits mean and include its legal heirs, successors-in-interest and assigns), of the second part.

It is agreed by the parties as follows:

Whereas, on the basis of information provided in the Appendix in description of the Project, the Institution has agreed to grant a Qard financing to the Client on the terms and conditions hereinafter appearing.

Now, therefore, this agreement witnesses as under:

1. The Institution hereby agrees to provide to the Client a Qard facility (hereinafter referred to as the "Loan") up to a maximum of local currency _____ (_____ only) on the basis of the description, cost and value of the project as in Appendix-1 and the terms and conditions hereinafter contained.
2. The parties hereto hereby mutually agree and covenant as under:
 - 2.1 The Client undertakes to repay the Loan with no added interest. However, the Institution is entitled to recover service charges up to a maximum of _____% and equivalent to the actual cost of disbursing and administering the Loan.
 - 2.2 The Client agrees to submit to the Institution the Demand Promissory Note (as per Appendix-2) for the full value of the Loan (principal + service charges).
 - 2.3 The Client agrees to repay the Loan and pay the service charges as per the schedule given in Appendix-3.
 - 2.4 The Client hereby agrees and undertakes to give such security as may be acceptable to the Institution and the terms and conditions of which shall be such as the Institution may determine.



Murabaha

Murabaha is the sale of a commodity by an institution to its client as per the purchase price/cost with a defined and agreed profit mark-up. It is a contract of sale in which the seller declares his cost and profit. The client purchases the commodity against either immediate or deferred payment. Some observers see this mode of Islamic finance as similar to a conventional interest-based lending operation. However, two major differences are that the mark-up in Murabaha is for the services the institution provides (for example, seeking and purchasing the required commodities at the best price), and that the mark-up is not expressed as a function of time. As such, if the client fails to make a deferred payment on time, the mark-up is not increased for the delay. Also, the institution owns the commodities before selling them, which means it carries the associated risks.

1. MURABAHA AS A MODE OF FINANCING

Classically, Murabaha is a particular type of sale and not a mode of finance. The declaration of cost by the seller and the buyer's agreement of a given profit margin for the seller are fundamental features of a Murabaha-based sale. Classical Murabaha is a spot sale transaction where the buyer must pay the agreed price at the time of sale with no deferment. As Sharia

permits deferred payment sales, whereby a seller sells an asset for a certain price based on an agreed mark-up over the cost price, this has led to using Murabaha financings associated with deferred payment. If the financial institution manages to obtain a discount on the price it buys at, it will benefit the client himself, as the discounted price is used as the cost price and the buyer pays the sale price (with the mark-up) over an agreed period of time (lumpsum or instalments).

2. USES OF MURABAHA

Murabaha can be used for the following specific client needs, amongst others:

- ▶ Product inventory
- ▶ Purchase of raw material or commodities
- ▶ Purchase of agricultural inputs
- ▶ Purchase of equipment and machinery
- ▶ Purchase of vehicles (taxicabs, transportation trucks, etc.)

3. MURABAHA VS. SHORT-TERM FIXED LOAN

Features of Murabaha	Features of a fixed conventional loan
Financing is based on a real asset	Need not be based on a real asset
Direct transfer to supplier preferred	Disbursement in cash to borrower
If permissible, an undertaking to pay a certain amount to charity in case of non-legitimate (non-genuine, non-justified or non-proved) delay in payment (except the expenses incurred by the financial institutions due to the non-genuine delay that need to be payed to the institution itself)	Typically, they are considered as penalties, i.e. becomes the property of the financial institutions when payed and are they are not capped

Features of Murabaha	Features of a fixed conventional loan
If permissible, the payments to charity shall not be recognized as income. Also, the institution cannot gain any implicit or explicit benefit	Penalty payments or additional interest taken as income
No additional profit above the agreed selling price due to rescheduling of payments allowed	Additional interest generated as income for delays in payment or due to rescheduling of payment
Asset and activity are Sharia-compliant	Asset and activity not necessarily Sharia-compliant

4. IMPACTFUL MURABAHA THROUGH ECONOMIC EMPOWERMENT

MFI/FIs that engage in Murabaha should negotiate with suppliers for the assets required by clients. Since the assets required by one client are also often required by other clients, the MFI/FI can arrange for bulk purchase of such assets or supplies (e.g., fertilizer, seeds, raw materials etc.). Some institutions even have their own storage facilities to effectively play the additional role of a wholesaler, while others negotiate with suppliers to be a preferred agent, with discounts ranging 10%-40% of the retail price. The savings generated from the negotiated discounts are passed on to their clients. Hence, the MFI/FI is not only the place where clients seek financing for supplies, but also the place they turn to for lower prices. By offering lower prices, the MFI/FI become a preferred retailer to which the client goes on a regular basis for supplies, financing or both.

5. RULES OF SALE APPLICABLE TO MURABAHA TRANSACTIONS

Being a contract of sale, the Murabaha transaction must comply with the general Islamic rules of sale, including:

- ▶ The subject of sale must exist at the time of sale
- ▶ The subject of sale must be in the ownership (or right to sell) of the seller at the time of sale
- ▶ A sale to be transacted on a future date or conditional to a future event is not allowed
- ▶ The price of sale must be known

- ▶ The subject of sale must be Halal (i.e. Sharia-compliant asset or activity)
- ▶ The subject of sale must be tangible/ identifiable
- ▶ There must be no ambiguity about the deliverability of the asset
- ▶ The cost price, selling price and mark-up of the transacted asset must be clearly known and defined.
- ▶ Deferred sales may be priced differently from spot sales

6. PARTIES TO MURABAHA

- ▶ Financing institution (seller and creditor)
- ▶ Vendor (supplier)
- ▶ Client (buyer and debtor)

7. STAGES OF MURABAHA

It is crucial to understand the different stages of a Murabaha transaction and follow these in the right order to maintain Sharia compliance. These stages are as follows.

Promise

At this stage, the client gives a legally binding purchase undertaking to the MFI/FI to purchase the goods procured by the latter based on his requisition (order form). In this regard, the following additional points should be noted:

- ▶ The transaction must be bona fide. The transaction may not relate to a current contractual relationship between the client and supplier (from whom the MFI/FI is to acquire the asset) as it is

not permissible to transfer a contract that has been executed between client and supplier in the past unless such contract is already completely revoked.

- ▶ Similarly, the MFI/FI must ensure that the party from whom the asset is being bought is a third party and not the client or an agent of the client. This helps avoid turning the Murabaha into a prohibited buyback transaction.
- ▶ The MFI/FI may ask the client to provide a security deposit to enforce the client's undertaking in case of non-fulfilment. This deposit may be converted into payment of the first instalment of the agreed Murabaha price.

Agency

The MFI/FI should acquire the asset based on the required specifications at an efficient price through negotiation with the supplier. It should be in a better position to provide market information on prices and would be more aware of the actors in the value chain. This is especially true for most homogeneous assets (e.g. fertilizer, seeds, small equipment, etc.). However, should there be a situation where the client is in a better position to acquire the desired quality of the asset at a better price, it is allowed to engage agents to acquire the asset on behalf of the MFI/FI. This is, nevertheless, more of an exception to the norm, and MFI/FIs should strive to develop their capacity to be a better purchasing agent than their clients. Additional points to consider, in this regard, are:

- ▶ Allowing appointment of the client as an agent should only be used as a last resort, as Sharia strongly encourages agency to be with a third party other than the client, therefore avoiding any non-bona fide exploitation of the contractual relationship.
- ▶ Agency can be specific for a certain transaction after which it terminates (when only a single Murabaha transaction is to be executed) or remain effective until terminated in writing by the MFI/FI (when a series of Murabahas or sub-Murabahas are undertaken through a single agency agreement)

- ▶ To exclude it from being a volunteered act, and to avoid any confusion with the subsequent expected selling transaction, it is highly recommended that a nominal agency fee (Wakalah fee) should be paid by the MFI/FI to the agent.
- ▶ All roles and responsibilities between principal and agent must be listed and agreed upon.

Acquisition

This is the stage where the MFI/FI acquires the asset, either directly or through the agent. Points to consider include:

- ▶ The MFI/FI must inspect the asset purchased by the agent to ensure genuineness of the transaction.
- ▶ In case of a third-party agency arrangement, the MFI/FI must match the specifications of the acquired asset with those written in the order form.
- ▶ The proof of purchase must confirm that the sale of asset happened only after the appointment of the agent.
- ▶ In some cases, it may be quite burdensome for the client to submit all the invoices if there are too many of them. For example, a number of small batches may be purchased from various sources when buying fruits, vegetables, and the like. In such situations, the clients can be allowed to submit a summary sheet as follows:
 - Date; Description of Asset; Invoice No.; Quantity; Price
 - Certification that the above invoices are available in our records and MFI/FI's representative may review and verify these invoices.
- ▶ Alternatively, the agent can sign a purchase agreement with the supplier.
- ▶ The MFI/FI should make direct payment to the supplier upon confirmation that the asset has been received.

Execution

At this stage, the Murabaha sale agreement is concluded between the client and the MFI/FI.

Awareness of the following points is important at this stage:

- ▶ If the client rejects the asset on the grounds of inferior quality/discrepancy between the specifications mentioned in the order form and those of the asset received before the execution of Murabaha, a new asset of requisite specifications can be acquired through a new Murabaha. However, after execution of the Murabaha, the MFI/FI would not be liable for any discrepancy and/or defect.
- ▶ The client should make an offer to purchase the asset at the Murabaha price (cost plus mark-up) (whether or not he was the appointed agent to buy the asset).
- ▶ The MFI/FI's acceptance confirms that all applicable terms of Murabaha (including the price) have been met.
- ▶ The client, upon receipt of the asset, must examine it and confirm that the specifications and quality are acceptable to him, thus relieving the MFI/FI from any liability related to the sale of the asset.
- ▶ The MFI/FI may ask the client to provide an acceptable security in the Murabaha purchase order. Among other things, the MFI/FI may accept a third-party guarantee or the pledge of any immovable or moveable property, or the pledge of the subject matter of the Murabaha contract as a fiduciary pledge (or a registered charge), either with or without taking possession of the pledged asset, or by taking possession of it and then releasing the pledge progressively in proportion to the percentage of the total payment received. This registered charge must be separated from the Murabaha agreement and may stop the client from selling/transferring the asset to someone else's name until full payment is made.
- ▶ It is permissible for the MFI/FI to require the client to provide cheques or promissory notes before the execution of the Murabaha contract as a security for payment of debt that is created after the execution of the contract. This is possible where the MFI/FI is not entitled to use these cheques or documents except on their due dates. The requirement to provide cheques as security would not be permissible if the law allows to present the cheques for payment before their due date.
- ▶ It is not permissible to stipulate that ownership of the asset would not be transferred to the client until the Murabaha price is fully paid. However, it is permissible to use the item as a collateral (from legal perspective, not physical one as this prevents the client from making use of it) to guarantee the full payment of the Murabaha price. The MFI/FI may receive authorization from the client to sell the asset in case the client delays payment of the price, in which case the MFI/FI should issue a counter-deed to the client to establish the latter's right to ownership. If the MFI/FI sells the asset as a result of the client's default on payment of the selling price on its due date, it must restrict itself to recovering the amount due to it (limited to the outstanding balance of the agreed selling price) and must return the balance to the client. In the course of this exercise, the MFI/FI should do its best to get the best market price for the asset.
- ▶ Where the MFI/FI receives a pledge from the client, it is entitled to stipulate that the client give the MFI/FI the right to sell the pledged asset for the purpose of recovering the amount due from the client without recourse to judiciary procedures.

Payment of Murabaha price

It is permissible for the MFI/FI and the client to agree that all remaining instalments become due before their originally agreed due dates in case of client's default on payment of any instalment with no acceptable reason. This may take place in one of the following ways:

- a) The instalments automatically become due as a result of a mere delay in a payment.
 - b) The instalments become due after a delay in payment exceeding a specified period.
 - c) The instalments become due after the sending of a reminder notice by the MFI/FI to the client giving a specified period for payment.
- ▶ It is permissible for the MFI/FI to receive a separate undertaking from the client to donate an amount of money (as a form of penalty) to charitable causes in the event of a delay on his part in paying

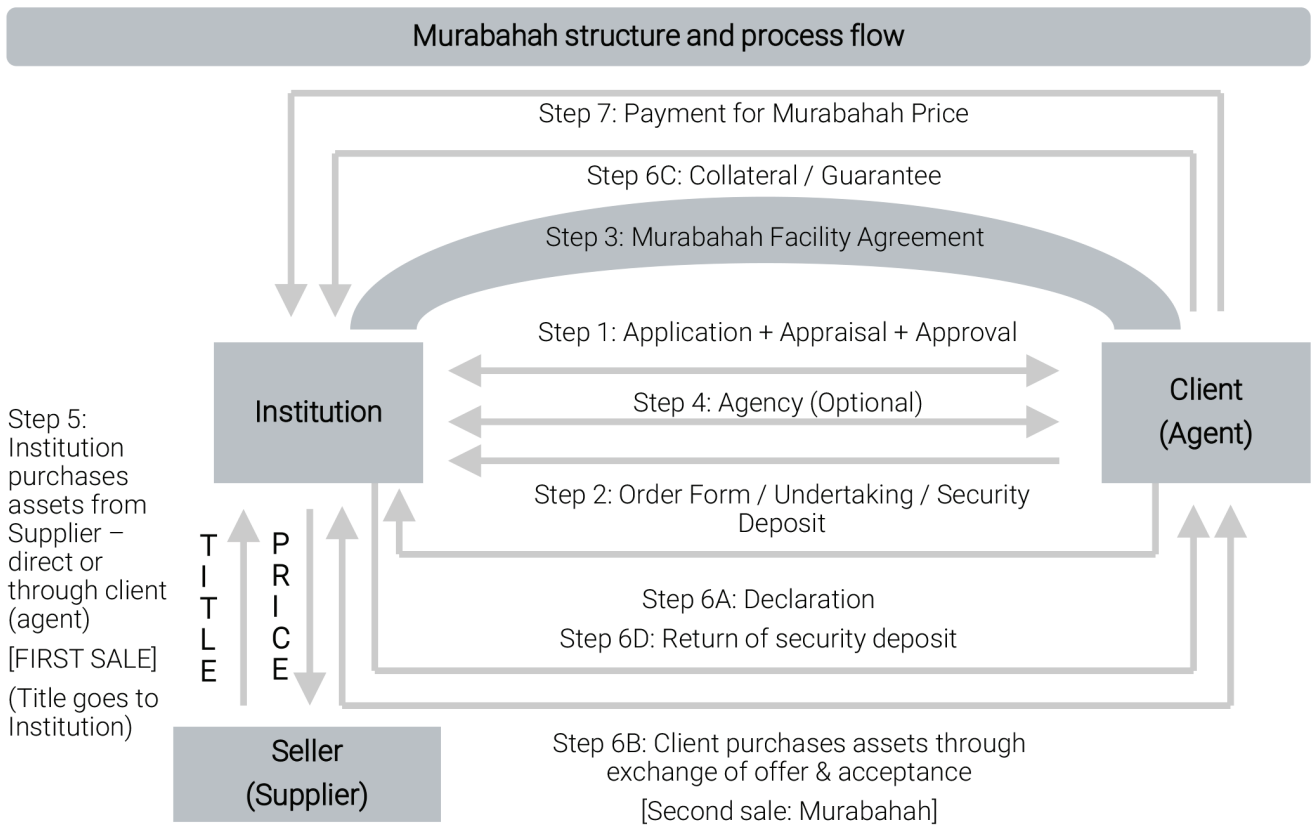
instalments on their due date, in case he fails to justify that he was genuinely incapable of doing so. The amount should be calculated as follows: $(\text{Unpaid Sum} \times 1\% \times \text{Unpaid Period}) / (365 \text{ Days})$. The Sharia governance body of the MFI/FI must receive proof that any such amount is indeed spent on charitable causes, and not for the benefit of the MFI/FI itself or as part of its “Corporate Social Responsibility” expenditures.

- ▶ It is not permissible to delay the date of payment of the debt in exchange for an additional payment

in case of rescheduling, whether the debtor is solvent or insolvent.

- ▶ When there is default by the client on payment of due instalments, it would not be permissible for the MFI/FI to impose any additional payment on the client for the MFI/FI’s benefit.
- ▶ Rescheduling of payment of the outstanding amount is allowed but repricing (rollover to another Murabaha) is not.

Figure 2. Summary Murabaha Process Flow



Note: The second sale can only take place after title/ownership of the asset is transferred to the MFI/FI from the supplier. The agreement should also specify when the ownership to the client from the MFI/FI will take place, and that must only be after the MFI/FI assumes ownership of the asset.

8. MURABAHA ACCOUNTING/BOOKKEEPING (INCLUDING WORKED EXAMPLES)

AAOIFI standards prescribe specific treatment for various accounting processes and transactions relating to bookkeeping in Murabaha transactions, including:

- ▶ The asset is measured and recorded at historical cost at the time of acquisition. After acquisition, any decline in value is reflected in the valuation of the asset at the end of the financial period.
- ▶ Profit is recognized at the time of contract conclusion. However, the basis of recognition of profit, the payment of which is due after the

current financial period, must be (a) proportionate allocation; (b) as and when received; or (c) offset against Murabaha receivables.

- ▶ Hamish Jiddiyah (security deposit to enforce promise) is treated as a liability on the MFI/FI and must be returned to the client after deducting the amount of actual loss, if any, due to non-fulfilment of the client's undertaking. In the absence of any guarantee or Hamish Jiddiyah, any loss incurred shall be recorded as receivable from the defaulting client.

- ▶ Any amount received due to delay in payment must be treated as an allocation to the charity fund less the actual cost incurred by the MFI/FI for administrative affairs such as follow-ups and reminders through electronic and printed means.
- ▶ Any discount granted to the MFI/FI when buying the asset from the supplier may not be considered as revenue, although it should reduce the cost of assets.

Hypothetical worked example scenarios (otherwise reflecting the real socioeconomic conditions, to the extent possible) are presented below.

Scenario 1 – Advance payment to supplier

Advance payment is made and goods are received after 14 days.

Table 2. Murabaha Accounting Example

MURABAHA PRICE CALCULATION SALE WITH ADVANCE PAYMENT TO SUPPLIER MURABAHA – SMALL ENTERPRISE – COTTON GINNING FACTORY							
Project Description	Purchase of Raw Cotton from supplier worth EGP 1,000,000 by a Cotton Ginning Factory. The ultimate sale product is ginned cotton with byproduct of cotton seed. The business cycle completes in 3 months, however, the factory can repay monthly from income generated from the cotton seed oil unit.						
Asset Specification	Egyptian Raw Cotton						
Date of Payment to Supplier	1-Sep-2014						
Murabaha Declaration (supply of goods to Institution and sale through Murabaha)	15-Sep-2014						
Date of Murabaha Maturity	30-Nov-2014						
First Installment Due	1-Oct-2014						
Profit Rate	10.00%						
Cost of Asset Calculations							
Quantity	Qintar						666.67
Unit Price							1,500.00
Purchase Price (U.price x Qty)							1,000,005.00
Other Expenses Details							
Transportation Charges	1%						10,000.05
Insurance	0.50%						5,000.03
Taxes							0.00
Total Other Expenses							15,000.08
Total Cost of Asset							1,015,005.08
2. Installment Payment							
S. No.	Due Dates	Beginning Balance	Amount of Installment	Amount of Cost	Amount of Profit		
1	1-Oct-2014	1,015,005.08	361,137.18	327,303.68	33,833.50	Profit Rate	10.00%
2	1-Nov-2014	687,701.40	361,137.18	338,213.80	22,923.38	Tenure (months)	3
3	1-Dec-2014	349,487.59	361,137.18	349,487.59	11,649.59	Periodic Rate	3.33%
			1,083,411.54	1,015,005.08	68,406.47	Monthly Payment	361,137.18

At the time of advance payment on behalf of the MFI/FI or directly to the supplier by the MFI/FI, the transaction will be accounted for as follows:

September 1, 2014

Dr	Advance against Murabaha	1,015,005
Cr	Pay order/party account	1,015,005

At the culmination of Murabaha, i.e. receipt of goods and their sale to the client with signing of declaration by the client and MFI/FI, i.e. on January 15, 2014, the following entries would be passed.:

September 15, 2014

Dr	Murabaha financing	1,015,005
Dr	Murabaha profit receivable	68,406
Cr	Advance against Murabaha	1,015,005
Cr	Deferred Murabaha income	68,406

Monthly income accruals

September 31, 2014

Dr	Deferred Murabaha income	33,833.50
Cr	Income on Murabaha financing	33,833.50

Note: Accrual will be posted monthly, irrespective of the frequency of payment of instalments

Payment of instalments

Each instalment is scheduled for receipt on the first day of the month following the instalment due date as follows:

October 1, 2014

Dr	Party A/C / institution	361,137.18
Cr	Murabaha financing	327,303.68
Cr	Murabaha profit receivable	33,833.50

(Entries will repeat at the time of payment of each instalment)

Scenario 2 – Spot payment to supplier (converting security deposit to upfront payment)

Goods are received upon payment on same day, client gives security deposit to be converted to upfront payment on declaration.

At the time of receiving the security deposit, i.e. May 15, 2014

Dr	Party account	42,000
Cr	Sec. deposit against Murabaha A/C	42,000

At the time of declaration and delivery of the asset (taxicab) to the client, i.e. June 1, 2014

Dr	Murabaha financing A/C	168,000
Dr	Murabaha profit receivable	6,667.08
Cr	Pay order/party account	168,000
Cr	Deferred Murabaha income	6,667.08

At the time of converting the security deposit received from the client into upfront payment:

June 1, 2014

Dr	Sec. deposit against Murabaha A/C	42,000
Dr	Murabaha financing A/C	42,000

Monthly Income Accruals

June 30, 2014

Dr	Deferred Murabaha income	525
Cr	Income on Murabaha financing	525

Payment of Instalments

July1, 2014

Dr	Party A/C	5,527.80
Cr	Murabaha financing	5,002.80
Cr	Murabaha profit receivable	525

(Entries will repeat at the time of payment of each instalment)

Table 3. Murabaha Accounting Example

MURABAHA PRICE CALCULATION SPOT PAYMENT TO SUPPLIER MURABAHA – SMALL ENTERPRISE – PURCHASE OF TAXI CAB						
Description of Project	An applicant is interested to purchase a new car to use as Taxi Cab and asks for financing his project. MFI considering feasibility of the project decides to finance the purchase of car from local car dealer. The applicant is required to deposit 25% of the price of car as security deposit which will be converted to upfront payment at the time of selling car to him against Murabaha. The Murabaha price will be paid through monthly installments over a period of two years. The applicant is also required to give an undertaking (separate from contracts and other documents) that the car will not be sold by him till termination of Murabaha contract.					
Asset Description	Taxi Cab					
Asset Specification	Toyota Corolla 1.6 limited model 2014					
Business turnover	Monthly					
Date of Payment to Supplier	(Advance Payment)					1-Jun-2014
Murabaha Declaration	1-Jun-2014					
Date of Murabaha Maturity	31-May-2016					
Credit Period	Months					24
Profit Rate	10.00%					
Frequency of Installment	Monthly					
Cost of Asset Calculation						
Purchase price of Car						168,000.00
Security Deposit (to be converted into upfront payment)	25%					42,000.00
Amount to be amortized and paid back through installments (subtracting SD converted to upfront payment)	126,000.00					
Transportation Charges	0.00%					0.00
Transportation Insurance	0.00%					0.00
Taxes (assumed to be included in selling prices)	0.00%					0.00
Total other Expenses	0.00					
Total Cost of Asset	168,000.00					
Installment Payment						
S. No.	Due Dates	Beginning Balance	Amt. of Installment	Amount of Cost	Amount of Profit	
	1-Jun-2014		42,000	42,000	Upfront Payment	
1	1-Jul-2014	126,000.00	5,527.80	5,002.80	525.00	
2	1-Aug-2014	120,997.20	5,527.80	5,023.64	504.16	
3	1-Sep-2014	115,973.56	5,527.80	5,044.57	483.22	
4	1-Oct-2014	110,928.99	5,527.80	5,065.59	462.20	
5	1-Nov-2014	105,863.40	5,527.80	5,086.70	441.10	
20	1-Feb-2016	27,296.82	5,527.80	5,414.06	113.74	
21	1-Mar-2016	21,882.76	5,527.80	5,436.62	91.18	
22	1-Apr-2016	16,446.14	5,527.80	5,459.27	68.53	
23	1-May-2016	10,986.87	5,527.80	5,482.02	45.78	
24	1-Jun-2016	5,504.86	5,527.80	5,504.86	22.94	
			132,667.08	126,000.00	6,667.08	
			174,667.08	168,000.00		

Scenario 3 – Murabaha on supplier credit

Goods are received and payment to supplier is made on deferred date as per credit terms (10 days credit).

MURABAHA PRICE CALCULATION SALE WITH SUPPLIER'S CREDIT MURABAHA – SMALL ENTERPRISE – MANUFACTURING OF TIN CANS FOR FOOD PROCESSING INDUSTRY							
Project Description	Purchase of raw material by a manufacturer of tin cans to be supplier to the food processing industry. The repayment plan has been assessed at 6 months through monthly installments						
Asset Specification	Fine tin sheets						
Date of Payment to Supplier							25-Jan-2014
Murabaha Declaration							15-Jan-2014
Date of Murabaha Maturity							31-Jul-2014
Credit Period							10
Profit Rate							10.00%
Cost of Asset Calculations							
Purchase Price (U.price x Qty)							50,000.00
Other Expenses Details							
	Transportation Charges					1%	500.00
	Insurance					0.00%	0.00
	Taxes						0.00
Total Other Expenses							500.00
Total Cost of Asset							50,500.00
2. Installment Payment							
S. No.	Start Date	Due Date	No. of Days	Outstanding Balance	Murabaha Cost Payment	Profit	Amount of Installment
1	25-Jan-2014	31-Jan-2014	6	50,500.00	4,208.33	83.01	4,291.34
2	31-Jan-2014	28-Feb-2014	28	46,291.67	4,208.33	355.11	4,563.44
3	28-Feb-2014	31-Mar-2014	31	42,083.34	4,208.33	357.42	4,565.75
4	31-Mar-2014	30-Apr-2014	30	37,875.01	4,208.33	311.30	4,519.63
5	30-Apr-2014	31-May-2014	31	33,666.68	4,208.33	285.94	4,494.27
6	31-May-2014	30-Jun-2014	30	29,458.35	4,208.33	242.12	4,450.45
7	30-Jun-2014	31-Jul-2014	31	25,250.02	4,208.33	214.45	4,422.78
8	31-Jul-2014	31-Aug-2014	31	21,041.69	4,208.33	178.71	4,387.04
9	31-Aug-2014	30-Sep-2014	30	16,833.36	4,208.33	138.36	4,346.69
10	30-Sep-2014	31-Oct-2014	31	12,625.03	4,208.33	107.23	4,315.56
11	31-Oct-2014	30-Nov-2014	30	8,416.70	4,208.33	69.18	4,277.51
12	30-Nov-2014	31-Dec-2014	31	4,208.37	4,208.33	35.74	4,244.07
					50,499.96	2,378.57	52,878.53

January 15, 2014

Goods are received from the supplier on January 15, 2014; simultaneously Murabaha declaration is executed by selling the goods at the agreed price, keeping in view the credit term.

January 25, 2014

When payment to the supplier is made, the following entry will be passed.

Dr	Murabaha financing	50,500
Dr	Murabaha profit receivable	2378.57
Cr	Pay order/party account	50,500
Cr	Deferred Murabaha income	2378.57

Monthly Income Accruals

January 31, 2014

Dr	Deferred Murabaha income	83.01
Cr	Income on Murabaha financing	83.01

Note: The profit will be charged only for days the facility remains outstanding.

Payment of Instalments

Instalments are received at the end of each month:

February 1, 2014

Dr	Party A/C /Institution	4,291.34
Cr	Murabaha financing	4,208.33
Cr	Murabaha profit receivable	83.01

(Entries will repeat at the end of each month)

Note: Monthly Murabaha accruals will start after culmination of Murabaha and will be calculated from the date of payment to the supplier. In case the Murabaha declaration is NOT received on the due date, no accrual entry would be passed until the declaration is received.

9. RISKS AND MITIGATION MEASURES RELATED TO USE OF MURABAHA FINANCING

Table 3. Murabaha Risks and Mitigation

Product-Specific Risks	Risk Mitigation Measures
<p>I. Credit Risk</p> <ol style="list-style-type: none"> 1. The client owes the Murabaha price to the MFI/ FI but does not pay part/all of it, or delays the payment (loss of invested amount). 2. Client may breach the promise and then the MFI/FI may not be entitled to any return of the amount already payed and may not be able to use the asset in another Murabaha transaction or selling it on the market/returning it to the supplier that, even if undertook, may result in partial loss of investment. 3. The repossessed asset (due to default by the client) may be sold at a discount, resulting in a loss for the EE. 4. Concentration in one or few geographical areas or economic sectors may also result in defaults. 	<ol style="list-style-type: none"> 1. The risk can be mitigated by gathering as much information as possible about existing and potential clients at the time of initiation of the relationship and updating it periodically. 2. Obtain Sharia-compliant collateral and enforce foreclosure as a final resort. 3. Enforce promissory note (if relevant). Obtain security deposit to enforce undertakings 4. Distribute finance in diversified locations to avoid concentration.
<p>II. Market Risk</p> <ol style="list-style-type: none"> 1. Macro- and microeconomic factors may create uncertainty, which may result in market risks around the asset price between the time of asset purchase by the MFI/FI from the supplier and its onward sale to the client. Change in prices and policies in the economy may impact the price of the subject asset of the Murabaha transaction. 2. If the Murabaha is for a medium or longer term (typically, for more than a year), market volatility around factors contributing to determination of mark-up may have an adverse impact on the MFI/FI's expected rate of return, which cannot be otherwise floating to track market movements. 	<ol style="list-style-type: none"> 1. Time lag between purchase of asset from supplier and its sale to client should be kept to the minimum possible. 2. MFI/FI should negotiate a price at a level sufficient to better manage the market risk, which will depend on various factors, including the period for which Murabaha financing is being provided

Product-Specific Risks	Risk Mitigation Measures
<p>III. Operational Risk</p> <ol style="list-style-type: none"> 1. Whenever a violation of the approved procedure, especially the process flow, is detected during Sharia review or Sharia audit (or it could be based on the information provided by the client), the transaction would become invalid, resulting in loss of income for the MFI/FI. 2. This Sharia non-compliance risk may also bring about reputational risks to the MFI/FI in addition to the negative impact on its market position, profitability and liquidity. 	<ol style="list-style-type: none"> 1. Top management (including the Sharia governance body of the MFI/FI) must ensure that a proper infrastructure and system exist for sound processes to be observed. 2. Capacity building and dedicated training programmes would help too.
<p>IV. Transit Risk</p> <p>This relates to the risk of loss of asset between the time it is purchased from the supplier to the time it is sold to the client.</p>	<p>It is commonly observed that the MFI/FI is better protected when there is a Takaful/Islamic insurance policy in place to cover the transition risk. The MFI/FI may declare and add this cost to the Murabaha price subject to client having agreed to including this among the cost items at the time the purchase order is made.</p>
<p>V. Security/Collateral Risk</p> <p>Ownership of the assets, once sold under Murabaha, is immediately transferred to the client. In case these assets are consumable or perishable, it may not help to create a collateral charge on these as a security.</p>	<p>It is common to have another asset as a collateral to cover such risk. It would be even better to have the client insure the collateralized asset with a provision that insurance proceeds would go to the MFI/FI.</p>
<p>VI. Buyback Risk</p> <ol style="list-style-type: none"> 1. The assets, once sold to the client, may not be bought back, as such buyback arrangements are not allowed under Sharia/AAOIFI standards. 2. The buyback risk also arises if the MFI/FI purchases the asset from a supplier that is a wholly owned subsidiary of the client. 	<p>Proper due diligence on client and selection of supplier in a vigilant manner will help identify such relationships and avoid prohibited buyback.</p>

10. MURABAHA SHARIA COMPLIANCE CHECKLIST- GUIDANCE FOR SHARIA CONTROLLER/AUDITOR

#	Item	Remarks
	General	
1	Obtain a list of all the Murabaha transactions entered into by the MFI/FI during the period under review.	
2	Select a sample of the transactions and obtain their respective agreements/ supporting documents and amounts disbursed from the account books.	
3	Compare the sampled agreements with the standard agreement as approved by the SGC.	
4	Document the transaction flow.	
5	Ensure that the documented transaction flow is in agreement with the standard Murabaha transaction flow.	
	Internal Controls	
6	Does the MFI/FI ensure that the price of the asset and the MFI/FI's mark-up are fixed and known to both parties?	
7	Does the MFI/FI ensure that the subject matter of the transaction is of a permissible type?	
8	Are there adequate controls to ensure that each step of standard Murabaha transactions is followed by the next step in the prescribed sequence?	
9	Ensure that the terms of the agreement are not amended except with the specific approval of the SGC.	
10	Does the MFI/FI ensure that the subject matter of the Murabaha was not in the possession of the client at the time of entering into the Murabaha agreement?	
11	Are there controls to ensure that the MFI/FI or the agent obtain physical or constructive possession of the subject matter before offering it for sale to the client?	
12	Ensure that in case of default by the client, any additional payment received by the MFI/FI is collected in a charity account and donated to a charitable institution approved by the SGC.	
13	Ensure that the Murabaha transaction is not used as a buyback facility by the client.	
	Legal Rules	
14	Ensure that the goods to be traded are real goods and not credit instruments.	
15	Ensure that the assets traded can be properly quantified and specified.	
16	Ensure that the subject matter is in the ownership of the seller at the time of sale by inspecting the possession report, delivery report, physical verification and ownership certificate of the MFI/FI.	
17	Ensure that the sale is instant and unrestricted.	
18	Ensure that the subject of sale is specifically known and identified to the buyer and seller.	

#	Item	Remarks
	Price and Delivery	
19	Ensure that the delivery of the commodity sold to the buyer is certain and is not contingent on any event.	
20	Ensure that the price of commodity sold is definite and not fluctuating.	
	Agency Agreement	
21	Check whether the MFI/FI has appointed the client/third party as agent. If yes, then ensure that there is an agency agreement whereby the MFI/FI appoints the client/third party as its agent for purchasing the commodity on its behalf.	
22	In case the client is appointed as agent of the MFI/FI, ensure that the client purchases the commodity on behalf of the MFI/FI and takes possession as an agent of the MFI/FI.	
23	Ensure that the client does not use or consume the commodity in his possession as an agent.	
	Risk and Ownership	
24	Ensure that the MFI/FI retains all risks and rewards of ownership during the period from the time when the client buys the commodity as an agent until the MFI/FI transfers the title of the goods to the client upon acceptance of the offer. This includes the risk of any damage to the commodity.	
	Documentation	
25	Ensure that the invoices/delivery orders issued by the suppliers are in the name of the MFI/FI. If not, ensure that the client has provided an affidavit that he has purchased such commodity on behalf of the MFI/FI.	
26	Ensure that the date on the invoices/delivery orders is not later than the date of declaration.	
27	In case of consumable goods, ensure that there is no significant delay between the dispatch of goods and the signing of the declaration.	
28	Ensure that, in case the client has been appointed as agent, he informs the MFI/FI in writing that he has purchased the commodity and then makes an offer to purchase it from the MFI/FI.	
29	Ensure that the MFI/FI accepts the offer and that the sale is thus concluded whereby the ownership as well as risk is transferred to the client.	
30	Ensure that the agreement specifies the maximum limit up to which the facility may be availed by the client and that the facility availed by the client is within that specified limit.	
31	Ensure that the agreement is properly signed and witnessed.	
	Donation Undertaking	
32	Inquire about clients in default.	
33	Obtain a list of those clients.	
34	Obtain a list of charitable Institutions approved by the SGC.	
35	Ensure that the MFI/FI channels any additional amounts paid to the approved charitable institution as a donation with no media publicity.	
36	Calculate the actual cost incurred in administration of the impairment such as phone calls, notices, etc.	

11. MURABAHA CONTRACTS AND DOCUMENTATION

Description

Application form

This form allows the MFI/FI to choose a suitable mode of financing to match the needs of the client and for which the application is being made. It also provides the personal and business details of the client to help evaluate the financing request.

Facility offer letter

This letter conveys to the client the approval decision of the requested facility and prescribes the terms and conditions of the financing offered, together with a place for the client to accept the offer made/terms stated.

Murabaha facility agreement

This is an agreement between the client and the MFI/FI whereby the client agrees to purchase certain assets from the MFI/FI from time to time as per the terms and conditions of this agreement. This is an overall facility agreement under which various sub-Murabahas may be executed between the parties, after having it signed once at the time the facility is sanctioned.

Order form (purchase undertaking)

This document is executed at the time of each sub-Murabaha request, i.e. every time the client requires to trigger Murabaha for the purchase of assets. Through this document, the client requests the MFI/FI to purchase assets from the supplier and undertakes to purchase the assets from the MFI/FI once it acquires them from the market. The client also undertakes to compensate the MFI/FI for any actual loss it may incur due to failure by the client to purchase the requested assets from the MFI/FI.

Agency agreement

Through this agreement, the MFI/FI appoints its agent to select and procure the specified assets on its behalf. This agreement needs to be signed only once between the agent and the MFI/FI to cover the specified agency period. The disbursement of funds is also effected under this agreement.

Declaration

This is one of the most important steps of the Murabaha process. The declaration is to be signed by the client immediately after the purchase of assets as the MFI/FI's agent, but before actual utilization/consumption. This document establishes the actual sale transaction, i.e. the transfer of ownership of the assets from the MFI/FI to the client. At this stage, the specific details of the assets must be known, i.e. quantity, quality, cost, etc. Proof of purchase in the form of bills, sales invoice and sales tax invoice must be furnished along with the declaration specifying the full details of the assets purchased. The cost of assets must be all-inclusive, including sales tax, transportation and handling, etc. Proper timing of the declaration is crucial, especially in cases of perishables or immediately consumable commodities. The Murabaha price (cost + mark-up) must be determined at this stage and stated clearly in the declaration. The declaration for a Murabaha transaction also consists an offer to purchase the assets by the client.

Sale of assets

Acceptance of offer and sale of assets on the basis of Murabaha, along with the schedule of payment of the Murabaha price and demand promissory note, are all mentioned in this document.

Sample Murabaha documents

Application form for Murabaha financing facilities

Date: _____

To: _____ [Insert name and address of the Institution]

We would like to request a financing facility under IFP as follows

1	Recommended facility type (Murabaha/Salam/Diminishing Musharaka / Ijara/Mudaraba/Musharaka)*	
2	Amount requested (local currency)	
3	Asset purchased (quantity and quality)	
4	Expected price of asset	
5	Security deposit (if applicable) (local currency)	
6	Requested tenor/period of payment (months/years)	
7	Purpose: (e.g. personal use, trade, raw material, etc.)	
8	Proposed business activity: (e.g. agriculture, livestock, etc.)	
9	Proposed total investment required for the business (local currency)	
10	Of which applicant's contribution (if required by the Institution) is (%)	
11	Name of business/Individual:	
12	Line of business:	
13	Address of business:	
14	Legal form of business: Individual / Sole Proprietorship / Partnership Company	
15	Incorporation documents of the business	Incorporation certificate and memorandum and articles of association/ bylaws of the company (tick as appropriate)
16	Audited financial statements Last 3 Years	Yes.....No..... (provide reason, e.g. new business)
17	Contact Details	Phone: _____ Fax: _____ Email: _____
18	National tax number of business	
19	Sales tax number of business	
20	Registration No.	

21	Date of establishment						
22	Details of Directors/Partners/ Owners (if applicable)	Name	Address	% Share- holding	National No.	Tax no.	Business Experience (Yrs)
		1.					
		2.					
		3.					
23	Name of Managing Partner/ Chief Executive						
24	Experience in business: (Years)						
25	Date of of business commencement						
26	Business premises	Owned			If leased, Lease start and completion dates		
27	Taxation status						
28	Protest status						
29	No. of employees						
30	Expected no of new employees	Year-1		Year-2		Year-3	
*Provided by the Institution. The officer responsible for filling up the information provides a recommended type based on information gathered from the applicant							

For and on behalf of

_____ [Insert name(s) of applicant(s)/company]

Murabaha facility offer letter

Date: _____

To: _____ [Insert name and address of the applicant(s)]

Dear Sir/Madam,

We refer to your application dated _____ and are pleased to advise you of the facility approval as per the terms given below:

1	Facility type	Murabaha
2	Facility amount (local currency)	
3	Purpose	
4	Asset/goods/commodity details	
5	Security deposit (if applicable) (local currency)	
6	Rate of profit (% per annum)	
7	Maturity (days/months)	
8	Payment frequency (e.g. monthly/quarterly/semi-annually, etc.)	
9	Securities: i. (e.g. promissory note, direct debit authority, post-dated cheques, any other securities as may reasonably be required by the Institution, etc.) ii. In addition, the Institution shall have a lien and right of set-off on all deposits, accounts and properties of the clients held in a bank.	Asset insurance
10	Comprehensive Takaful/insurance (for default and assets)	
11	Processing charges	
12	Documentation charges	Actual
13	Draw down (facility may be drawn in lumpsum or in tranches)	

Other Terms and Conditions:

1. The facility shall be governed by the relevant/applicable rules and regulations of (Country name), including those of the Central Bank of (Country name) (if applicable).
2. The client may not create any charge on the asset(s) offered as security by way of pledge, hypothecation, mortgage or in any other way created in favour of the Institution, with any other bank, financial institution or any other person in any manner whatsoever.

3. The Murabaha asset may be inspected by the Institution)before the sale to the client and after the sale to the client, if the asset also serves as the security(as and when it requires and the client shall arrange (with supplier)/allow access to and cooperate with authorized representative of the Institution in carrying out such inspections.
4. The Institution shall inform the client of all expenses incurred on account of documentation, valuation, charge registration or any other costs in relation to the facility mentioned in this letter now or hereafter levied on the Institution in respect of, or in connection, with the facility and security thereof, which client shall need to pay immediately on demand by the Institution.
5. This facility offer is subject to internal final approvals, satisfactory review of all documentation, securities, necessary formalities and receipt of duplicate copy of this letter duly signed by the authorized signatory of the client evidencing agreement on all terms and conditions.

Please return a signed and accepted copy of this letter within _____ days.

This offer is valid for a period of days from date of this letter. If the facility offered herein is not utilized within the specified period, the facility shall stand withdrawn.

Yours faithfully,

For and on behalf of _____[Insert name of Institution]

Acceptance of Terms and Conditions

Date: _____

To: _____ [Insert name and address of the Institution]

Dear Sirs,

Reference your approval of our request dated _____, we hereby accept the facility offer and terms and conditions of the approval provided and request to proceed with the facility. We undertake to abide by the terms of approval. We shall provide a promissory note, surety and other collateral(s), if required. We also undertake to avail the facilities and meet all documentation, customary and other requirements in form and substance acceptable to the Institution wherever required.

Yours faithfully,

For and on behalf of _____ [Insert name(s) of applicant(s)]

Master Murabaha facility agreement (MMFA)

(Micro/small enterprises)

(to be used between wholesale institution with retail institutions or between retail institution and end beneficiary)

This Master Murabaha Facility Agreement ('the Agreement') is made on the _____ day of _____ between _____, a _____ company incorporated under the laws of (Country name), having its registered office at _____, through its _____ (hereinafter referred to as the "Institution" and "Seller" which expression shall, where the context so permits, mean and include its successors-in-interest and assigns), of the

one part;

and

_____ [insert name and legal form of the financed party which shall have a legal status of an individual, sole proprietorship, company, or corporation] registered under the laws of (Country name) and having its place of business / registered office at _____(hereinafter referred to as the "Client" and "Purchaser" which expression shall, where the context so permits mean and include its legal heirs, successors-in-interest and assigns), of the second part;

The following is agreed by the parties:

1. Purpose and Definitions

The Client has requested the Institution to enter into Murabaha transaction(s) up to a total aggregate Sale Price of (local currency) (_____ only) at any given time and the Institution has agreed to enter into Murabaha transaction(s) on the terms and conditions set forth hereunder.

In this Agreement, unless the context otherwise requires:

- ▶ **"Agent"** shall mean the person appointed under the terms of the Agency Agreement, where the Institution appoints the Client (or a third party) to act as its disclosed/undisclosed agent in respect of the purchase of the specified Asset from the Supplier, as formulated in Appendix - 1.
- ▶ **"Asset"** means asset(s) to be purchased by the Client, which the Institution shall acquire for the purpose of selling it to the Client, from time to time, as described in the Declaration, in Appendix-3

hereto, to be filled in at the time of execution of the Murabaha Transaction.

- ▶ **"Cost Price"** means the amount paid by the Institution to the Supplier of the Assets, or to its agent, as the case may be, for acquisition of the Asset for the purpose(s) of the Murabaha Transaction(s).
- ▶ **"Event of Default"** means any of the events or circumstances described as such in this Agreement.
- ▶ **"Murabaha Facility"** means the total facility amount of local currency (_____ only) to be made available to the Client by the Institution which may be paid to the Supplier(s) of the Asset directly as Cost Price, or drawn down by the Agent for onward payment to the Supplier(s) for and on behalf of the Institution, from time to time.
- ▶ **"Murabaha Transactions"** means the sale and purchase of Assets in the manner specified in Clause 3 hereunder.
- ▶ **"Order Form"** means the instructions as set out in Appendix-2 hereto whereby the Client requests the Institution to acquire the Assets, which the Client will subsequently purchase pursuant to the Murabaha Transactions.
- ▶ **"Payment Date"** means the dates as shown in the payment schedule in respect of each Murabaha Transaction.
- ▶ **"Payment Schedule"** means the schedule specifying the portion of the Sale Price payable on the Payment Dates in respect of each Murabaha Transaction as set out in Appendix-4 hereto.
- ▶ **"Profit"** means any part of the Sale Price, which is not part of the Cost Price, and is payable by the Client as specified in the Payment Schedule in

respect of the Murabaha Transaction.

- ▶ **“Sale Price”** or **“Murabaha Price”** is the sum of the Cost Price and the Profit payable by the Client to the Institution for the Asset pursuant to the Murabaha Transactions. The aggregate of all the Sale Prices shall be the amounts due and payable by the Client to the Institution under this Agreement in case more than one Murabaha transaction take place under the Agreement.
- ▶ **“Security Deposit”** means a sum of money placed by the Client with the Institution to reflect the financial position of the Client as well as security to compensate the damage sustained by the Institution due to Client’s failure to fulfil the binding promise to purchase the Asset from the Institution on the basis of Murabaha, which the Institution procures at the request of the Client in the form of an aforementioned “Order Form”. It is agreed that the Institution may, with agreement of the Client, convert the Security Deposit into a Murabaha price payable by the Client pursuant to the conclusion of the Murabaha Transaction, in which case the payment schedule given in Appendix-4 shall reflect this conversion.

2. Purchase of Asset from Supplier

The Institution, on the request of the Client, pursuant to the submission of the Order Form by the Client and subject to the terms and conditions of this Agreement, shall purchase the Assets directly, or through an agent, from Supplier, designated by the Client or otherwise, and as per the specifications provided by the Client, for the purposes of entering into Murabaha Transactions with the Client.

3. Murabaha Transactions

- 3.1. Subsequent to the acquisition of the Assets by the Institution, the Asset shall be sold by the Institution and purchased by the Client on Murabaha basis.
- 3.2. The parties shall execute a Declaration (Appendix-3) and a Payment Schedule (Appendix-4) annexed hereto for each Murabaha transaction respectively, which shall

form an integral part of this agreement.

- 3.3. The Client shall execute and deliver a Demand Promissory Note as per Appendix-4 as security for the payment of the amounts payable by the Client under the Murabaha Transactions. The Client further agrees to execute and provide to the Institution such Security Documents as the Institution may require from time to time.

4. Sale and Purchase of Assets

The Client agrees that it shall buy the Assets from the Institution strictly on an “as-is, where-is basis” without any responsibility on the Institution for any defect(s) therein and without any warranty relating to the condition, suitability or efficacy of the Assets, whether such warranty be expressed, implied, by law or recognized by custom.

5. Payments

- 5.1. The Client shall pay the Sale Price on the payment date(s) as specified in the payment schedule given in Appendix 4.
- 5.2. The Client shall also pay to the Institution on demand all expenses (legal and out of pocket expenses) incurred by the Institution.
- 5.3. In the event of a default in the payment of the Sale Price, any part thereof or any other amount due hereunder, the Client hereby undertakes to pay to the Institution an amount calculated as follows: $(\text{Unpaid Sum} \times 1\% \times \text{Unpaid Period}) / (365 \text{ Days})$. This amount is to be utilized by the Institution for charitable and humanitarian purposes as approved by the Sharia advisor or Sharia Governance Committee of the Institution.

6. Client’s Representations and Warranties

The Client warrants and confirms that:

- 6.1. The Client is duly organized as a company/legal entity/legal person under the laws of (Country name) and has the power to execute, deliver and perform its obligations under this Agreement.

- 6.2. The execution, delivery and performance of this Agreement and the Security Documents by the Client shall not contravene any existing law, regulations or authorization to which the Client is subject to.

7. Undertakings

- 7.1. The Client undertakes to cooperate with the Institution as long as any amounts are owed by the Client to the Institution under this Agreement, and the Client shall provide to the Institution, whenever required, copies of all documentation relating to the purchase of the Assets.
- 7.2. (For companies) The Client shall not, without written consent of the Institution, sell, transfer, lease or otherwise dispose of all or a sizeable part of its assets which would materially affect the Client's ability to perform its obligations under this Agreement.
- 7.3. (For companies) The Client shall inform the Institution promptly of any change in the management structure/directors of the Client.

8. Events of Default

There shall be an Event of Default if any of the following occurs:

- 8.1. The Client fails to pay any instalment or part thereof or defaults in the performance of any other provision of this Agreement.
- 8.2. Any representation or warranty made which is proved to have been incorrect in any material respect.
- 8.3. Notwithstanding anything contained herein, the Institution may, without prejudice to any of its other rights, at any time after the happening of an Event of Default by notice to the client declare that its obligations hereunder are immediately terminated and all sums payable under this

Agreement have become due and payable, whereupon the same shall immediately or in accordance with such notice become due and payable.

9. Indemnities

The Client shall indemnify the Institution against any expense which the Institution rightly certifies as incurred by it because of any default in payment by the Client under this Agreement.

10. Set-off

The Client authorizes the Institution to apply any credit balance to which the Client is entitled or any amount which is payable by the Institution to the Client at any time in or towards partial or total satisfaction of any sum that may be due or payable from the Client to the Institution under this Agreement.

11. Law and Jurisdiction

This Agreement is governed by and shall be construed in accordance with the laws of (Country name) as long as this does not conflict with Sharia.

12. Force Majeure

Any delays or failure by the Client hereto in the performance hereunder, if and to the extent it is caused by occurrences or circumstances beyond the Client's reasonable control, including but not limited to, acts of God, fire, strikes or other labour disturbances, riots, civil commotion, war (declared or not), sabotage or any other causes similar to those herein specified which cannot be controlled by the Client, shall be considered Force Majeure. The Client affected by such events shall promptly inform the Institution of the occurrence of such events and shall furnish proof of details of the occurrence and reasons for its non-performance of whole or part of this Agreement. The parties shall by consultation between them decide whether to terminate this Agreement, to discharge part of the obligations of the affected Party or extend its obligations on a best-effort basis.

IN WITNESS WHEREOF the parties to this Agreement have caused this Agreement to be duly executed on the date and year first aforementioned.

For and on behalf of

_____ [insert name of the Institution]

For and on behalf of

_____ [Insert name(s) of Client]

Witnesses:

Appendix 1 - Agency agreement

(if client is appointed as Agent- in case of third party being an Agent, Appendix 1 shall not apply to MMFA and instead a separate Agency agreement will be signed below)

_____ (Institution)

M/S _____ (Client)

With reference to the Master Murabaha Facility Agreement (MMFA) dated _____, we hereby appoint you as our Agent (Wakeel) for a fee not exceeding ____ local currency to purchase the Assets under the following terms and conditions:

1. We shall make payment of the funds directly to the Supplier of the Assets and/or you will be provided with funds from time to time pursuant to the Murabaha Transaction(s) to be entered into between us in accordance with the terms and conditions of the MMFA.

2. Immediately after the acquisition of the Assets, you shall provide us with a Declaration as per Appendix-3 of the MMFA confirming the acquisition of the Assets along with details and evidence of acquisition of the Assets in a form acceptable to us.
3. You shall ensure that the assets are not being consumed/sold before providing us with the Declaration mentioned as above.
4. You shall exercise due diligence to ensure that the Assets purchased on our behalf are free from any defect. Any loss or damage occurring to the Assets due to any contravention of the terms of this Agency Agreement by you shall be borne by you. If you are not able to acquire the Assets due to any reason, you shall immediately and fully return the funds provided, if any.

5. We shall have the authority to revoke this Agency Agreement at any time, without assigning any reason thereof.
6. The Client shall be fully and solely responsible for the quality, condition, selection and specifications of the Assets and for deciding the need for, and the extent and the manner of, the transaction and storage thereof.
7. The Client shall ensure that all necessary permits, exchange control approvals, import licenses and all other consents required in connection with the import of the Assets are obtained

Please affirm your acceptance of the foregoing terms and conditions by signing the duplicate.

List of Assets:

#	Description

For and on behalf of

_____ [insert name of the Institution]

Witnesses:

Acceptance of Agent (Wakeel)

I accept the authorization and shall purchase the Assets in your favour and on your behalf as per the terms and conditions contained in the MMFA.

Accepted for and on behalf of

_____ [Insert name of Agent]

Agency agreement

(if third party is appointed as Agent)

_____ (Institution)

M/S. _____ (Client)

We hereby appoint you as our Agent (Wakeel) for a fee not exceeding _____ (local currency) to purchase the Assets (defined below) from the Supplier under the following terms and conditions:

1. The Assets to be purchased are defined as below:

#	Date	Description	Quantity	Value (Local currency)

2. We shall make payment of the funds directly to the Supplier of the Assets.
3. Immediately after the acquisition of the Assets, you shall provide us with the annexed Declaration confirming acquisition of the Assets along with details and evidence of acquisition of the Assets in a form acceptable to us.
4. You shall ensure that the assets are not being consumed/sold before providing us with the Declaration mentioned as above.
5. You will exercise due diligence to ensure that the Assets purchased on our behalf are free from any

defect. Any loss or damage occurring to the Assets due to any contravention of the terms of this Agency Agreement by you shall be borne by you. If you are not able to acquire the assets due to any reason, you shall immediately and fully return the funds provided, if any.

6. We shall have the authority to revoke this Agency Agreement at any time, without assigning any reason thereof.
7. You shall be fully and solely responsible for the quality, condition, selection and specifications of the Assets if different from what we advised you of.
8. You shall ensure that all necessary permits, exchange control approvals, import licenses and all other consents required in connection with the import of the Assets are obtained.
9. Please affirm your acceptance of the foregoing terms and conditions by signing the duplicate.

For and on behalf of

_____ [insert name of the Institution]

Witnesses:

Acceptance of Agent (Wakeel)

I accept the authorization and shall purchase the Assets in your favour and on your behalf as per the terms and conditions contained herein.

Accepted for and on behalf of

_____ [Insert name of Agent]

Annexure: Declaration

We hereby declare and certify that, acting as your Agent, we have purchased the Assets for

local currency _____ (_____ only) and have taken the delivery from the Vendor/Supplier. We hereby certify that the Assets procured on your behalf, as your Agent, have not been consumed at the time of signing of this Declaration.

#	Date	Description	Quantity	Value (Local currency)

For and on behalf of

_____ [Insert name(s) of Agent]

Appendix 2 - Order form

(To be filled by the client)

Date: _____

To: _____

[Insert name and address of the Institution]

Dear Sirs,

With reference to the Master Murabaha Facility Agreement (MMFA) dated _____ entered into between us, we hereby request you to acquire the following Assets worth Local Currency _____ only):

#	Date	Description	Quantity	Value (Local currency)

Note: The assets are available for sale from ----- (Vendor/Supplier’s name)

- i. We undertake to purchase immediately the Assets from you on Murabaha Price (Local Currency.....) and under the terms of MMFA, failing which we undertake to compensate you for any actual loss suffered (not being opportunity costs) due to the resale of Assets to a third party or the Supplier.
- ii. We shall execute all documents including but not limited to sale of goods, purchase agreement and promissory note.

For and on behalf of

_____ [Insert name(s) of Client]

(For Institution’s use)

Advice to Purchaser: You are advised to purchase the described Asset and upon purchase, provide the possession report along with the Supplier’s invoice/cash memo/bill etc.

For and on behalf of _____ [Insert name of Institution]

Appendix 3 - Order form*(if the Client is appointed as the Agent)*

Date: _____

To: _____

[Insert name and address of the Institution]

Dear Sirs,

We hereby declare and certify that, acting as your Agent, we have purchased the Assets as mentioned in Order Form for local currency _____ and have taken the delivery from the Vendor/Supplier. We hereby certify that the Assets procured on your behalf, as your agent, have not been consumed at the time of signing of this Declaration.

#	Date	Description	Quantity	Value (Local currency)

We hereby offer to purchase the Assets from you on day/month/year on Murabaha price _____ local currency to be paid over a period of _____ days/months as per the Schedule given in Appendix-4. You are requested to advise us of your acceptance.

For and on behalf of

_____ [Insert name(s) of Client]

Declaration of purchase offer*(if third party is appointed as the Agent)*

Date: _____

To: _____ [Insert name and address of the Institution]

Dear Sirs,

We refer to our purchase undertaking given via the Order Form and hereby offer to purchase the Assets from you on day/month/year on Murabaha price local currency to be paid over a period of days/months as per the Schedule given in Appendix-4. You are requested to advise us of your acceptance.

For and on behalf of

_____ [Insert name(s) of Client]

Appendix 4 - Sale of assets

(This document is executed after the Institution physically inspects the Assets)

Date:_____

To:_____ [Insert name and address of the Client]

Dear Sirs,

With reference to your request of Murabaha, we accept your offer and agree to sell the Assets to you on the following terms and conditions:

- i. Murabaha price has been fixed at local currency _____ (_____only)
- ii. The Murabaha Price referred to above is payable as per the MMFA dated_____ and the schedule given as under:

#	Description and Specification of Asset	Quantity	Cost (Local currency)

For and on behalf of

_____ [Insert name of Institution]

Demand Promissory Note

On demand we, promise to pay _____ (delete as appropriate) or order the sum of _____ local currency for value consideration received.

Date:

For and on behalf of _____ [Insert name(s) of Client]



Salam

Salam is a sale contract, traditionally used in agricultural financing, with deferred delivery of goods (contrary to Murabaha financing) in exchange of a spot price fully paid in advance. This is an exception to the general Sharia principles of sale, as it allows the seller to sell something he does not yet own but with carefully defined conditions.

1. USES OF SALAM

Salam can be used for the following purposes:

- ▶ Working capital financing
- ▶ Commercial and industrial financing
- ▶ Operations and capital cost financing
- ▶ Agricultural financing (financing of agricultural operations)

2. SALAM VS. SHORT-TERM LOAN

Features of Salam	Features of conventional short-term factoring loan
Salam is a forward sale. Delivery of the purchased good is deferred; the price is paid in advance.	Loan is given to a client who has made a sale but is yet to receive payment.
The objective is to advance payment and effect an actual sale. The price has to be fully paid in advance.	The objective is to advance payment for a delivered sale (to another party).
Salam is an advance purchase sale. The contract helps clients gain access to markets.	Not valid if client has not fulfilled its contractual sale. Does not help client gain access to markets.
Institution takes risk of client not delivering the product that is purchased.	Institution takes risk of payment from client's buyer in exchange for profit.
Salam is not executed on commodities that cannot be identified by origin.	No restrictions on commodities.
Salam cannot be executed in respect of commodities that must be delivered on the spot, e.g. gold and silver.	No restrictions on commodities.

3. IMPACTFUL SALAM THROUGH ECONOMIC EMPOWERMENT

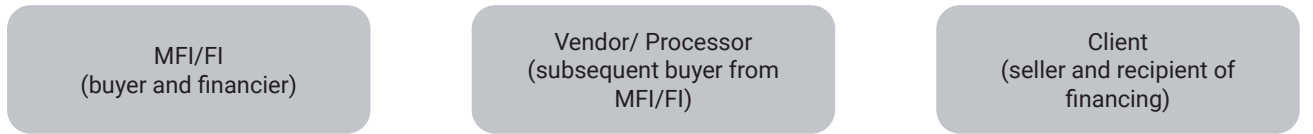
MFI/FIs that engage in Salam are able to negotiate with buyers/processors for the products required by the clients. Since the products supplied by one client are also often supplied by other clients, the MFI/FI can arrange for bulk sale of such products (e.g. fruits, vegetables, etc.). Some institutions even have their own storage facilities to effectively play the additional role of an aggregator, while others negotiate with buyers as part of a master contract ranging in value 10%-40% higher than what farmers would be able to earn without negotiation. The additional profits generated from the negotiated prices are passed on to their clients. Hence, the MFI/FI is not only the place where clients receive better prices, but also the place to which they turn to sell their products even on spot basis. By offering fair prices, the MFI/FI becomes a preferred aggregator/middleman that the client goes to on a regular basis for market access, financing or both.

4. RULES OF SALE APPLICABLE TO SALAM TRANSACTIONS

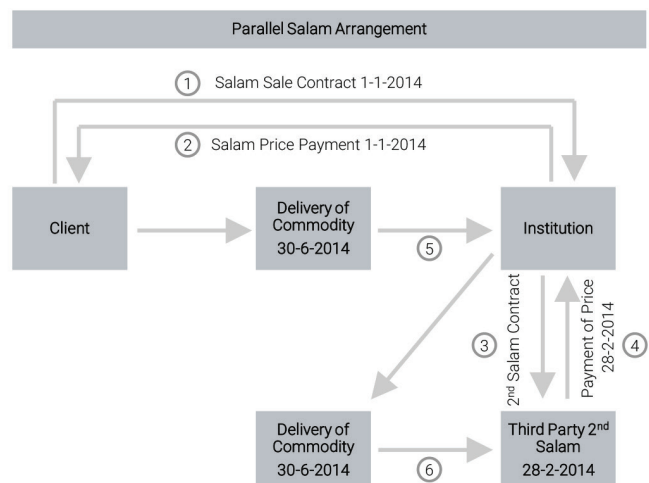
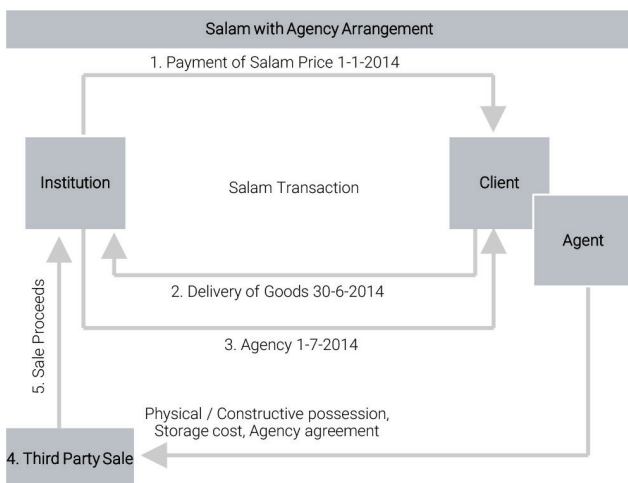
Salam is beneficial to the seller because he receives the price in advance. It is also beneficial to the buyer as, normally, the price in Salam is lower than the price in spot sale (i.e. at the time of delivery). Since the permissibility of Salam was an exception to the general rule that prohibits forward sales, it was subjected to some strict conditions as summarized below:

- ▶ Salam cannot be effected on a particular commodity or on a product of a particular field or farm (origin) since supply of such commodities is not certain.
 - ▶ Salam sale is impermissible on existing commodities or on land and real estate because the description of the land or the real estate entails the location.
 - ▶ The commodities must satisfy the conditions of Dhawat ul Amthal (where one constituent unit of commodity is similar to the other), i.e. if the commodity is lost or destroyed, a similar commodity can be acquired from another source, e.g. wheat, rice, sugar, etc.
 - ▶ The time of delivery of the commodity should be sufficient for the convenient use of the Salam capital with a resulting impact on the price of Salam commodities.
 - ▶ The exact date and place of delivery must be specified in the contract.
 - ▶ Salam contract can be rescinded with the consent of both parties, but only the original price paid is refunded.
 - ▶ Salam cannot be effected on commodities that are considered media of exchange, i.e. currency, gold or silver.
 - ▶ Sharia does not allow the Institution to sell the commodity before it is delivered.
 - ▶ Before delivery, the goods remain at the risk of the seller. After delivery, the risk is transferred to the purchaser.
- ▶ The buyer pays the price in full to the seller at the time of effecting the sale.
 - ▶ Salam can only be effected on commodities the quality and quantity of which can be exactly specified.

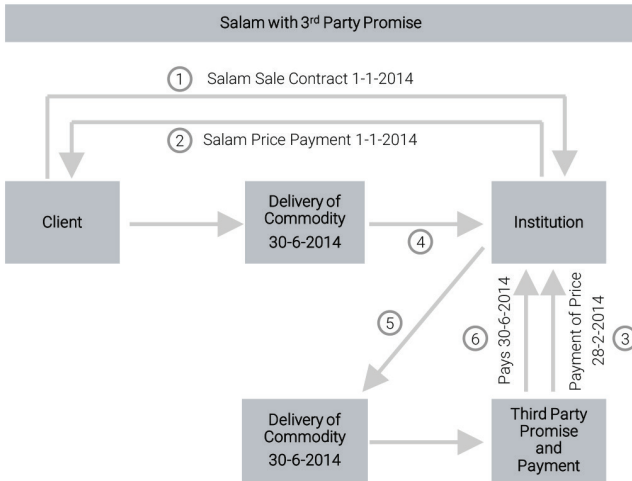
5. PARTIES AND PROCESS OF SALAM FINANCING



- ▶ Salam is primarily a mode of financing for small farmers and traders. However, it can also be used efficiently in the industrial sector, particularly agrobased, subject to the basic principles of Salam.
- ▶ The price in Salam is normally fixed at a lower rate than the price at spot (when the commodity is delivered). In this way, the difference between the two prices becomes a valid profit for the MFI/FI.
- ▶ In order to ensure that the seller deliver the commodity on the agreed date, the MFI/FI can also ask the client to furnish a security, which may be in the form of a promissory note, a guarantee, a mortgage or hypothecation for example.
- ▶ In the case of failure by the client to deliver goods, the guarantees may be invoked or the original price can be returned by the client if agreed between the parties.
- ▶ If due to any unforeseen reason, it is not possible to deliver the commodity on the due date, it is permissible to replace it with other one by mutual consent. The market value of such substituted goods may not be higher than the market value of the originally agreed commodity at the time of delivery.
- ▶ Standardized production of companies can also be transacted under Salam (sugar, fertilizer, poultry feed, etc.).
- ▶ As it would be impractical for the MFI/FI to receive different commodities from different clients and sell them in the market, it may resort to the following solutions:
 - ★ Once the commodity is received by the MFI/FI, even if kept in the warehouse/store of the client against payment of rent, the client or any third party can be appointed as an agent to sell the commodity on the market and deposit the sale proceeds with the MFI/FI. This is the most common practice and is convenient for MFI/FIs.
 - ★ Alternatively, after purchasing a commodity on Salam basis, the MFI/FI may sell it through a parallel contract of Salam for the same date of delivery agreed in the first Salam contract. This can also be used as a liquidity management tool by the MFI/FI. However, the two Salam contracts need to be kept separate and non-contingent, i.e. delivery of the commodity in the first Salam cannot be set as a condition for delivery in the second Salam



- ★ The Institution may also obtain from a third party a promise (undertaking) to purchase the commodity.



6. STAGES OF SALAM FINANCING

- ▶ The client approaches the MFI/FI with a request for financing.
- ▶ The MFI/FI enters into a Salam agreement with the client setting out the terms and conditions subject to which the client agrees to supply the specific commodities to the MFI/FI.
- ▶ The client submits a 'Written Offer' to sell the specified commodities now (for future delivery) to the MFI/FI against a given price to be paid in full by the MFI/FI in advance.
- ▶ On the delivery date, the client delivers the agreed commodities to the MFI/FI alongside a 'Notice of Delivery' informing the latter of the delivery place to receive the delivery.
- ▶ The MFI/FI takes possession of the commodities either directly or through its agent at the designated place of delivery and issues a Commodity Receipt Note acknowledging receipt.
- ▶ The MFI/FI sells the goods, either directly or through its agent, where the sale proceeds comprise the amount advanced together with the profit
- ▶ The agency agreement must be separate from the Salam agreement. Alternatives of selling the commodities to a third party through a parallel

Salam or obtaining a third-party purchase undertaking may also be resorted to

7. SALAM ACCOUNTING/BOOKKEEPING (INCLUDING WORKED EXAMPLES)

AAOIFI standards prescribe specific treatment for various accounting processes and transactions relating to bookkeeping in Salam transactions, including:

- ▶ Salam financing is recognized when paid or made available to the seller and recorded as "Salam financing" in the financial statements.
- ▶ Parallel Salam is recognized when the MFI/FI receives the price from the third party and records it as a liability in the financial statements.
- ▶ Initial measurement of capital/price is made at the amount of cash paid or at fair value of the asset if the capital is provided in-kind.
- ▶ When the commodity is received, it is recorded as an asset at historical cost. If the market value is equal to the contract value, the commodity is recorded at book value. If the market value is lower than the book value, the difference is recognized as loss.
- ▶ If the Salam contract is cancelled and the client does not repay the capital, the amount is recognized as a receivable from the client.

Table 4. Salam Accounting Example

Salam Purchase Price Calculation Small Enterprise Financing - Salam Small Enterprise - Purchase of Feed Stock from Poultry Feed Mill						
Description of project: A small poultry feed mill is in need of working capital to pay (i) transportation cost of manufactured feed to whole sellers; (ii) salaries; and (iii) utility bills. The mill requests a Murabaha facility to satisfy its requirements. The MFI/FI negotiates with the mill and rules out the possibility of meeting the requirement through Murabaha as no tangible item is required to be purchased. Alternatively, Salam is proposed to this corporate client to meet its liquidity requirements. The business cycle covers 90-91 days (purchase of raw material to production of feed to giving possession to institution, selling as agent to the poultry farmers and realization of sale proceeds from them). The mill agrees to enter into a Salam contract and also to become an agent for selling the MFI/FI's feed to the market. The mill requests financing for four 90-91 days Salam cycles, each of \$500,000. Accordingly, the MFI/FI and the mill enter into a Salam facility agreement under which four individual Salam agreements are to be executed. The most important task is to calculate the discounted price of feed after determining the expected profit margin and other expenses (agency, insurance, rent and taxes) against which the forward sale (Salam) will be effected. The first Salam is worked out here. The other Salam transactions will follow the same procedure.						
Salam Working Sheet/Salam (Quantity) Calculation Sheet						
Commodity Information						
Product Poultry Feed	# Detail (Bags)	(\$/bag)	(\$)	Quantity Unit	Price Total	Price
Quantity per bag (50 Pounds)	kg	22.68	Market Sale Price (Per Bag)	68.04	690,288	
			1 Applicable taxes	6.8	69,029	
Market Price per bag	\$	68.04	2 Discount margin	10.21	103,543	
Discounted Sale Price					\$ 517,716	
Financing detail				1 Profit	1.23	12,466
Salam amount	\$	500,000.00		2 Agency Remuneration	0.25	2,500
Date of advance		1-Jun-14		3 Insurance Expense	0.15	1,500
Date of delivery of feed stock to MFI/FI		31-Aug-14		4 Storage cost at premises of client	0.12	1,250
Average sale turnover	days	90		5 Any Other Expense	0	-
Date of payment to MFI/FI 3-Sep-2014			Purchase price \$500,000			
No. of financing days 91						
Profit rate 10.00%			MFI/FI will purchase 10,145 bags of poultry feed @ \$49.28 per bag			
Value of goods at time of sale						
Salam Amount	\$	500,000		Discounted Sale Price (Per Bag)	Per Bag-50 Pound	
Insurance Expense	0.3% \$	1,500		Market Price \$	68.04	
Storage cost at premises of client	0.25% \$	1,250		Applicable taxes 10.00%	6.804	
Agency commission	0.50%	2,500		Discount margin (FSM) 15.00%	10.206	
Other charges	\$	-		Discounted sale price/purchase price of MFI/FI	51.03	
Total cost of acquiring goods	\$	505,250				
Profit	\$	12,466				
		517,716		Quantity required by MFI/FI Bags	10,145	

Following is an example of accounting treatment and recording of Salam transactions:

- ▶ At the time of advance payment to the client for the purchase of Salam goods, the transaction is accounted for as follows:

Dr	Advance against Salam financing	500,000
Cr	Client account	500,000

- ▶ At the time of delivery of Salam goods in accordance with the Salam contract, the transaction is accounted for as follows:

Dr	Salam financing	500,000
Cr	Advance against Salam financing	500,000

- ▶ If the Salam goods are insured after delivery, the transaction is accounted for as follows::

Dr	Insurance of goods	1,500
Cr	P.O / DD	1,500

- ▶ After receipt of goods, the agency agreement is executed and the agency commission is paid as per the Salam agreement

Dr	Agency commission expense	2,500
Cr	Client A/C	2,500

- ▶ Profit accrual is recorded keeping in view the purchase price.t

Dr	Profit receivable on Salam financing	12,466
Cr	Income on Salam financing	12,466

- ▶ If the client fails to deliver the Salam goods on time in accordance with the Salam contract, the transaction related to the undertook charity donation is accounted for as follows:

Dr	Client non-chequing account	xxxx
Cr	Charity payable	xxxx

- ▶ Payment of storage charges

Dr	Storage charges	1,250
Cr	Client A/C /pay order/DD	1,250

- ▶ **Scenario-1** Goods sold at profit: At the time of sale of Salam, if the goods are sold at profit in accordance with the agency agreement, the transaction will be accounted for as follows:

Dr	Client non-chequing A/C (sale proceeds)	517,716
Cr	Salam financing	500,000

Cr	Profit receivable on Salam financing	12,466
Cr	Insurance of goods	1,500
Cr	Income on Salam financing*	3,750

*(Recovery of agency and storage charges from sale proceeds as income)

- **Scenario-2** Goods sold at loss: (e.g. \$8,305)*: If the Salam goods are sold at a lower price than the Salam capital or if the MFI/FI faces loss after receipt of the Salam goods, the transaction will be accounted for as follows:

Dr	Client non-chequing A/C (sale proceeds)	509,411
Dr	Loss on Salam financing**	4,555
Cr	Salam financing	500,000
Cr	Profit receivable on Salam financing	12,466
Cr	Prepaid insurance	1,500

*The loss of \$5,105 includes expense of agency and storage i.e. \$2,500 + \$1,250 + Loss** due to sale of goods \$4,555.

8. RISKS AND MITIGATION MEASURES RELATED TO USE OF SALAM FINANCING

Table 5. Salam Risks and Mitigation

Product-Specific Risks	Risk Mitigation Measures
<p>I. Credit Risk</p> <p>1. In a Salam transaction, settlement risk may arise if the seller/client fails to deliver the commodity on time, causing the buyer (MFI/FI) to face potential loss.</p> <p>2. The counterparty risk may include failure of the client to deliver the commodity or part thereof at the due date of delivery, or in case of delivery of a similar kind of commodity but of a different quality and failure of the MFI/FI to receive the commodity due to client's misconduct or negligence.</p>	<ol style="list-style-type: none"> Such risk can be mitigated by proper due diligence on existing and potential clients at the time of initiation of a relationship and keeping it current at all times thereafter. As the subject matter of transaction must be among Dhawat ul Amthal in characteristics (traded by counting, measuring or weighing according to usage and customs of trade) and must be normally available on the market, avoiding mistakes on it will help mitigate counterparty credit risk adequately. The MFI/FI may also have a recourse to collateral obtained from the client.
<p>II. Market Risk</p> <p>Macro- and microeconomic factors may create uncertainty, which results in market risk due to change in prices and policies in the economy or impact of change on price of the subject matter of the Salam transaction.</p>	<ol style="list-style-type: none"> The market risk is managed by negotiating a lower price than the prevailing market price at the time of the Salam contract and applying such discounting factor, which should not only cover the expected profit and other costs, but also the expected depression in the market (especially in the case of agricultural commodities). By making the client an agent for onward disposal of the subject of Salam, and by paying him an agency fee (any amount above the MFI/FI's required return), the client does not get to lose any income he may otherwise had made and, hence, willingly accepts the lower initial selling price in the original Salam, as the agency fee makes up for his remaining expected income. Higher than expected market prices should be shared with the client
<p>III. Operational Risk</p> <p>In parallel Salam, selling the commodity to a third party requires the two contracts not to be contingent or interlinked to avoid Sharia non-compliance.</p>	<ol style="list-style-type: none"> Top management (including the Sharia governance body of the MFI/FI) must ensure that a proper infrastructure and system exist for sound processes to be observed. Capacity building and dedicated training programmes would help too.

9. SALAM SHARIA COMPLIANCE CHECKLIST- GUIDANCE FOR SHARIA CONTROLLER/AUDITOR

#	Item	Remarks
	General	
1	Obtain a list of all Salam transactions entered into by the MFI/FI during the period under review.	
2	Select a sample of the transactions and obtain their respective agreements.	
3	Compare the sampled agreements with the standard agreement as approved by the SGC.	
4	Ensure that all the transactions entered, and the respective subject matters are in accordance with Sharia rules.	
5	Document actual transaction flow.	
6	Perform walkthrough test to check that the actual transaction flow is in line with the documented transaction flow.	
	Internal Controls	
7	Are there adequate controls to ensure proper transaction flow?	
8	Are there adequate controls to ensure that each step of standard Salam transactions is followed by the next step?	
9	Ensure that the terms of the agreement are not amended except with the specific approval of the SGC.	
10	Ensure proper documentation of the transaction.	
11	Has the MFI/FI implemented controls to ensure that the commodity purchased by the MFI/FI on Salam basis is not sold before receiving the commodity?	
12	Ensure that Salam contract is not on specific items (e.g. this car).	

#	Item	Remarks
	Legal Rules	
13	Ensure that the subject matter of the transaction is of a permissible type.	
14	Ensure that the price is paid in full to the seller at the time of effecting the sale (i.e. entering into the Salam contract)	
15	Ensure that the commodity is known to both contracting parties and meets the criteria applicable for commodities in Salam sale.	
16	Ensure that the commodity under consideration will be available for delivery when it is due. Ensure that the commodity in Salam contract is not seasonal, and/or it must be available on the market from the day of contract until the date of delivery.	
17	Ensure the Salam sale contract is not made on existing commodities already owned by the seller/client.	
18	Ensure that the Salam sale is not effected on gold, silver or currency.	
19	Ensure that the assets in the Salam contract can be precisely specified in quality and quantity.	
20	Ensure that Salam is not affected on a particular commodity or on a product of particular origin.	
21	Ensure that the exact date and place of delivery is specified in the contract.	
22	Ensure that the subject of sale is in physical or constructive possession of the buyer when he sells it to another person.	
23	Ensure that the MFI/FI does not sell the commodity for cash before receiving it from the client.	
24	Ensure that the delivery of the commodity is certain and not contingent on any event.	
25	Ensure that price and other conditions, once agreed between the MFI/FI and the client, are not amended without explicit approval of the SGC.	
26	Review and document any kind of mortgage or security obtained by the MFI/FI from the client/seller.	

10. SALAM CONTRACTS AND DOCUMENTATION

Facility offer letter

Date: _____

To: _____ [Insert name and address of the applicant(s)]

Dear Sirs,

We refer to your application dated _____ and are pleased to advise you of the facility approval as per the terms given below:

1	Facility type:	Salam
2	Purpose: (e.g. Forward sale of poultry feed stock)	
3	Quantity of contracted commodity	
4	Commodity details	
5	Facility amount (\$)	
6	Draw down of facility	Facility to be drawn in full at the time of entering the agreement
7	Maturity (Days/Months)	
8	Securities [list as approved, e.g., promissory note, evidence of personal net worth, other collateral (.....) etc.]	
9	Financial performance	Audited financials to be forwarded

Other Terms and Conditions

1. The facility shall be governed by the relevant/applicable rules and regulations of [Country name], including those of the Central Bank of [Country name] (if applicable).
2. The client may not create any charge on the asset(s) offered as security by way of pledge, hypothecation, mortgage or in any other way created in favour of the Institution, with any other bank, financial institution or any other person in any manner whatsoever.
3. The Salam facility agreement may be cancelled with mutual consent in return for payment of the original contract price.
4. This Salam facility offer letter, together with all related legal documents (subsequently executed by the seller/client), shall form the entire basis of this arrangement.
5. The Institution shall inform the client of all expenses (incurred on account of documentation, valuation, charge registration or any other costs in relation to the facility mentioned in this letter now or hereafter

levied on the Institution in respect of or in connection with the facility and security thereof) which client shall pay immediately on demand by the Institution.

6. This facility offer is subject to internal final approvals, satisfactory review of all documentation, securities, necessary formalities and receipt of duplicate copy of this letter duly signed by the authorized signatory evidencing agreement on all terms and conditions.

Please return a signed and accepted copy of this letter within _____ days.

This offer is valid for a period of days from the date of this letter. If the facility offered herein is not utilized within the specified period, the facility shall stand withdrawn.

Yours faithfully,

For and on behalf of

_____ [Insert name of Institution]

Acceptance of Offer and Terms and Conditions

Date: _____

To: _____ [Insert name and address of the Institution]

Reference your approval of our request dated _____, we hereby accept the facility offer and terms and conditions of the approval provided and request to proceed with the facility. We undertake to abide by the terms of approval. We shall provide a promissory note, surety and other collateral(s), if required. We also undertake to avail the facilities and meet all documentation, customary and other requirements, in form and substance acceptable to the Institution wherever required.

Yours faithfully,

For and on behalf of

_____ [Insert name(s) of applicant(s)]

Salam facility agreement

This Salam Agreement ('the Agreement') is made on this _____ day of _____, between _____, a company incorporated under the laws of [Country name], having its registered office at _____, through its _____ (hereinafter referred to as the "Institution" or "Purchaser" which expression shall, where the context so permits, mean and include its successors-in-interest and assigns), of the one part; and _____, an individual/proprietorship/company/corporation registered under the laws of the [Country name] and having its place of business / registered office at _____ (hereinafter referred to as the "Client" or "Seller" which expression shall, where the context so permits, mean and include its legal heirs, successors-in-interest and assigns), of the second part;

It is agreed by the parties as follows:

1. This Agreement sets out the terms and conditions upon and subject to which the Institution has agreed to purchase the Goods/Commodity from the Client.

2. Supply of the Goods/Commodity purchased:

- 2.1. The Client will, through the form in Appendix-1, request the Institution to provide funds under the Agreement on account of the Goods/Commodity to be provided against the said funds..
- 2.2. The Institution will, through the form in Appendix-2, inform the Client of the quantity of Goods/Commodity to be purchased and the price per unit thereof. The Client agrees to supply the following Goods/Commodity_____ (insert description of Goods/Commodity) to the Institution pursuant to the written offer made for the Sale Price through the form in Appendix-3.
- 2.3. Upon receipt by the Institution of the Client's Notice of Delivery through the form in Appendix-4 indicating the date and place of delivery as mutually agreed between the parties, the Institution will receive the Goods/Commodity through the Goods Receipt Note.
- 2.4. The Goods/Commodity shall remain at the risk of the client until they are delivered to the point of delivery and have been inspected and accepted by the Institution, immediately upon which all risks in respect of the Goods/Commodity shall pass on to the Institution.

3. Security: The Client, under this Agreement, shall furnish to the Institution a Promissory Note. The Client further agrees to provide additional securities if requested by the Institution.

4. Payment of Sale Price: Payment to the Client under this Agreement shall be made in cash exclusive of any taxes applicable under relevant laws in force.

5. Undertaking:

- 5.1. The Client covenants and undertakes that as long as it remains bound under this Agreement, it shall inform the Institution of any Event of Default or any event that, with the giving of notice or lapse of time or both, would constitute an Event of Default forthwith upon becoming aware thereof.
- 5.2. (For companies) The Client shall not, without the written consent of the Institution, sell, transfer, lease or otherwise dispose of all or a sizeable part of its assets in a manner that would materially affect the Client's ability to perform its obligation under this Agreement
- 5.3. (For companies) The Client shall promptly inform the Institution of any change in the management structure/directors of the Client.

6. Events of Default and Termination

- 6.1. There shall be an Event of Default if, in the opinion of the Institution, the Client fails to deliver the Goods/Commodity contracted to be delivered under this Agreement on the Delivery Date at _____ [insert Place of Delivery].
- 6.2. The total interruption or cessation of the business activities of the Client shall constitute an Event of Default.
- 6.3. Notwithstanding anything contained herein, the Institution may, without prejudice to any of its other rights, at any time after the happening of an Event of Default, by notice to the Client, declare that.
- 6.3.1. The obligation of the Institution to take delivery of the Goods from the Client shall be terminated

forthwith; and/or

6.3.2. The entire outstanding amount of the Sale Price and any other amounts paid to the Client under this Agreement along with all other costs, charges and expenses incurred or actual loss sustained by the Institution shall forthwith become due and refundable.

7. Penalty

7.1. Where any Goods/Commodity that are/is due to be delivered by the Client under this Agreement on a specified date and are/is not delivered by that date, or an extension thereof permitted by the Institution without any decrease in the Sale Price, the Client hereby undertakes to pay directly to the designated charity account, as advised by the Institution, a sum proportional to the entire period of default and of the total value of the Goods/Commodity remaining undelivered. The charity fund shall be used as per guidance from the Sharia governance body of the Institution.

7.2. In case the amount undertaken to be paid directly to the charity fund by the Client is not paid by the Client, or the Client delays the payment of any amount due under this Agreement and/ or the payment of the designated amount to the charity fund, as a result of which any direct or indirect costs are incurred by the Institution, the Institution shall have the right to approach a competent Court for recovery of any such amounts remaining unpaid.

8. Indemnities: The client shall indemnify the Institution against any expense that the Institution may prove as rightly incurred by it as a consequence of any default by the Client in the performance of any obligation under this Agreement, the occurrence of any Event of Default or arising out of any misrepresentation.

9. Force Majeure: Any delays or failure by the Client in the performance hereunder, and to the extent it is caused by occurrences or circumstances beyond the Client's reasonable control, including but not limited to, acts of God, fire, strikes or other labour disturbances, riots, civil commotion, war (declared or not), sabotage or any other causes similar to those herein specified that cannot be controlled by the client, shall be considered Force Majeure. The Client affected by such events shall promptly inform the Institution of the occurrence of such events and shall furnish proof of details of the occurrence and reasons for its non-performance of whole or part of this Agreement. The parties shall by consultation between them decide whether to terminate this Agreement, discharge part of the obligations of the affected Party or extend its obligations on a best-effort basis.

IN WITNESS WHEREOF, the Parties to this Agreement have caused this Agreement to be duly executed on the date and year first aforementioned.

For and on behalf of

For and on behalf of

_____ [insert name of the Institution]

_____ [Insert name(s) of Client]

Appendix 1 - Request for funds under Salam facility agreement

Date: _____

To: _____ [Insert name and address of the Institution]

Dear Sirs,

This refers to the Salam Facility Agreement, dated_____. We hereby request to provide us the funds amounting to Local Currency _____ (_____only) on account of selling the Goods/Commodity to you by us as mentioned in the Agreement. Please advise us of the required quantity of the Goods/Commodity to be sold by us against the requested funds.

Yours faithfully,

For and on behalf of

_____ [Insert name(s) of Client]

Appendix 2 - Declaration of required quantity and purchase price per unit

Date: _____

To: _____ [Insert name and address of the Client]

Dear Sirs,

Reference to your request dated _____ regarding disbursement of funds against the sale of Goods/Commodity, please find below the required quantity and unit price to be supplied by you as per Salam Facility Agreement:

#	Specification of Goods/Commodity	Quantity	Unit Price (Local Currency)	Total Value (Local Currency)

Yours faithfully,

For and on behalf of

----- [Insert name of Institution]

Appendix 3 - Written offer to sell the Goods/Commodity

Dear Sirs,

1. Reference your request dated..... regarding the required quantity, we are pleased to confirm our willingness to supply the Goods/Commodity as per the description below:
2. Description of the Goods:

#	Specification of Goods/Commodity	Quantity	Sale Price

- i. Validity of the Offer: _____ days
 - ii. Delivery Date:
 - iii. Terms of delivery:
 - iv. Place of delivery:
3. We certify that we do not foresee, during the term of Salam Agreement, any circumstances that may:
 - i. Materially and adversely affect the continuity of our business, operations, prospects or financial position;
or
 - ii. Make the fulfilment of our obligations unlikely.

Yours faithfully,

For and on behalf of _____[Insert name(s) of Client]

Appendix 4 - Notice of delivery

Date: _____

To: _____ [Insert name and address of the Institution]

Dear Sirs,

Reference to the Salam Facility Agreement dated _____, and our Written Offer for Sale _____dated, we are pleased to inform you that we are ready to deliver the Goods/Commodity as per the following detail:

- i. Delivery Date:
- ii. Place of delivery:
- iii. Description of the Goods/Commodity:

#	Specification of Goods/Commodity	Quantity	Sale Price

Yours faithfully,

For and on behalf of

_____ [Insert name(s) of Client]

Appendix 5 - Goods/commodity receipt note

Date: _____

To: _____ (Client)

Dear Sirs,

We acknowledge having received the Goods/Commodity as detailed in the above Notice of Delivery:

- i. Date of receipt:
- ii. Time of delivery:
- iii. Place of delivery:
- iv. Description of Goods/Commodity delivered:

#	Specification of Goods/Commodity	Quantity	Sale Price

We hereby confirm that there are no claims or liabilities against you.

Yours faithfully,

For and on behalf of

----- [Insert name(s) of Institution]

Appendix 6 - Agency agreement

[In case the Institution wishes to appoint an Agent for the sale of the Goods/Commodity (received under Salam) on the market] This Agency Agreement (the "Agreement") is made at _____ on _____ day of _____, between _____, a company incorporated under the laws of [Country name], having its registered office at _____, through its _____ (hereinafter referred to as the "Institution" or "Principal" which expression shall, where the context so permits, mean and include its successors-in-interest and assigns), of the one part; and _____ (Name of Agent) (hereinafter referred to as the "Agent" or "Wakeel" which expression shall, where the context so permits, mean and include its legal heirs, successors-in-interest and assigns), of the second part.

1. Whereas:

- 1.1. The Institution is the owner of _____ kg/ M. tons of the Goods/Commodity;
- 1.2. The Agent is in the business of, inter alia, selling such Goods/Commodity;
- 1.3. The Agent has represented to Institution that it has the necessary infrastructure, knowhow and expertise to undertake the assignment of marketing and selling the Goods/Commodity; and
- 1.4. Based on such representations of the Agent, the Institution has agreed to entrust the job of marketing/ selling the Goods/Commodity to the Agent.

2. Now, therefore, this Agency Agreement witnesses as under and that the parties have agreed that the Agent shall:

- 2.1. Sell the Goods at the rate of local currency _____ per kg/M. ton (Forced Sale Price)
- 2.2. Upon sale of the Goods/Commodity, deposit the sale price of _____ (total forced sale value) with the Institution by or before _____.
- 2.3. Secure Takaful/Insurance arrangements for the supply of the Goods/Commodity (if required).

3. During the selling period, the Goods/Commodity shall remain stored at the Agent's premises at their common address _____.

4. The Institution shall pay an Agency Fee of _____ to the Agent for performance of this contract. If the Agent fails to do so within the stipulated time, the Institution will not pay the Agency Fee to the Agent. However, in case of timely completion of Sale of Goods/Commodity, the Institution may pay an additional amount as incentive.

5. In order to secure the performance of Agent's obligations under the Agreement, the Agent has provided the Demand Promissory Note as provided in this Agreement. The Institution may demand additional collateral from the Agent.

6. In case of non-performance of the Agent's obligations and/or delay in payment of the sale price due to any negligence on the part of Agent, the Institution shall have the right to liquidate the collateral (as mentioned under Clause 5) and recover the amounts due.

7. It is specifically agreed between the parties that the Agent shall complete the sale of the Goods/Commodity by _____. If the Agent sells the Goods/Commodity and fails to deposit the Sale Proceeds of the

Goods/Commodity with the Institution within 24 hours of the Sale of Goods/Commodity, the Agent hereby undertakes to pay directly to the charity account advised by the Institution a sum calculated at ____% per annum for the entire period of default of the total amount of the obligations remaining undischarged. Such additional amounts shall be utilized by the Institution on behalf of the client for charitable purposes.

In witness whereof, this Agency Agreement has been signed by the parties on the date and place first above-mentioned.

For and on behalf of

For and on behalf of

_____ [Insert name of the Institution]

_____ Insert name(s) of Client]



Ijara

Ijara is a leasing contract whereby a party leases an asset for a specified rent and term. The owner of the asset (the Institution) bears all risks/expenses associated with ownership, while the client bears the expenses related to usage. In Sharia, Ijara is similar to an operating lease.

1. USES OF IJARA

Ijara can be used for the following purposes:

- ▶ Financing of machinery, equipment, real estate, buildings, etc.
- ▶ Financing of medical and IT equipment

2. IJARA VS. CONVENTIONAL LEASING

Ijara differs from conventional hire-purchase, where the terms of sale and leasing are applied to the subject matter at the same time and subsequently the ownership of the asset is transferred to the lessee when he pays the last instalment without the need for a separate contract for the transfer of ownership. In contrast, the provisions governing Ijara are applied to the leased asset until the end of the Ijara term, after which the lessee obtains the ownership of the asset through a separate sale/purchase contract. The type of Ijara used here is one which relates to the usufruct of assets and properties, i.e. to transfer the usufruct of a property to another person in exchange for a rent claimed from him. It is generally used as a form of investment and as a mode of financing. The term 'Ijara' is equivalent to the English term 'leasing' and covers the following:

- ▶ Lessor (Mu'jir),
- ▶ Lessee (Musta'jir),
- ▶ Rent payable to the lessor (Ujrah).

The principles of Ijara (or leasing) are similar to that of sale, because in both cases something is transferred to another person for a valuable consideration. In sale,

the physical object of the property is transferred to the purchaser, while in the case of Ijara, the physical object of the property remains in the ownership of the transferor, but only its usufruct, i.e. the right to use, is transferred to the lessee.

3. IMPACTFUL IJARA THROUGH ECONOMIC EMPOWERMENT

During the Ijara financing tenor, ownership risks remain with the lessor during the lease period, which is particularly beneficial in capital-intensive assets. Institutions can make such financing even more beneficial if they can: (a) reduce the purchase costs of the asset through negotiations with suppliers; (b) optimize the utilization of resources so that the asset is more productive; and (c) ensure proper protection of the asset through appropriate Takaful/insurance products and regular maintenance.

4. RULES APPLICABLE TO IJARA TRANSACTIONS

Leased asset

- ▶ The subject of lease must have a valuable use. Therefore, totally useless items may not be leased.
- ▶ It is required for the validity of an Ijara contract that the physical object of the leased property remain in the ownership of the seller, and only its usufruct be transferred to the lessee.
- ▶ Anything which can be consumed, such as money, eatables and fuel, cannot be leased out, as they are consumed during lease. If anything of this nature is leased out, it would be deemed to be a loan and all the rules concerning loan transactions shall accordingly apply. Any rent charged on this transaction would be interest charged on a loan.
- ▶ It is required for the validity of a lease contract that the leased asset be fully identified by the parties.

- ▶ It is permissible to accept a promise from the client that the asset would be taken by the client on lease after the MFI/FI purchases it from the supplier.

Terms of Ijara period

- ▶ The lease period commences from the date on which the leased asset is delivered to the lessee, whether the lessee starts to use it or not.
- ▶ The period of lease must be determined in clear terms
- ▶ A property jointly owned by two or more persons may be leased out, but the rental must be distributed among all co-owners according to the proportion of their respective shares in the property.
- ▶ The rental must be determined at the time of contract for the whole period of lease. It is permissible that different amounts of rent be fixed for different phases during the lease period, provided that the amount of rent for each phase is specifically agreed upon at the time of effecting the lease. If the rent for a subsequent phase of the lease period is not determined or is left to the option of the lessor, the lease contract would be invalid.
- ▶ The lessor may not unilaterally increase the rent, and any agreement to this effect would be considered void.
- ▶ The rent, or any part thereof, may be payable in advance before the delivery of the asset to the lessee, but the amount so collected by the lessor remains with him as an 'on account' payment and is adjusted towards the rent after it becomes due once the asset is delivered.
- ▶ The rentals are to be paid instantly except when delayed due to genuine reasons, in which case the lessor may extend the period of payment, but no increase in the amount of rental is allowed.
- ▶ In case of delay in payment of rentals with no good reason, an amount (being a certain percentage of rentals) may be stipulated in the contract to be donated directly to a specified charity fund.

Distribution of liabilities in an Ijara contract

- ▶ As the physical object of the leased property remains in the ownership of the lessor, all liabilities emerging from its ownership are borne by the lessor, whereas liabilities relating to the use of the property are borne by the lessee.
- ▶ The lessee may not use the leased asset for any purpose other than the purpose specified in the lease agreement. If no such purpose is specified in the agreement, the lessee can use it for whatever purpose it is used in the normal course. If he wishes to use it for an unusual purpose, he cannot do so without express permission from the lessor.
- ▶ The lessee is liable to compensate the lessor for any harm to the leased asset caused by any misuse or negligence on the part of the lessee.
- ▶ The leased asset remains at the risk of the lessor throughout the lease period, in the sense that any harm or loss caused by factors beyond the control of the lessee are borne by the lessor.

Damage to the leased asset

- ▶ If the leased asset totally loses the function for which it was leased beyond repair, the lease terminates on the day on which such loss occurs. However, if the loss is caused by misuse or negligence of the lessee, he will be liable to compensate the lessor for the depreciated value of the asset.

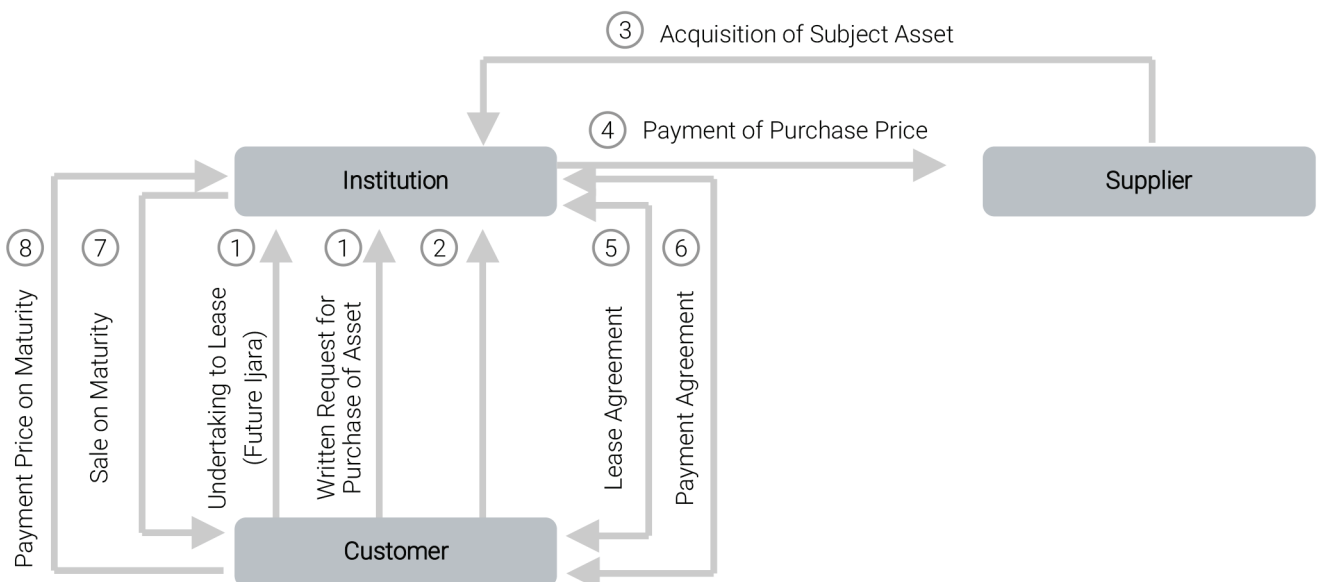
Security deposit

- ▶ The MFI/FI may obtain a security deposit (Hamish Jiddiyah) from the client alongside the latter's promise to rent. This promise becomes binding once the MFI/FI purchases the asset. The amount is used to compensate actual losses sustained by the MFI/FI due to a breach of the promise.
- ▶ The security is to be kept by the MFI/FI as a trust.
- ▶ It is permissible to agree that the security amount be treated as advance payments of the rentals once the promise is fulfilled and the asset has been taken on lease by the client.

5. STAGES AND PROCESS FLOW OF IJARA FINANCING

1. The client approaches the MFI/FI with a request for financing, which the latter offers to provide under Ijara.
2. The MFI/FI, pursuant to the client’s signing of a letter of undertaking to lease (in case of future Ijara), purchases the asset required for Ijara by making payment to the vendor and receives title of ownership from the vendor.
3. The letter of undertaking to lease is a unilateral undertaking by the client to lease the asset from the MFI/FI and indemnify the MFI/FI against any loss or expense that it may incur because of the client’s failure to lease the assets.
4. An agency agreement is executed between the MFI/FI and the client. This agreement contains all terms and conditions related to the appointment of the client as an agent of the MFI/FI to acquire, to the MFI/FI’s account and benefit, the Ijara asset. The MFI/FI leases the asset to the client after execution of the Ijara agreement.
5. The Ijara agreement is the basic document that contains all the terms and conditions pertinent to the asset Ijara. The Ijara agreement is signed after the lessor takes possession of the asset and not earlier. Auxiliary agreements are also executed along with the Ijara agreement:
 - ▶ Undertaking to purchase the Ijara asset: This document contains an undertaking from the lessee to purchase the Ijara asset at the purchase price corresponding to the purchase date. The document contains a schedule that shows the purchase price(s) during the Ijara term at which the lessee can purchase the asset by making a lumpsum payment.
 - ▶ Letter of authorization to repossess the leased assets: Authorization/appointment of the lessor or any of its officers, agents or representatives by the lessee to repossess the Ijara asset upon the happening of an event of default and termination.
 - ▶ Undertaking and indemnity: Undertaking by the client to indemnify the MFI/FI against all proceedings, claims, expenses, penalties and liabilities.
6. The client makes periodic rental payments as per the contract. At the end of the Ijara Term, the client may purchase the asset from the MFI/FI through the execution of a separate sale deed.
7. Sale deed: This document is used to record the sale of the Ijara asset from the MFI/FI to the client.

Figure 3. Ijara Process Flow



6. IJARA ACCOUNTING/BOOKKEEPING (INCLUDING WORKED EXAMPLES)

The Ijara asset is recognized at historical cost, which is allocated over the term of lease and depreciated as per normal depreciation policy. Ijara revenues/expenses are booked proportionately in financial periods over the lease term. Repairs undertaken by the lessee with the consent of the lessor are recognized as expenses. The legal title passes at the end of the lease term, subject to settlement of Ijara instalments and deed of sale. If the lessee is not obliged to purchase the asset and if the cash equivalent value is less than the net book value, the difference between the two is recognized as loss. Following are examples of accounting treatment and bookkeeping for Ijara transactions.

Small enterprise – Ijara for machines for carpet weaving – deferred delivery of asset:

Table 6. Ijara Accounting Example

Small Enterprise Finance – Machines for Carpet Weaving										
Document Info	Machinery Ijara – Deferred Delivery Against Payment to Supplier									
Document Info	Machinery									
Specific Information	Machines for Carpet Weaving									
Applicant	XXXX									
Value of Assets	EGP	1,000,000								
Security Deposit	20.00%	200,000								
Amount Financed	80.00%	800,000								
Residual Value	20.00%	200,000								
Insurance	3.00%	30,000								
Profit Rate	10.00%									
Tenure	5	60	Months							
Disbursement Rate	01-Jan-2014									
Delivery Date	01-Feb-2014									
1st Installment Date	01-Apr-2014									
Period between disbursement and delivery date	31									
Grace Period to start first installment	90									
Profit for the period for which asset was no delivered	6,795									
Inst #	Due Date	O/S Principal	Principal	Profit	Installment	Insurance	Profit for grace period	Ijara Rental	O/S Insurance	O/S Period
		1	2	3	4	5	6	7	8	
		1,000,000								
1	01-04-2014	986,667	13,333	4,256	17,589	2,500	113	20,202	27,500	
2	01-05-2014	973,333	13,333	4,256	17,589	2,500	113	20,202	25,000	
3	01-06-2014	960,000	13,333	4,256	17,589	2,500	113	20,202	22,500	
4	01-07-2014	946,667	13,333	4,256	17,589	2,500	113	20,202	20,000	
5	01-08-2014	933,333	13,333	4,256	17,589	2,500	113	20,202	17,500	
6	01-09-2014	920,000	13,333	4,256	17,589	2,500	113	20,202	15,000	
7	01-10-2014	906,667	13,333	4,256	17,589	2,500	113	20,202	12,500	
8	01-11-2014	893,333	13,333	4,256	17,589	2,500	113	20,202	10,000	
9	01-12-2014	880,000	13,333	4,256	17,589	2,500	113	20,202	7,500	
10	01-01-2015	866,667	13,333	4,256	17,589	2,500	113	20,202	5,000	
56	01-11-2018	253,333	13,333	5,856	19,189	900	113	20,202	3,600	
57	01-12-2018	240,000	13,333	5,856	19,189	900	113	20,202	2,700	
58	01-01-2019	226,667	13,333	5,856	19,189	900	113	20,202	1,800	
59	01-02-2019	213,333	13,333	5,856	19,189	900	113	20,202	900	
60	01-03-2019	200,000	13,333	5,856	19,189	900	113	20,202	0	
			800,000	303,333	1,103,333	102,000	6,795	1,212,128		

Small enterprise – Ijara for machines for carpet weaving – immediate delivery of asset:

Small Enterprise Finance – Machines for Carpet Weaving									
Document Info	Machinery Ijara – Immediate Delivery Against Payment to Supplier								
Specific Information	Machines for Carpet Weaving								
Applicant	XXXX								
Value of Assets	1,000,000								
Security Deposit	25.00%	250,000							
Amount Financed	75.00%	750,000							
Residual Value	25.00%	250,000							
Insurance Rate	3.00%	30,000							
Profit Rate	10.00%								
Tenure (Years)	5	60	Months						
Disbursement Date	01-Jan-2014								
Delivery Date	01-Jan-2014								
1st Installment Date	01-Apr-2014								
Inst #	Due Date	O/S Principal	Principal	Profit	Installment	Insurance	Ijara Rental	O/S Insurance	Termination Value
		1,000,000						30,000	
1	01-04-2014	987,500	12,500	4,605	17,105	2,500	19,605	27,500	1,029,750
2	01-05-2014	975,000	12,500	4,605	17,105	2,500	19,605	25,000	1,014,500
3	01-06-2014	962,500	12,500	4,605	17,105	2,500	19,605	22,500	999,250
4	01-07-2014	950,000	12,500	4,605	17,105	2,500	19,605	20,000	984,000
5	01-08-2014	937,500	12,500	4,605	17,105	2,500	19,605	17,500	968,750
6	01-09-2014	925,000	12,500	4,605	17,105	2,500	19,605	15,000	953,500
7	01-10-2014	912,500	12,500	4,605	17,105	2,500	19,605	12,500	938,250
8	01-11-2014	900,000	12,500	4,605	17,105	2,500	19,605	10,000	923,000
9	01-12-2014	887,500	12,500	4,605	17,105	2,500	19,605	7,500	907,750
10	01-01-2015	875,000	12,500	4,605	17,105	2,500	19,605	5,000	892,500
56	01-11-2018	300,000	12,500	6,105	18,605	1,000	19,605	4,000	305,000
57	01-12-2018	287,500	12,500	6,105	18,605	1,000	19,605	3,000	291,250
58	01-01-2019	275,000	12,500	6,105	18,605	1,000	19,605	2,000	277,500
59	01-02-2019	262,500	12,500	6,105	18,605	1,000	19,605	1,000	263,750
60	01-03-2019	250,000	12,500	6,105	18,605	1,000	19,605	0	250,000
	-		750,000	321,313	1,071,313	105,000	1,176,313		

The accounting treatment of Ijara transactions in various scenarios is given below.

Charging processing fee and receiving security deposit:

January 1, 2014

Dr	Party non-chequing account	205,000
Cr	Processing fee	5,000
Cr	Security deposit (HJ)	200,000

Scenario 1 - Advance payment/future delivery

When advance payment is made to manufacturer/supplier, Ijara asset is delivered at some future date:

1. Disbursement to manufacturer/supplier (advance payment): (the MFI/FI opens a non-chequing A/C in a bank in the name of client)

January 1, 2014

Dr	Advance against Ijara asset	1,000,000
Cr	Party non-chequing account	1,000,000
Dr	Party non-chequing account	1,000,000
Cr	Transit A/C (P.O/D.D)	1,000,000

[At this stage, the MFI/FI will obtain an undertaking from the client to lease the asset]

2. Delivery of asset:

February 1, 2014

Dr	Ijara leased asset	1,000,000
Cr	Advance against Ijara asset	1,000,000

[At this stage, the Ijara agreement is executed]

Scenario 2 - Immediate/ready delivery

In case the asset is acquired on ready-to-deliver basis, entry No.1 above is not passed.

January 1, 2014

Dr	Ijara leased asset	1,000,000
Cr	Party non-chequing account	1,000,000

[No undertaking to lease will be obtained, however, only the Ijara agreement is executed]

Dr	Party non-chequing Account	1,000,000
Cr	Transit A/c (P.O/D.D)	1,000,000

Upon receipt of the asset, insurance charges are paid (on February 1, 2014 in case of advance payment and on January 1, 2014 in case of immediate delivery)

Insurance

July 1, 2014

Dr	Prepaid insurance Ijara asset	30,000
Cr	Transit A/C (P.O/D.D)	30,000

Income Accrual of Ijara rental

April 1, 2014

Dr	Rental income receivable on Ijara asset	20,202
Cr	Rental income on Ijara	20,202

[In case of ready Ijara, this amount will be 19,605]

Expense Accruals

March 31, 2014

Dr	Depreciation expense on Ijara asset	13,333
Dr	Insurance expense Ijara	2,500
Cr	Accumulated depreciation on Ijara asset	13,333
Cr	Prepaid insurance Ijara asset	2,500

Receipt of Ijara rental

April 1, 2014 (Receipt of Ijara rentals)

Dr	Party non-chequing account	20,202
Cr	Rental income receivable on Ijara asset	20,202

[In case of future Ijara, the amount will be 24,280 to be received on April 1, 2014]

Scenario 3 - Early termination

When after five repayments are timely received and agreement is terminated early after payment of the 5th rental:

Early termination of Ijara Agreement

August 1, 2014

Dr	Security deposit	200,000
Dr	Party non-chequing account	755,515*
Dr	Accumulated depreciation – Ijara	66,665
Cr	Ijara leased asset	1,000,000
Cr	Prepaid insurance charges	17,500
Cr	Profit/loss on termination of Ijara	20,893

* As per amortization (purchase price) schedule: the price is 955,515 minus 200,000 = 771,728

Available funds: 771,728 in non-chequing A/C + SD + Acc. Dep. = 1,038,393

Total cost of MFI/FI: Asset + prepaid insurance = 1,017,500

Difference of available funds – total cost of MFI/FI = 1,038,393- 1,017,500 = 20,893

Scenario 4 - Maturity of Ijara

In case the client pays all instalments, the above accrual entries are passed on each month end and continue to be passed until maturity

At final maturity

In case the client returns the asset to the MFI/FI and amount of security deposit is refunded:

Dr	Security deposit	200,000
Cr	Party non-chequing account	200,000
Dr	Party non-chequing account	200,000
Cr	Transit A/C (P.O/D.D)	200,000

Adjustment of facility after sale of asset on the market

Dr	Accumulated depreciation on Ijara	800,000
Dr	Non-chequing account (sale proceeds)	300,000
Cr	Ijara leased asset	1,000,000
Cr	Profit on sale of leased asset	100,000

In case the client wants to retain the asset, ownership is transferred to the client and the security deposit amount is adjusted:

Dr	Accumulated depreciation on Ijara	800,000
Dr	Security deposit	200,000
Cr	Ijara leased asset	1,000,000

Scenario 5 - Client default

When first repayment is timely received and the client defaults on the next three instalments:

Accruals are passed until July 31, 2014 then a specific provision at 25% of the Ijara asset is recorded and already accrued rental income is suspended.

August 1, 2014

Profit suspended

Dr	Rental Income on Ijara	58,815
Cr	Income suspense A/C	58,815

[58,815 being the income accrued for three months but when client defaults on three instalments (more than 90 days) this goes to the income suspense A/C.]

Reversal of depreciation (except for the period rentals have been received)

Dr	Accumulated depreciation on Ijara	39,999
Cr	Depreciation expense on Ijara	39,999

7. RISKS AND MITIGATION MEASURES RELATED TO USE OF IJARA FINANCING

Table 7. Ijara Risks and Mitigation

Product-Specific Risks	Risk Mitigation Measures
<p>I. Non-repayment Risk</p> <ol style="list-style-type: none"> 1. The lessee may be unable to pay the rental as and when it falls due. 2. Asset repossessed due to default of the lessee may not sell or lease to another party at higher than the original price. 3. The MFI/FI may be unable to recover future rentals that are “accelerated” or declared immediately due upon default by the lessee. The MFI/FI may have to bear the potential loss as the fair value of the asset at the maturity stage falls below its residual value estimated at the time of contract (low fair value). 	<ol style="list-style-type: none"> 1. Repossession of asset may be accompanied by additional collateral to make good the difference between contracted rentals and the market price realized. 2. Undertaking for donation to be paid to charity can be added.
<p>II. Market Risk</p> <ol style="list-style-type: none"> 1. Normally, the lessor acquires the lease asset prior to securing any leasing contracts. Thus, the leased asset is subject to price risk, the risk that the lessor may not be able to profitably lease out the asset. 2. Market risk also arises when rentals lose value in changing market conditions. 	<ol style="list-style-type: none"> 1. Ensure that the promise to Ijara is properly documented and is legally enforceable. 2. Variable rentals can be agreed in Ijara contract.
<p>III. Early Termination Risk</p> <p>This risk arises when client wants to terminate earlier than the tenor agreed in the contract, causing loss of income to the MFI/FI.</p>	<p>Early termination risk can be mitigated by applying purchase undertaking (if relevant) with a price covering the remaining rents or to sell the asset in the market to cover partially/totally the sums that were supposed to be generated by the lease if not terminated.</p>

Product-Specific Risks	Risk Mitigation Measures
<p>IV. Operational Risk</p> <ol style="list-style-type: none"> Specific risks of the lessor relating to the physical damage, theft and/or loss on destruction of the leased asset may arise. Any violation of the approved operating procedure results in Sharia non-compliance risk, hence loss of income. Similarly, combining sale and lease contracts also raises Sharia non-compliance risk. 	<ol style="list-style-type: none"> The risk can be compensated by purchasing Takaful insurance. The lessor may include the cost of the Takaful premium in the Ijara rental. Any escalation in the Takaful premium may also trigger rent adjustment if it is specified in the Ijara contract. Top-management (including the Sharia governance body of the MFI/FI) must ensure that a proper infrastructure and system exist for sound processes to be observed. Capacity building and dedicated training programmes would help too.

8. IJARA SHARIA COMPLIANCE CHECKLIST- GUIDANCE FOR SHARIA CONTROLLER/AUDITOR

#	Item	Remarks
	General	
1	Obtain a list of all the Ijara transactions entered into by the MFI/FI during the period under review.	
2	Select a sample of the transactions and obtain their respective agreements to check their Sharia compliance.	
3	Review the standard agreement approved by the SGC and compare the sampled agreements for correctness.	
4	Document the actual transaction flow.	
5	Perform walkthrough test to check that the actual transaction flow is in line with the documented transaction flow.	
6	Ensure that the MFI/FI has properly classified the Ijara as per the modes approved by SGC.	
	Internal Controls	
7	Does the MFI/FI ensure that the subject matter of the transaction is held on permissible items?	
8	Are there adequate controls implemented to ensure proper transaction flow?	
9	Are there adequate controls implemented to ensure that each step of standard Ijara transaction is followed by the next step?	

#	Item	Remarks
10	Ensure that the terms of the agreement are not amended except with the specific approval of the SGC.	
11	Ensure proper documentation of the transactions.	
12	Ensure that the agreements are properly signed and witnessed.	
	Legal Rules	
13	Ensure the leased assets are/were not perishable or consumable items.	
14	Check that the subject of the contract is legally attainable.	
15	Ensure that the Ijara agreement stipulates that the lessor be responsible for major repairs and maintenance of the leased asset and bear any loss thereto. If Takaful/ insurance is considered necessary, its cost is borne by the lessor.	
16	Ensure that the lease contract specifies that the responsibility for damage is borne by the one who brings it about.	
17	Check that the lease period is clearly and unambiguously stated in the contract.	
18	Ensure that the rental charges start after the date of the contract and after delivery of the asset.	
19	Ensure that any Urboun (earnest money) taken in respect of the lease at the execution of the contract is treated as advance payment. Also ensure that only actual damages are offset using the Urboun in case of default.	
20	Subject to the approval of the SGC, advance rent may also be taken but not credited to the income of the MFI/FI until the asset is delivered to the client.	
21	Check whether any security deposit has been obtained by the MFI/FI as a guarantee for accepting the lease. Also ensure that no amount has been deducted from this sum except expenses that are in proportion to the actual damage suffered by the MFI/FI in case of client default.	
22	Document the amount of security deposit and cross-reference it with the agreement.	
23	In case of floating rentals, ensure that rentals for the first period are specified and then a certain benchmark applied for the determination of future rentals.	
24	In case of default or late payment of rentals, ensure that penalty received is paid as a donation to an approved charity.	
25	Ensure that a separate contract is being entered into for transfer of ownership of the asset at end of the lease term.	

9. IJARA CONTRACTS AND DOCUMENTATION

Ijara facility offer letter

Date: _____

To: _____ [Insert name and address of the applicant(s)]

Dear Sirs,

We refer to your application dated _____ and are pleased to advise you of the facility approval as per the terms given below:

1	Facility type:	Ijara
2	Facility amounts (\$)	
3	Purpose	
4	Asset details	
5	Security Deposit (% of the total value of asset))	
6	Rental	(\$ _____ /month)
7	Revision of profit rate, if any	As agreed in Ijara agreement
8	Facility tenor/expiry	
9	Tentative delivery period: (No. of days)	
10	Payment: (e.g. monthly/quarterly/semi-annual rentals payable in arrears after delivery of asset to client by the Institution)	
11	Securities: (exclusive ownership of the leased asset, personal guarantee and/or direct debit authority/post-dated cheques, other securities as agreed, etc.)	
12	Comprehensive Takaful/insurance (asset insurance; life insurance, if required; insurance for default)	
13	Processing charges	\$ _____ (non- refundable)
14	Documentation charges	Actual
15	Specific terms and conditions: (if any)	

Other Terms and Conditions:

1. The facility shall be governed by the relevant/applicable rules and regulations of the (Country name) including those of the Central Bank of (Country name) (if applicable).
2. The client may not create any charge on the asset(s) offered as security by way of pledge, hypothecation, mortgage or in any other way created in favour of the Institution, with any other bank, financial institution or any other person in any manner whatsoever.
3. The Ijara (leased) asset shall be duly covered by Takaful/insurance in favour of the Institution in a manner that the Takaful contribution/insurance premium of the Ijara (leased) asset will be paid by the Institution. (If the Institution wants the client to bear the cost of Takaful/insurance, the client must explicitly state in the agreement that the client volunteers to pay the premium in the knowledge that it is originally the liability of the Institution. Alternatively, and preferably, if the Institution wishes this cost to be shifted to client, the rental can be set at a level that covers for such an expense.)
4. The Ijara (leased) asset may be inspected by the Institution as and when required, and the client shall allow access and cooperate with the authorized representative of the Institution in carrying out such inspections.
5. Any security created in favour of the Institution for the facility by way of mortgage, hypothecation or otherwise shall be maintained throughout the tenure of the facility.
6. The Institution shall inform the client of all expenses incurred on account of documentation, valuation, charge registration or any other costs in relation to the facility mentioned in this letter now or hereafter levied on the Institution in respect of or in connection with the facility and security thereof which client shall need to pay immediately on demand by the Institution.
7. This facility offer is subject to internal final approvals, satisfactory review of all documentation, securities, necessary formalities and receipt of duplicate copy of this letter duly signed by the authorized signatory evidencing agreement on all terms and conditions.

Please return a signed and accepted copy of this letter within _____ days.

This offer is valid for a period of days from date of this letter. If the facility offered herein is not utilized within the specified period, the facility shall stand withdrawn.

Yours faithfully,

For and on behalf of

_____ [Insert name of Institution]

Acceptance of Terms and Conditions

Date: _____

To: _____ [Insert name and address of the Institution]

Reference your approval of our request dated _____, we hereby accept the facility offer and terms and conditions of the approval provided and request to proceed with the facility. We undertake to abide by the terms of approval. We shall provide a promissory note, surety, and other collateral(s), if required. We also undertake to avail the facilities and meet all documentation, customary and other requirements, in form and substance acceptable to the Institution wherever required.

Yours faithfully,

For and on behalf of _____ [Insert name(s) of applicant(s)]

Undertaking to lease

Dear Sirs,

Reference my application dated _____ to _____ (the Institution), whereby

I requested the Institution to lease out to me the asset(s) mentioned in my request to be acquired for this purpose.

1. Whereas the Institution agreed to acquire the specified asset(s) to be subsequently leased out to me as per the Ijara agreement to be executed between the Institution (*delete as appropriate*) and myself (the Agreement). The cost of the asset(s) to be paid by the Institution is approximately \$_____.
2. And whereas, I agreed to take on Ijara basis the asset(s) to be acquired upon the terms and conditions set forth as follows.

NOW THEREFORE:

- i. I hereby irrevocably undertake to lease the asset(s) on Ijara basis from the Institution on the date when the asset(s) shall be delivered to me (value date) through execution of the Ijara agreement.
- ii. I hereby agree and undertake that, in case I fail to take the asset(s) on Ijara basis, I shall pay the Institution the amount of actual loss it incurs/sustains due to my failure to effect asset receipt.
- iii. This Undertaking to Lease shall come into effect on the date of its execution by me and shall expire on the date I receive the assets on Ijara basis from the Institution as mentioned above.

In witness whereof, I have executed this Undertaking to Lease on this _____ day of _____.

By and on behalf of client

Witnesses

Ijara agreement

This Ijara agreement ('the Agreement') is made on this _____day of_____ between the _____institution, a company incorporated under the laws of (Country name), having its registered office at _____, through its _____ (hereinafter referred to as the "Lessor" which expression shall, where the context so permits, mean and include its successors-in-interest and assigns), of the one part;

and

_____, a sole proprietorship/company/corporation registered under the laws of (Country name) and having its place of business/registered office at _____ (hereinafter referred to as the "Lessee" which expression shall, where the context so permits mean and include its legal heirs, successors-in-interest and assigns), of the second part;

It is agreed by the parties as follows:

1. Purpose

1.1. The Lessor, acting on the written request of the Lessee as in Appendix-1 of this Agreement, acquired/beneficially acquired the requested assets (Lessor may have acquired these assets directly from the supplier or through an agent, which may have been the Lessee itself but through a separate agency agreement) and agreed to lease the same to the Lessee in accordance with the terms herein, including Appendices 2-5 of this Agreement.

2. Delivery of Assets: The Lessee shall obtain delivery of the assets directly from the supplier as notified by the Lessor. Upon obtaining delivery of the assets, the Lessee shall execute and deliver to the supplier and the Lessor a receipt or acceptance thereof using the form annexed to the lease documents. Upon such acceptance of the assets, the Lessee agrees and covenants that the assets are in good working order, condition and appearance and are satisfactory to the Lessee.

3. Maintenance of Leased Assets

3.1. All expenses related to ownership of the assets are the responsibility of the Lessor and all expenses related to use of the assets are the responsibility of the Lessee.

3.2. The Lessee agrees to maintain the leased assets in reasonable condition satisfactory to the Lessor and bear all operating costs and expenses, including but not limited to items such as fuel, oil, repairs, replacement of components and/or parts, etc.

3.3. The Lessor shall pay the registration charges and any taxes applicable to the purchase of the assets.

3.4. The Lessee shall not alienate the leased asset in any manner without the Lessor's consent.

4. Insurance, Accidents, Injuries and Indemnification

4.1. Takaful/Insurance:

4.1.1. Takaful/Insurance arrangement by Lessor/Institution: the Ijara assets shall be comprehensively covered/insured by the Institution with a Takaful/insurance company offering protection against the risk of loss/theft/damage, etc.

- 4.1.2. Takaful/Insurance arrangement by Lessee/Client: The Lessee shall ensure that the Ijara asset is satisfactorily covered/insured in the manner and with the company as mutually agreed between the Lessee and the Lessor, preferably offering protection under the Islamic concept of Takaful. In case the Takaful option is not available, the Ijara assets shall be comprehensively insured with an insurance company to the satisfaction of the Institution.
 - 4.2. The Lessee shall remain responsible and liable for any third-party liability, fraud, gross negligence or any misuse or non-customary use of the assets.
 - 4.3. All proceeds of the Takaful/insurance, whether consisting of total loss proceeds, or otherwise, shall be applied at the option of the Lessor towards the replacement, restoration or repair of the leased assets, if reasonably possible.
 - 4.4. The Lessee agrees to pay the Lessor the cost of repairing or replacing any damage arising out of misuse of the leased assets.
 - 4.5. If the leased assets are damaged out of no fault on the part of the Lessee but can be repaired, and if the respective Takaful/insurance proceeds are insufficient to cover the repair expenses, the Lessee shall pay for repairs and claim the difference from the Lessor. However, if the leased assets are totally lost or damaged beyond repair, the Takaful/insurance proceeds shall be payable to the Lessor and this Agreement shall stand terminated.
 - 4.6. All repairs, replacements or substitutions of parts or components of the leased assets necessitated due to normal usage shall be at the Lessee's expense.
 - 4.7. The Lessee's obligation to pay the rentals shall commence once it has accepted delivery of the leased assets.
5. Termination, Default, and Total Loss of Asset
 - 5.1. This Agreement in respect of the leased assets may be terminated only with the mutual consent of the parties hereto.
 - 5.2. There shall be an Event of Default if, in the opinion of the Lessor, there is (i) any misrepresentation from the Lessee, (ii) any default(s) in any lease rental payment(s), and/or (iii) any material or changed adverse circumstances at the end of the Lessee that are deemed an Event of Default in the opinion of the Lessor, including but not limited to cessation of business, change in ownership, insolvency, etc. All such occurrences shall entitle the Lessor to repossess the asset(s) without judicial intervention, and its costs shall be payable by the Lessee.
 - 5.3. In the event of total loss of the leased assets, the Ijara contract shall be terminated with immediate effect and payment of all future rentals shall cease.
6. Inspection: The Lessor retains the right to inspect the assets at its discretion and the Lessee agrees to maintain the leased assets in reasonable condition satisfactory to the Lessor.
7. Security Deposit: Should any profit be earned in respect of the security deposit given by Lessee against the undertaking to lease given in Appendix-1 as a result of it being deposited in a profit-bearing Islamic account, the Lessor shall be liable to pass such profit to the Lessee.

8. Donation undertaking: In case of delay in any payment on its due date, the Lessee undertakes to pay directly to the charity account advised by the Lessor a sum calculated as follows: $(\text{Unpaid Sum} \times 1\% \times \text{Unpaid Period}) / (365 \text{ Days})$
9. Assignment
- 9.1. The Lessee may not assign or transfer any of its rights or obligations under this Agreement without the written consent of the Lessor. The Lessor may assign all or any part of its rights or transfer all or any part of its obligations and/or commitments under this Agreement to any other lessor or person. The Lessee shall not be liable for the costs of the assignment and/or transfer of commitments hereunder by the Lessor.
- 9.2. The Lessor may disclose to a potential assignee or transferee or to any other person who may propose entering into contractual relations with the Lessor in relation to this Agreement such information about the Lessee as the Lessor shall consider appropriate.
10. Security: Lessee shall execute a demand promissory note in favour of the Lessor for the entire amount of lease rentals (the "Demand Promissory Note"); provide surety, if required, and also furnish to the Lessor collateral in the form and substance as required by and acceptable to the Lessor.
11. Force Majeure: Any delays or failure by the Lessee in the performance hereunder, and to the extent it is caused by occurrences or circumstances beyond the Lessee's reasonable control, including but not limited to, acts of God, fire, strikes or other labour disturbances, riots, civil commotion, war (declared or not), sabotage or any other causes similar to those herein specified that cannot be controlled by the Lessee shall be considered Force Majeure. The Lessee affected by such events shall promptly inform the Lessor of the occurrence of such events and shall furnish proof of details of the occurrence and reasons for its non-performance of whole or part of this Agreement. The parties shall by consultation between them decide whether to terminate this Agreement, discharge part of the obligations of the affected Party or extend its obligations on a best-effort basis.

These terms and conditions shall be deemed amended and/or modified if the rights and duties of the parties hereto are altered by change in the laws and rules of (Country name), provided that such changes do not contradict the Islamic Sharia. In case of any contradiction, the rules of Islamic Sharia shall prevail.

In witness whereof, the parties to this Agreement have caused this Agreement to be duly executed on the date and year.

For and on behalf of Lessor

For and on behalf of Lessee

_____ [insert name of the Lessor]

_____ [Insert name(s) of Lessee]

Appendix 1 - Written request for purchase of asset

Date: _____

To: _____ [Insert name and address of the Lessor]

Dear Sirs,

We request you to kindly procure the assets described below to be leased to us under a separate agreement:

#	Specification of Asset	Amount (\$)

We hereby undertake to lease the assets as soon as these have been purchased/acquired by you.

For and on behalf of

_____ [Insert name(s) of Lessee]

Appendix 2 - Receipt of leased assets

(To be filled by the Client/Lessee)

Date: _____

To: _____ [Insert name and address of the Lessor]

Dear Sirs,

We refer to the Ijara Agreement dated _____ and hereby confirm that the assets described below are received complete in all respects and in perfect working order and condition (*insert description of assets*):

For and on behalf of

_____ [Insert name(s) of Lessee]

Appendix 3 - Delivery schedule

This schedule is attached to and forms an integral part of the Lease Agreement made at _____ on _____ day of, _____ between _____ (Lessor) and _____ (Lessee).

It is agreed by the parties as follows:

1. The Lessee authorizes the Lessor to procure the assets noted below, and after having taken the possession of the asset, lease it to the Lessee in terms of the agreement and the following terms and conditions:

#	Description of Assets	Value (\$)	Specifications

- i. Total cost of assets:
- ii. Monthly Ijara rentals:
- iii. Tenor of Ijara:
- iv. Security deposit*:
 - *(to be adjusted towards the residual value at the end of the lease period)
- v. Value date (date of delivery):
- vi. Place of return (the place where assets will be returned in case they are to be returned by the Lessee and not retained): (This is optional)
- vii. Commencement date of Ijara:

2. All terms defined in the above referred Ijara agreement bear the same meaning herein.

3. All terms and conditions shall form an integral part of this Appendix.

For and on behalf of Lessee

For and on behalf of Lessor

_____ [Insert name of the Lessee]

_____ [Insert name of Lessor]

Appendix 4 - Schedule of Ijara rentals

Ijara rentals are to be paid by Lessee to the Lessor on the ...th day from the beginning of each month/quarter/six months/year (delete as appropriate).

The date of first payment shall be _____ .

#	Date	Ijara Rental (\$)	#	Date	Ijara Rental (\$)

For and on behalf of Lessee

For and on behalf of Lessor

_____ [insert name of the Lessee]

_____ Insert name of Lessor]

Appendix 5 - Undertaking to purchase Ijara asset

Date: _____

To: _____ [Insert name and address of Lessor]

Dear Sirs,

In reference to the Lease Agreement dated _____, we hereby agree and undertake that if you desire to terminate this Lease on account of any of the grounds mentioned in the Lease Agreement during the currency of the Lease or when the Lease reaches its natural end, we shall be obliged to purchase the Leased Assets at the Purchase Price mentioned below against the date immediately preceding the date of termination of the Lease (Purchase Date). In any such event, all our rights under the Lease Agreement and in the Leased Assets covered by this Lease Agreement shall forthwith terminate and, if we fail to pay the Purchase Price on or before the date specified by you, you shall have the right to take immediate possession of the Leased Assets and we shall immediately deliver to you the Leased Assets together with the registration certificate, permit or other documents pertaining thereto;

Purchase Price: _____ (Local Currency)

For and on behalf of

_____ [Insert name(s) of Lessee]

Appendix 6 - Agency agreement

From: _____ [Insert name of Institution]

To: _____ [Insert name of Agent]

Dear Sirs,

We hereby appoint you as our Agent (Wakeel) for a fee not exceeding _____ (Local currency) to purchase the Assets (defined below) from the supplier under the following terms and conditions:

1. The Assets to be purchased are defined as below:

#	Date	Description	Quantity	Value (\$)

2. We shall make payment of the funds directly to the supplier of the Assets or to you.
3. Immediately after the acquisition of the Assets, you shall provide us with the annexed Declaration confirming acquisition of the Assets along with details and evidence of acquisition of the Assets in a form acceptable to us.
4. You shall ensure that the Assets are not being consumed/sold before providing us with the declaration mentioned as above.
5. You shall exercise due diligence to ensure that the Assets purchased on our behalf are free from any defect. Any loss or damage occurring to the Assets due to any contravention of the terms of this Agency Agreement by you shall be borne by you. If you are not able to acquire the Assets due to any reason, you shall immediately and fully return the funds provided, if any.
6. We shall have the authority to revoke this Agency Agreement at any time, without assigning any reason thereof.
7. You shall be fully and solely responsible for the quality, condition, selection and specifications of the Assets if different from what we advised you of.
8. You shall ensure that all necessary permits, exchange control approvals, import licenses and all other consents required in connection with the import of the Assets are obtained

Please affirm your acceptance of the foregoing terms and conditions by signing the duplicate.

For and on behalf of Institution

_____ [insert name of the Institution]

Acceptance of agent (Wakeel)

I accept the authorization and shall purchase the Assets in your favour and on your behalf as per the terms and conditions contained herein.

Accepted for and on behalf of

_____ [Insert name of Agent]

Annex: Declaration

We hereby declare and certify that, acting as your Agent, we have purchased the Assets for (local currency_____ only) and have taken the delivery from the vendor/supplier. We hereby certify that the Assets procured on your behalf, as your Agent, have not been consumed at the time of signing of this Declaration.

#	Date	Description	Quantity	Value (\$)

For and on behalf of

_____ [Insert name of Agent]



Musharaka

Musharaka refers to a partnership between two or more parties, which may take effect through a contractual relationship, whereby all contracting parties will share the profit and bear loss from the partnership.

1. MUSHARAKA AS A MODE OF FINANCING

Generally, there are two types of Musharaka (Shareka), namely:

- ▶ Sharekat al-Milk (partnership in ownership) is a partnership in ownership that refers to the possession of an asset by two or more persons with or without prior arrangement to enter into a joint ownership. Under Sharekat al-Milk, none of the partners may deal in any other partner's asset without his consent.
- ▶ Sharekat al-Aqd (contractual partnership) refers to a contract executed between two or more partners to venture into business activities to generate profit. Under Sharekat al-Aqd, each partner acts as an agent of the other partners. In this regard, the actions of one partner in the ordinary course of business represent the entire partnership.

2. USES OF MUSHARAKA

Musharaka can be used for following purposes:

- ▶ Enterprise setup
- ▶ Productive projects
- ▶ Working capital financing
- ▶ Export financing (pre-shipment financing)
- ▶ Import financing
- ▶ Bridge financing
- ▶ Working capital financing
- ▶ Running accounts financing/short-term advances

3. HOW IS MUSHARAKA DIFFERENT?

Musharaka is a joint venture on an asset or an enterprise between two or more parties. This is an equity-oriented partnership where the partners contribute to the investment capital. It does not necessarily require a transfer in the enterprise shares, as it is measured based on the net asset value of the firm and not on the future expected returns. It is similar to equity trading in the sense that the partners share the profits of the venture through dividends. However, a Musharaka partner is not necessarily an owner of the firm.

In a Musharaka, an investor contributes to the capital of the firm in exchange for the right to a portion of the profits generated from the firm or asset. While the profit-sharing arrangement may be negotiated upfront, any loss must be shared in proportion to the share of capital contribution.

4. IMPACTFUL MUSHARAKA THROUGH ECONOMIC EMPOWERMENT

Like all equity instruments, Musharaka facilitates a risk-sharing arrangement between the entrepreneur and the investor. As it is the investor who will invest in the asset or venture, the investor should ensure all risk mitigation measures, including relevant Takaful and permits are obtained. As the highest risks are during the initial stages, the investor's role in ensuring that the asset or the venture can generate high returns is critical. Besides the capital provided, the investor may, and should, provide advisory services, linkages to market, know-how, technology, etc. It is to his interest to do so and the contribution of both parties both in kind and capital will be the main determinant in agreeing to the profit-sharing ratio. While the profit-sharing ratio can be negotiated between the parties, the loss sharing ratio is based solely on the capital contribution.

5. RULES APPLICABLE TO MUSHARAKA

Capital

- ▶ Musharaka capital should be identifiable, readily available and accessible.
- ▶ Musharaka capital may be in the form of cash or in-kind, which may also include intangible assets.
- ▶ Capital in-kind is valued in monetary terms by a third party, which may include experts valuers, or as agreed among the partners at the establishment of the contract.
- ▶ Any form of debt does not qualify as Musharaka capital. All account receivables and payments due from other partners or third parties are considered as debts.
- ▶ The capital may be fully or partially disbursed as per the terms of the contract.
- ▶ Additional capital may be injected subject to agreement of all partners. In this regard, the partners may agree to vary or revise the proportion of capital contribution and the profit-sharing ratio.
- ▶ The effect of a failure of a partner to provide capital under a Musharaka contract (defaulting partner) in the following situations shall be as follows:
 - i. When no capital has been paid by the defaulting partner within the stipulated time, the non-defaulting partners may terminate the contract with the defaulting partner and may impose on the defaulting partner to indemnify the partnership for any expenses incurred due to his default.
 - ii. When the Musharaka contract involves staggered capital payment, with the defaulting partner having made partial capital payment, the non- defaulting partners may, subject to the terms and conditions of the contract, revise the Musharaka contract based on the actual capital paid by the defaulting partner.
- ▶ A share of the Musharaka capital may be transferred to existing partners or a third party according to the agreed terms and conditions of the Musharaka contract.
- ▶ The Musharaka agreement may impose a condition that compels a partner to sell his share of capital to existing partners based on agreed terms and conditions.
- ▶ The Musharaka contract may provide for the partner to withdraw capital during the tenure of the Musharaka contract, unless stated otherwise in the Musharaka agreement

Management of Musharaka

- ▶ A Musharaka venture can be managed by all partners, one or more of the partners having management skills, or by a third party. However, in case of third-party management, a separate employment agreement must be concluded.
- ▶ A managing partner may be offered an additional share in the profit (and not a fixed fee, except if the appointment for a fee is through a separate and independent management agreement and not part of the Musharaka itself) for his services as manager, in addition to his share in profit as a partner.
- ▶ A managing partner shall be liable for any loss caused by his misconduct, negligence or breach of specified terms.
- ▶ Any amendments to the Musharaka agreement may be effected with the consent of all partners and from a mutually agreed effective date.

Profit sharing

- ▶ The proportion of profit to be distributed between the partners must be agreed upon at the time of concluding the contract. The amount of profit for each partner must be determined in proportion to the actual profit accrued to the business and not in proportion to the capital invested by such partner. It is also not allowed to fix a lumpsum amount for any of the partners.
- ▶ If a lumpsum amount or a certain percentage of the investment has been agreed for any of the partners, it must be expressly mentioned in the agreement that it would be subject to the final settlement at the end of the term, meaning that any amount so drawn by any partner would be

treated as 'on account payment' and would be adjusted to the actual profit he may deserve at the end of the term. If no profit is earned or is less than anticipated, the amount drawn by such partner must be returned.

- ▶ The ratio of profit may differ from the ratio of investment in normal conditions. However, if a certain partner puts an express condition in the agreement that he would not work for the Musharaka and would remain a sleeping partner throughout the term of Musharaka, then his share of profit may not be more than the percentage of his investment.
- ▶ The partners may agree that in the event actual profit exceeds a given threshold, the excess amount may be distributed based on a different profit-sharing ratio agreed by the partners or be paid to any of the partners as per agreement.
- ▶ The partnership may impose on a defaulting partner to indemnify the partnership for any expenses incurred due to his default.
- ▶ Any expression of expected return as a percentage of the Musharaka capital amount is only permissible as an indicative profit rate subject to settlement after liquidation of the Musharaka business.
- ▶ Any partner may relinquish his right to realized profits, if any, to the other partner(s), provided that such waiver is only exercised after recognition of profit.
- ▶ Profit can be recognized either against actual or constructive (progressive) liquidation of the assets of the Musharaka partnership. In case the profit is recognized against constructive liquidation, a profit reserve may be created and a final settlement is undertaken at the end of a certain period or at the times of actual realization of profit to arrive at the actual amount of profit.

Sharing of loss

- ▶ Any loss is charged to the capital. Each partner suffers the loss exactly according to the percentage of his investment. Loss due to misconduct, negligence or breach of specified terms by a partner are borne by that partner. Once

loss is realized, any partner may voluntarily absorb such loss.

- ▶ Consequent to capital reduction, the loss sharing ratio is to be revised accordingly

Indemnifying capital or profit

- ▶ Partners are not allowed to indemnify against loss of capital or profit. However, each partner may be required to provide collateral, provided that the collateral may only be liquidated in the event of misconduct, negligence or breach of specified terms of contract by the partner(s).
- ▶ The Musharaka venture may require the arrangement of an independent third-party guarantee, including performance guarantee of the Musharaka venture, where the guarantee is executed as a separate contract and utilised to cover for any loss or depletion of capital. In this case, the third-party guarantor must be independent from the Musharaka venture.

Termination of Musharaka

Musharaka will stand terminated in any one or more of the following events:

- ▶ Every partner has a right to terminate the Musharaka at any time after giving the other partner(s) a notice to this effect, whereby the Musharaka will come to an end.
- ▶ If any one of the partners dies or if bankruptcy or insolvency occurs during the currency of the Musharaka, the contract of Musharaka stands terminated.
- ▶ If the term of the Musharaka expires, the Musharaka terminates.

6. PARTIES TO MUSHARAKA:

The parties to a Musharaka contract may be natural and/or legal persons. A partner to a Musharaka contract must have the legal capacity to execute the contract. A Musharaka contract is concluded by offer and acceptance between the partners. The partners are bound by the terms and conditions mutually agreed in the contract, provided these do not contravene Sharia principles.

7. STAGES OF MUSHARAKA

- ▶ Due to the unique inherent nature of participatory modes, all partners contribute the capital and all of them have the right to manage the venture. The type of Musharaka and the terms and conditions agreed to between the parties are stipulated in the Musharaka agreement that governs the business.
- ▶ The client submits an application and proposed project details to the MFI/FI requesting it to finance its business requirements. With the application, the client submits the following documents:
 - i. Project information form, providing description of the project and revenue projections for the next 3 years
 - ii. Profiles of the business, along with legal form, bona fide proof of the directors/partners/self, tax etc.
- ▶ The MFI/FI, after processing the application and verifying creditworthiness, may accept or reject the application. In case the application is approved, the MFI/FI offers the facility to the applicant through a facility offer letter prescribing the terms of Musharaka, which should be accepted by the applicant within a certain number of days to become eligible for financing.
- ▶ As soon as acceptance is received by the MFI/FI, the Musharaka agreement is concluded with the applicant and all other parameters related to profit-sharing ratio, on-account payment, redemption of capital, tenor, management of Musharaka, details about disbursements, draw down dates, authorized signatories, etc. are decided and recorded as part of the agreement.
- ▶ The client is then asked to open a bank account.
- ▶ The funds are released as per the agreed draw down dates or through other criteria as agreed between the parties.
- ▶ The client (as Musharaka manager) pays the profits to the Musharaka over periodic intervals. It is also his responsibility to liquidate the Musharaka business to help redeem the capital as agreed.
- ▶ Finally, the Musharaka terminates upon the physical liquidation of the assets.

8. MUSHARAKA ACCOUNTING/BOOKKEEPING (INCLUDING WORKED EXAMPLES)

- ▶ The Musharaka capital is recognized when it is paid to the partner or made available to him on account of the Musharaka.
- ▶ Musharaka shares are measured at historical cost at the end of the financial period. The difference between the historical cost and the fair value is recognized as profit or loss.
- ▶ If the Musharaka is terminated or liquidated, any amount that remains unpaid is recognized as a receivable due from the partner.
- ▶ Profit or loss on Musharaka transactions that commence and culminate within the same financial period are recognized at the time of [constructive] liquidation.
- ▶ The MFI/FI's share of profit on Musharaka financing that continues for more than one financial period is recognized to the extent of profit distribution and share of loss is deducted from the Musharaka capital.
- ▶ The share of profits is recognized as receivable due from the partner if he does not pay the MFI/FI's due share of profits after liquidation or settlement of accounts has been made.
- ▶ Loss incurred due to negligence or misconduct of the partner is recognized as receivable due from the partner.

Recording of accounting entries – worked examples

Table 8. Musharaka Accounting Example

MUSHARAKAH VENTURE					
Project	SMALL ENTERPRISE FINANCE – DEALER OF AUTO RIKSHAW				
Applicant	Dealer Of Auto Rikshaw				
Musharika Asset	Auto Rikshaw (Tuk-Tuk)				
Order received	24	Units	1-Jan-2014		
Delivery Date	3	Months	1-Apr-2014		
Market Price	19,000				
Expected Profit Rate of the Institution	(Monthly Accrual will be posted by the Institution at Expected Profit Rate)				
Unit Cost of Asset					
Price of Rickshaw (including taxes and import duty)	18,000				
Insurance / Takaful during carriage and at show room	1%				180
Total	18,180				
Musharika Financing Ratio by the Institution and Client					
Institution	70%				
Client	30%				
Profit Sharing Ratio					
Institution	40%				
Client	60%				
1-Jan-2014	Musharika Investment Detail				
	Units	Total Investment	Client Contribution	Institution Contribution	
Rickshaw	24	432,000	129,600	302,400	
Insurance	24	4,320	1,296	3,024	
Total Investment		436,320	130,896	305,424	
Investment Ratio				30%	70%
1-Apr-2014	Revenue from Musharika Venture				
	Units	Revenue / Cost per Unit	Total sale proceeds / Total Cost		
Revenue From Sales	24	19,000	456,000		313,296
Less: Cost	24	18,180	436,320		
Profit / (Loss)	820		19,680		341
	Share in Profit		Return on Investment		
Institution	7,872		10.45%	Exp. Return Jan	2,594.01
Client	11,808		36.58%	Exp. Return Feb	2,342.98
Total	19,680			Exp. Return Mar	2,594.01
				Total Exp. Return	7,531.00
Alternate Scenario – In case Musharakah Earns Very Low Profit					
1-Apr-2014	Revenue from Musharika Venture				
Revenue From Sales	18,500		24	444,000	
Less: Cost	18,180		24	436,320	
Profit	7,680				
	Share in Profit		Return on Investment		
Institution	3,072		4.08%		
Client	4,608		14.28%		
Total	7,680				
Institution Loss against expected profit			(4,459)		

Processing charges at the time of initiation of proposal

Dr	Client account	xxxx
Cr	Processing fee – Musharaka finance	xxxx

At the time of disbursement of funds (January 1, 2014)

Dr	Musharaka finance A/C	302,400
Cr	Client account / P.O / DD	302,400

Payment of Takaful/Insurance

January 1, 2014

Dr	Prepaid insurance	3,024
Dr	Client A/C	1,296
Cr	P.O / DD (Remittance)	4,320

Monthly Income Accruals

January 1, 2014

Dr	Profit receivable on Musharaka finance	2,624
Cr	Profit on Musharaka finance	2,624

Each month end income accrual will be posted at expected rate of return

Maturity of Musharaka Venture:

April 1, 2014

Dr	Client's A/C	313,296
Cr	Musharaka finance A/C	302,400
Cr	Prepaid insurance	3,024
Cr	Profit receivable on Musharaka finance	7,531
Cr	Profit/loss on Musharaka finance	341

9. MUSHARAKA ACCOUNTING/BOOKKEEPING (INCLUDING WORKED EXAMPLES)

Product-Specific Risks	Risk Mitigation Measures
<p>I. Equity Investment Risk</p> <p>This type of equity investment is exposed to a combination of risks associated with the managing partner, business activity and operations.</p>	<p>The mitigation of these risks may require the investor to take an active role in monitoring the investment, or the use of specific risk mitigating structures. The MFI/FI should have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments. There should be well-defined exit strategies in respect of the equity investment activities, including extension and redemption conditions.</p>
<p>II. Other Risks</p> <ol style="list-style-type: none"> 1. Credit risk – counterparty risk when withdrawing partner owes money to the MFI/FI. 2. Operational risk – managing partner does not disclose actual profits. 3. Sharia non-compliance risk. 4. Expense risk – parties might charge direct personal and indirect expenses to the Musharaka operation. 	<ol style="list-style-type: none"> 1. Ensure that the promise to Ijara is properly documented and is legally enforceable. <ul style="list-style-type: none"> - Gross instead of net Musharaka to mitigate some of the risk - In order to mitigate and contain risks, a schedule of expenses may be used to manage the expenses that may or may not be allowed. For example, relating to valuation of inventories, depreciation policies, agreed level or magnitude of admissible costs, etc. By managing the agreed level or magnitude of admissible expenses, the Musharaka can effectively be managed as a gross Musharaka instead of net Musharaka. - Most institutions can, and do, obtain security in order to manage and mitigate the risks involved in cases where the managing partner has done gross negligence or fraud etc. - Takaful coverage should be arranged to mitigate certain risks
<p>III. Fiduciary Risk</p> <p>Fiduciary risk may arise from the MFI/FI's failure to perform in accordance with explicit and implicit standards applicable to the fiduciary responsibilities.</p>	<p>Fiduciary risk can be mitigated by adhering to the specific policies and terms stated in the agreement signed with the client.</p>
<ol style="list-style-type: none"> 1. General risk mitigation can be achieved by maintaining good quality data on past performances of the counterparty and by determining the probability of default. Often, information about the creditworthiness of the client is gathered through informal sources and through local community networks. 2. The MFI/FI must ensure that a holistic and robust feasibility and due-diligence framework is in place to facilitate effective decision-making in assessing the viability of the Musharaka venture. 	

10. MUSHARAKA SHARIA COMPLIANCE CHECKLIST- GUIDANCE FOR SHARIA CONTROLLER/AUDITOR

#	Item	Remarks
	General	
1	Obtain a list of all the Musharaka transactions entered into by the MFI/FI during the period under review.	
2	Select a sample of the transactions and obtain their respective agreements to check their Sharia compliance.	
3	Review the standard agreement approved by the SGC and compare the sampled agreements for correctness.	
5	Ensure that all the transactions entered into and their subjects are in accordance with the contracts.	
6	Document the actual transaction flow.	
7	Perform walkthrough test to check that the actual transaction flow is in line with the documented transaction flow.	
	Internal Controls	
8	Does the MFI/FI ensure that the subject matter of the transaction is held on permissible items and, particularly, that the nature of business is Halal?	
9	Are there adequate controls implemented to ensure proper transaction flow?	
10	Are there adequate controls implemented by the MFI/FI to ensure that each step of the standard Musharaka transaction is followed by the next step?	
11	Ensure that the terms of the agreement are not amended except with the specific approval of the SGC.	
12	Ensure proper documentation of the transaction.	
	Legal Rules	
13	Ensure that the capital is specific and existent such as cash, gold or trading assets.	
14	Ensure that Musharaka is not established on non-existent funds or on a debt.	
15	Review the selected Musharaka agreement and ensure that the capital is invested in terms of money and is of valuable nature. Capital may consist of merchandise subject to the condition that the value of such merchandise has been agreed at the time of entering into the agreement.	
16	Ensure that the profit-sharing ratio is agreed between the MFI/FI and the client at the time of contract	
17	Ensure that the profit is quantifiable.	
18	Ensure that the profit-sharing ratio is specific (in defined terms) and not stipulated as a lumpsum profit.	
19	Ensure that the Musharaka agreement contains a clause stipulating that the loss is divided in proportion to the respective contribution of the partners in the capital of the Musharaka.	
20	Ensure that the Musharaka agreement does not forbid any partner to be active in the Musharaka business.	
21	Review the agreement and ensure that no partner indemnifies the other partner against loss of capital.	

11. MUSHARAKA CONTRACTS AND DOCUMENTATION

Facility offer letter – Musharaka

Date: _____

To: _____ [Insert name and address of the applicant(s)]

Dear Sirs,

We refer to your application dated _____ and are pleased to advise you of the facility approval as per the terms given below:

1	Facility type	Musharaka
	Purpose (e.g. establishing business of supermarket)	
2	Total proposed investment (\$)	Institution: \$ _____ (_____ %) Client: \$ _____ (_____%)
	Contribution by the parties to the Musharaka venture	
3	Profit distribution ratio	Institution: \$ _____ (_____ %) Client: \$ _____ (_____%)
	Loss bearing ratio	
4	Commencement date	
5	Liquidation: actual/constructive (if constructive, mention frequency)	
6	Maturity: (Days/Months/Years)	
7	Redemption frequency: (e.g. quarterly/semi-annual, etc.)	
8	Securities: (Promissory Note, other collateral as agreed, any other securities as may reasonably be required by the Institution, etc.)	
9	Processing charges (proportionate to client share in capital)	\$_____ (non- refundable)
10	Documentation charges (proportionate to client share in capital)	Actual
11	Draw down: (facility may be drawn in lumpsum or in tranches)	

Other Terms and Conditions

1. The facility shall be governed by the relevant/applicable rules and regulations of (Country name) including those of the Central Bank of (Country name) (if applicable).
2. The client may not create any charge on the asset(s) offered as security by way of pledge, hypothecation, mortgage or in any other way created in favour of the Institution, with any other bank, financial institution or any other person in any manner whatsoever.
3. The Musharaka venture may be inspected by the Institution as and when required by it and the client shall allow access to and cooperate with the authorized representative of the Institution in carrying out such inspections.
4. All expenses incurred on account of documentation, valuation, charge registration or any other costs in relation to the facility mentioned in this letter now or hereafter levied on the Institution in respect of or in connection with the facility and security thereof shall be payable by the client in proportion to its share in the Musharaka asset.
5. This facility offer is subject to internal final approvals, satisfactory review of all documentation, securities, necessary formalities and receipt of duplicate copy of this letter duly signed by the authorized signatory evidencing agreement on all terms and conditions.

Please return a signed and accepted copy of this letter within _____ days.

This offer is valid for a period of days from date of this letter. If the facility offered herein is not utilized within the specified period, the facility shall stand withdrawn.

Yours faithfully, for and on behalf of

_____ [Insert name of Institution]

Acceptance of Terms and Conditions

Date: _____

To: _____ [Insert name and address of the Institution]

Dear Sirs,

Reference your approval of our request dated _____, we hereby accept the facility offer and terms and conditions of the approval provided and request to proceed with the facility. We undertake to abide by the terms of approval. We shall provide a promissory note, surety, and other collateral(s), if required. We also undertake to avail the facilities and meet all documentation, customary and other requirements, in form and substance acceptable to the Institution wherever required.

Yours faithfully,

For and on behalf of

_____ [Insert name(s) of applicant(s)]

Musharaka agreement

(Small Enterprises)

This Musharaka agreement ('the Agreement') is made on this _____ day of _____ between _____, a _____ company incorporated under the laws of (Country name), having its registered office at _____, through its _____ (hereinafter referred to as the "Institution" which expression shall, where the context so permits, mean and include its successors-in-interest and assigns), of the one part;

and

_____, a sole proprietorship/company/corporation registered under the laws of (Country name) and having its place of business/ registered office at _____ (hereinafter referred to as the "Client", which expression shall where the context so permits mean and include its legal heirs, successors-in-interest and assigns), of the second part.

Whereas the parties hereto have agreed that the Institution shall provide financing to the client on profit-and-loss-sharing basis on the terms and conditions hereinafter appearing.

Now, therefore, this Agreement witnesses as under:

1. This Agreement sets out the terms and conditions upon and subject to which the Institution has agreed to finance the client by way of Musharaka investment.
2. In this Agreement, unless the context otherwise requires:

"Client's Investment" means as defined in clause 5.2.

"Financial Statements" means the Client's balance sheet, profit and loss statement, cash flow statement and statement of changes in equity.

"Institution's Investment" means as defined in Clause 3.

"Musharaka Capital" means the sum of Client's Investment and Institution's Investment.

"Principal Documents" means this Agreement and the Security Documents.

"Security Documents" means such deeds and documents as the Institution may require the Client to furnish or execute under this Agreement.

"Secured Assets" means all the Client's (insert description of the proposed securities).

"Written Request" means the request submitted by the Client to the Institution.

3. The Institution hereby agrees, at the written request of the Client, to provide financing up to a sum of \$_____ (_____ only) on the terms and conditions hereinafter contained (which financing is hereinafter referred to as "Institution's Investment").
4. This Agreement shall be valid for a period of _____ years from the date of first disbursement of the Institution's Investment.

5. The Client and the Institution hereby mutually agree and covenant as under:
- 5.1. The Institution's Investment shall be used only for *[insert description of purpose of the Musharaka Investment]* (the "Project") and shall not be used for and/or diverted to any other purpose.
 - 5.2. The Client's Investment for the purpose of this Agreement amounts to \$ _____ (_____ only).
 - 5.3. The Client shall not make any change in its paid-up capital, accumulated reserves or unappropriated profits, except based on annual audited accounts, and shall also not, without prior written consent of the Institution, make any additional borrowing or accept any further funds on profit-and-loss-sharing basis, whether short-term or long-term, from any source.
 - 5.4. The Client shall not declare any dividends (wherever applicable) without prior written consent from the Institution
 - 5.5. The Client hereby covenants that, based on past experience and data available with the Client, it is expected that after adding the Institution's Investment to the Client's investment, the projected pre-tax annual profit of the client hereafter will be ____ % per annum of the total investments of the Client and the Institution. The aforesaid profit percentage is hereinafter referred to as the "Projected Rate of Return" of the Project.
 - 5.6. It is hereby expressly agreed that the Client may avail the Institution's Investment as and when required, provided that the outstanding amount of the Institution's Investment at any time not exceed the amount specified in clause 3 hereof.
 - 5.7. The Client shall furnish to the Institution, within one month of the end of each quarter of the Client's accounting year, a report of its operations and statements of financial affairs and any other information in such form as may be devised by the Institution from time to time.
 - 5.8. It is agreed that the Client shall also serve as manager of the Project ("Manager") with all the powers and authorities required to manage the Project in a diligent manner.
 - 5.9. The Manager must maintain separate accounts for the Project, including the respective income statement. The Institution shall have the right to review these accounts and any other necessary data at any time it deems appropriate.
 - 5.10. It is agreed that the Client shall be entitled to a greater share in the profit of the Project than the Client's Investment because of its role as Manager.
 - 5.11. Based on the Projected Rate of Return, it is agreed that the Institution and the client shall share the expected profit in the ratio as given in Appendix-1 and that the Manager shall pay to the Client and the Institution their respective expected shares of profit as well as the share in the redeemed capital of the Project, whereby the Institution's share will be paid in accordance with the schedule given in Appendix-2.
 - 5.12. Payments under clause (5.11) above shall be treated as provisional, to be adjusted upon preparation of the final accounts for the whole accounting year in accordance with clause 5.

- 5.13. Upon finalization of the annual Financial Statements, the pre-tax net profits for that year shall be distributed among the Institution and the Client based on the ratio of profit-sharing stipulated in Appendix-1 and subject to such conditions as contained therein.
- 5.14. Any loss shall be shared between the Institution and the Client in proportion to their respective shares in the Musharaka Capital. The amount of such loss shall be either paid by the respective parties into the Musharaka Capital or deducted from the Musharaka Capital at the option of the respective party.
6. Subject only to the express terms of this Agreement, management and control shall be primarily vested in the Client, who shall be responsible for the management and control of the business.
7. This Agreement shall not be deemed to create a partnership or company and in no event shall the Client have any authority to bind the Institution. In no event shall the Institution be liable for the debts and obligations of the Client incurred for other purposes, except as stipulated in this Agreement.
8. In the event of the Client defaulting on payment of the due share of profit, redemption of the Institution's investment as mentioned hereabove or performance of any of the covenants under this Agreement, provided such default remains unrectified for a period of _____ days from the date of notice served by the Institution, the Institution shall have the right to dispose of the securities defined in Clause 13 hereto and adjust the sale proceeds thereof towards the amounts receivable by it.
9. Where any amount is required to be paid by the Client under the Principal Documents on a specified date and is not paid by that date, or an extension thereof permitted by the Institution without any increase in the amount payable, the Client hereby undertakes to pay directly to the charity fund maintained by the Institution a sum calculated as follows: $(\text{Unpaid Sum} \times 1\% \times \text{Unpaid Period}) / (365 \text{ Days})$. The charity fund shall be used at the absolute discretion of the Institution, exclusively for the purposes of approved charity.
10. In case the client delays the payment of any amount due as mentioned in Clause 9 above and the payment of amount to the charity fund, as a result of which any direct or indirect costs are incurred by the Institution, the Institution shall have the right to approach a competent court of law for recovery of any amounts remaining unpaid.
11. This Agreement shall be binding upon and inure to the benefit of and be enforceable by the Institution, the Client and respective successors, permitted assigns and transferees of the parties hereto, provided that the Client shall not assign or transfer any of its rights or obligations under this Agreement without the written consent of the Institution. The Institution may assign all or any part of its obligations and/or commitments under this Agreement to any bank, financial institution or other person.
12. Force Majeure: Any delays in, or failure by, a party hereto in the performance hereunder, if and to the extent it is caused by occurrences or circumstances beyond such party's reasonable control, including but not limited to, acts of God, fire, strikes or other labour disturbances, riots, civil commotion, war (declared or not) sabotage, any other causes similar to those herein specified which cannot be controlled by such party shall be considered Force Majeure. The party affected by such events shall promptly inform the other party of the occurrence of such events and shall furnish proof of details of the occurrence and reasons for its non-performance of whole or part of this Agreement. The parties shall by consultation between them decide whether to terminate this Agreement, discharge part of the obligations of the affected party or extend its obligations on a best-effort and arm's length basis.

13. The Institution shall, with mutual consent of the parties hereto, obtain security for redemption of the Institution's Investment together with profit and/or all other sums receivable by the Institution as aforesaid after adjustment of losses (if any). The Client hereby agrees and undertakes to give the securities as required by the Institution for the purpose mentioned hereabove and that the Institution may determine to secure its priority over other creditors of the client.
14. This Agreement represents the entire agreement and understanding between the Parties in relation to the subject matter and no amendment or modification to this Agreement shall be effective or binding unless it is in writing, signed by both parties and refers to this Agreement.

In Witness Whereof the Client and the Institution have executed this Agreement on the day, month and year hereinabove mentioned.

For and on behalf of

For and on behalf of

_____ [insert name of the Institution]

_____ [Insert name(s) of Client]

Annexes to include:

- ▶ Project information sheet
- ▶ Cashflow and revenue projection
- ▶ Schedule of approved expenses
- ▶ Client information form
- ▶ Draw down dates
- ▶ Capital redemption and profit payment schedule

Appendix 1 - Written request for purchase of asset

1. Ratio of sharing of Profit

Institution	_____ %
Client	_____ %

2. Other conditions, if any

(For example, relating to valuation of inventories, depreciation policies, agreed level or quantum of admissible costs, etc.)

Appendix 2 - Capital redemption

Capital Redemption + Profit Payment Schedule		
#	Due Date	Amount in \$
1	Date of 1st withdrawal + xx months	
2	Date of 1st withdrawal + xx months	
3	Date of 1st withdrawal + xx months	
..	Date of 1st withdrawal + xx months	
..	Date of 1st withdrawal + xx months	
..	Date of 1st withdrawal + xx months	
..	Date of 1st withdrawal + xx months	
..	Date of 1st withdrawal + xx months	
n	Date of 1st withdrawal + xx months	
Total		



Mudaraba

Mudaraba is a contract based on a fiduciary relationship (Aqd Amana). It is a form of partnership between the party contributing capital (Rabb al-Mal/ capital provider) and the other party contributing efforts in the form of managerial skills (Mudarib/ manager). Profit from the outcome of the venture is shared between the capital provider and manager according to a mutually agreed profit-sharing ratio, while losses are borne solely by the capital provider, provided such loss is not due to the manager's negligence, misconduct or breach of trust.

Negligence: Among the typical conditions specified in the Mudaraba contract is that the managing partner is to exercise due care and diligence. For example, suppose the assets purchased for sale were kept in the store without Takaful/insurance coverage against fire and theft. For any loss of such assets due to fire or theft, the manager would bear the liability due to his negligence of not arranging for necessary protection.

Misconduct: During the course of investments, if the manager, in pursuit of higher profits, invests in a business not included in the agreed list and loss arises from such investment, the manager would be liable for the loss of capital.

Breach of terms: According to the terms of Mudaraba, the manager must disclose all relevant information to his knowledge, mainly unfavourable one, that is significant for the capital provider to form a decision to proceed with investing in the Mudaraba. If the manager conceals in his feasibility study significant information known to him to be material to the decision-making process and losses on investment occur, he would be considered in breach of the terms of engagement and, hence, bear such loss of capital due to his wilful non-disclosure, should the findings indicate that such unfavourable information was not disclosed.

1. MUDARABA AS A MODE OF FINANCING

Mudaraba may be classified into two types:

- ▶ **Restricted Mudaraba (Mudaraba Muqayyadah):** A Mudaraba contract in which the capital provider restricts the actions of the Mudarib to a particular location or to a particular type of investment as the capital provider considers appropriate, but not in a manner that would unduly constrain the Mudarib in its operations.
- ▶ **Unrestricted Mudaraba (Mudaraba Mutlaqah):** A Mudaraba contract in which the capital provider permits the Mudarib to administer the Mudaraba fund under no restrictions.

In addition, Mudaraba may be multipurpose or for a specific purpose, perpetual or for a fixed period, closed or open-ended and one-, two- or multitiered. Two-tier Mudaraba specifically refers to the situation where the capital provider invests capital with a Mudarib (intermediary) who subsequently invests the fund with another Mudarib.

2. USES OF MUDARABA

This mode may be used to meet many types of financing needs, including:

- ▶ Working capital requirement of a business
- ▶ Wholesale financing for intermediaries
- ▶ Project financing

3. HOW IS MUDARABA DIFFERENT?

Mudaraba is a joint venture on an asset or an enterprise between two parties; an investor who provides all the capital and an entrepreneur who manages the capital based on the mandate provided by the investor. This is an equity-oriented partnership, where the partners do not necessarily require a transfer in the enterprise shares as it is measured based on the net asset

value of the firm and not on future expected returns. A comparison can be made to the investment of fund managers but strictly based on profit-sharing and not debt. A Mudaraba can be used as a form of revenue or profit-sharing for depositors in banks, Takaful providers or investment funds. The concept has also been applied to enterprise-financing, similar to Musharaka but with the difference that the investor provides 100% of the capital, while in a Musharaka part of the capital is also provided by the entrepreneur.

4. IMPACTFUL MUDARABA THROUGH ECONOMIC EMPOWERMENT

Like all equity instruments, Mudaraba facilitates a risk-sharing arrangement between the entrepreneur and the investor. The investor should ensure all risk mitigation measures, including relevant Takaful and permits, are obtained. As the highest risks are during the initial stages, the investor's role in ensuring the asset or the venture is able to generate high returns is critical. Besides the capital provided, the investor may, and should, provide advisory services, linkages to market, know-how, technology, etc. It is also a means to match between people with capital and those with knowhow in the case of Mudaraba to fund managers. In line with the principles of Musharaka, while the profit-sharing ratio can be negotiated between the parties, the loss sharing ratio is based on the capital contribution only. Since the investor provides all the capital in Mudaraba, he bears all the loss.

5. RULES APPLICABLE TO MUDARABA

Nature of the Mudaraba contract

In general, a Mudaraba contract allows any of the contracting parties to terminate the contract unilaterally. However, the contract may not be terminated unilaterally if the manager has commenced the work or when both parties have agreed not to terminate the contract during a specified time.

Capital

▶ Capital is the principal feature of Mudaraba forming the substance of the contract. The capital is contributed by the capital provider only. The

primary purpose of managing the capital is to generate profits.

- ▶ The Mudaraba capital may be in the form of monetary or non-monetary assets.
- ▶ Capital in the form of non-monetary assets, which may include intangible assets, is valued by a third party, possibly including authoritative bodies, experts or valuers, or as agreed upon by the contracting parties at the time of conclusion of contract
- ▶ Debts such as account receivables or loans due to a capital provider do not qualify as capital for Mudaraba.
- ▶ The capital may be fully, partially or periodically disbursed or made available to the Mudarib at the time of the conclusion of the contract based on terms of the contract.
- ▶ The capital provider and Mudarib may agree on gradual/periodic redemption of the Mudaraba capital by the capital provider.
- ▶ The Mudarib may assign the Mudaraba capital under his management to another Mudarib in another Mudaraba or to an agent (Wakeel), provided the consent of the capital provider is obtained. This is also known as two-tier Mudaraba and can be used for providing credit lines to intermediaries.
- ▶ Failure to provide capital by the capital provider as per the agreed schedule shall constitute a breach of promise according to the specified terms and conditions of the contract. The Mudarib has an option to terminate the agreement or both parties may agree to revise the agreement based on actual capital contribution.
- ▶ Where the agreement is terminated, the Mudarib must return the outstanding capital, if any. If the Mudaraba expenditure exceeds the actual capital contribution, such liability shall be borne by the capital provider up to the limit of the total amount committed under the contract.
- ▶ The Mudarib may not guarantee return of capital. However, the capital provider may require the Mudarib to arrange for an independent third-party performance guarantee. The guarantee must be

executed as a separate contract and be utilized to cover for any loss or depletion of capital in the event of misconduct, negligence, dishonesty, fraud or breach of the terms of the contract by the Mudarib.

- ▶ The third-party guarantor must be independent from the Mudarib and not a related party where the Mudarib has majority ownership and/or having control in the entity, nor a subsidiary or an entity that the Mudarib owns or controls.
- ▶ Obtaining security or agreeing on determined rate of return in a Mudaraba agreement (and in partnerships in general) is not allowed. However, most institutions can, and do, obtain performance guarantees to manage and mitigate the risks involved in cases where a Mudarib demonstrates gross negligence, fraud etc.
- ▶ Security shall be obtained on case-to-case basis, including but not limited to lien on deposits, pledge of inventory, mortgage of property, charge on company's assets, pledge of shares of listed companies, etc.
- ▶ The Mudarib may inject his own funds into the Mudaraba capital subject to the consent of the main capital provider and, hence, a Musharaka contract is established between the Mudarib (as partner under Musharaka) and the Mudaraba venture. The Mudarib, in this case, will be entitled to two shares of profit, one in his capacity as Mudarib and the other as partner in Musharaka.

Management of the Mudaraba venture

- ▶ All works and activities undertaken by the Mudarib in relation to the Mudaraba capital must be Sharia-compliant.
- ▶ The Mudarib has the exclusive right to manage the Mudaraba venture. The capital provider is precluded from managing the venture. However, the capital provider has the right to information regarding the conduct of business by the Mudarib.
- ▶ The powers/authority of the Mudarib are provided under the terms and conditions of the Mudaraba contract, which may include the scope and

assignment of management of the Mudaraba capital to a third party.

- ▶ The scope of a restricted Mudaraba contract may specify conditions restricting the Mudarib's role/functions such as determination of location, period for investment, type of project and commingling of funds, provided this does not defeat the purpose/objective of the contract and does not unduly constrain the Mudarib.
- ▶ A Mudaraba contract requires the Mudarib to deploy the capital to a profitable venture. The Mudarib is personally responsible to ensure the proper management of the capital to the best interests of the capital provider.
- ▶ The Mudarib in a Mudaraba contract may assign the capital to another Mudarib in another Mudaraba contract with the written consent of the primary capital provider.
- ▶ If the Mudaraba agreement becomes void due to any reason, the Mudarib's status may change into that of an employee, meaning:
 - If he is travelling or doing business in his city, he would not be entitled to any expense such as lodging, transportation, etc.
 - He would not be entitled to any share of profit. Rather, he would be only paid fair wages for his work.

Profit sharing

- ▶ Profit sharing is the primary motive of the Mudaraba contract.
- ▶ Due to the participatory nature of this mode, the parties must agree the profit-sharing ratio in advance. The profit rate cannot be predetermined, even though at times it may be possible to have a reasonably acceptable estimate of the expected rate of return.
- ▶ Usually, the Mudarib has limited ability to negotiate the profit-sharing ratio but also limited liability with respect to the business, although it may have attractive incentive to perform.
- ▶ It is impermissible to include a condition in Mudaraba contract that stipulates a predetermined fixed amount of profit for one partner, as this

would negatively impact the profit share of the other partner.

- ▶ The capital redemption and profit payment terms are determined by mutual agreement between the parties and documented as a schedule in the Mudaraba agreement. To facilitate matters, clauses relating to 'on account' payment of profit through constructive liquidation and over-time redemption of capital may be established.
- ▶ Profit is based on revenue after deducting all operating costs of the venture and taxes (where relevant). However, it should be clearly decided in the contract whether the Mudaraba will be settled on gross or net basis.
- ▶ A party may undertake to assign its right to the profits (if any) to another contracting party on the basis of Tanazul (waiver) at the inception of the contract. However, the waiver would only be effective on the date of profit-distribution.
- ▶ Profit is recognized on actual basis by selling the assets of the Mudaraba partnership, or on a constructive basis by constructive valuation of the assets, including accounts receivables.
- ▶ In case of constructive valuation, the constructive profit reserve may be maintained by mutual agreement. The reserve from the constructive valuation may be distributed when gains are realized at the time of disposal.
- ▶ Parties to the contract may agree to set aside a portion of the profit as a reserve (e.g. profit equalization reserve) or for any other purpose. However, for capital-protection purposes, the reserve may only be taken from the profit portion of the capital provider(s) - the investment risk reserve.
- ▶ Unrealized gains recognized during the financing are recognized as appreciation of capital and included in the profit and loss measurement/calculation for the Mudaraba contract.
- ▶ In a two- or multitiered Mudaraba contract, two or more profit sharing arrangements may be agreed between capital provider and Mudarib. The profit generated by the Mudarib from the second tier is shared between the Mudarib and the capital provider based on the pre-agreed ratio.
- ▶ The Mudarib is not permitted to earn a fee in addition to his share of profit in the Mudaraba contract.
- ▶ Any investment income inadvertently earned from non-Sharia-compliant activities of a Mudaraba venture must be channelled to charitable purposes.

Liability of loss

- ▶ Loss must be solely borne by the capital provider, except in the event of misconduct, negligence or breach of contract by the Mudarib.
- ▶ Loss is recognized as a liability on the Mudaraba business if it exceeds the value of the assets. In contrast, when expenses exceed revenue for a defined period, an operating loss is recorded. Such loss is settled against prior or future profits.

Termination of Mudaraba

- ▶ The Mudaraba contract may be terminated at any time by either of the two parties, but after notifying the other party. However, the contract shall not be terminated unilaterally if the manager has commenced the work or when both parties have agreed not to terminate the contract during a specified time.
- ▶ If all the assets of the Mudaraba are in cash form at the time of termination and some profit has been earned on the principal amount, it is distributed between the parties according to the agreed ratio. However, if the assets of the Mudaraba are not in cash form, the Mudarib must be given an opportunity to sell and liquidate them to determine the actual profit.
- ▶ The Mudaraba can be restricted to a particular term, e.g. one year, six months, etc., after which it would terminate without notice.
- ▶ Mudaraba may also be deemed terminated should loss occur.

6. STAGES OF MUDARABA

- ▶ The client submits an application and proposed project details to the MFI/FI requesting it to finance its business requirements. With the application, the client submits the following documents:
 - i. Project information form, providing a description of the project and revenue projections for the next 3 years.
 - ii. Profiles of the business, along with legal form, bona fide proof of the directors/partners/self, tax, etc.
- ▶ The MFI/FI, after processing the application and verifying creditworthiness of the applicant, may accept or reject the application. In case the application is approved, the MFI/FI offers the facility to the applicant through a facility offer letter prescribing the terms of Mudaraba, which should be accepted by the applicant within a certain number of days to become eligible for financing.
 - ▶ As soon as acceptance is received by the MFI/FI, the Mudaraba agreement is concluded with the applicant, fulfilling all details of disbursements, draw down dates, authorized signatories, on-account payment of profits, etc.
 - ▶ The client is then asked to open an account in a bank chosen by the MFI/FI. The funds are released as per the agreed draw down dates or through other criteria as agreed between the parties.
 - ▶ The client pays the profits to the MFI/FI over periodic intervals and gradually liquidates the Mudaraba business to help the MFI/FI redeem its capital over time in accordance with the agreed schedules. Finally, the Mudaraba terminates upon physical liquidation of the assets.

Examples of three possible Mudaraba structures are given below:

Figure 4. Mudaraba Venture Process Flow– Funding for a Specific Purpose

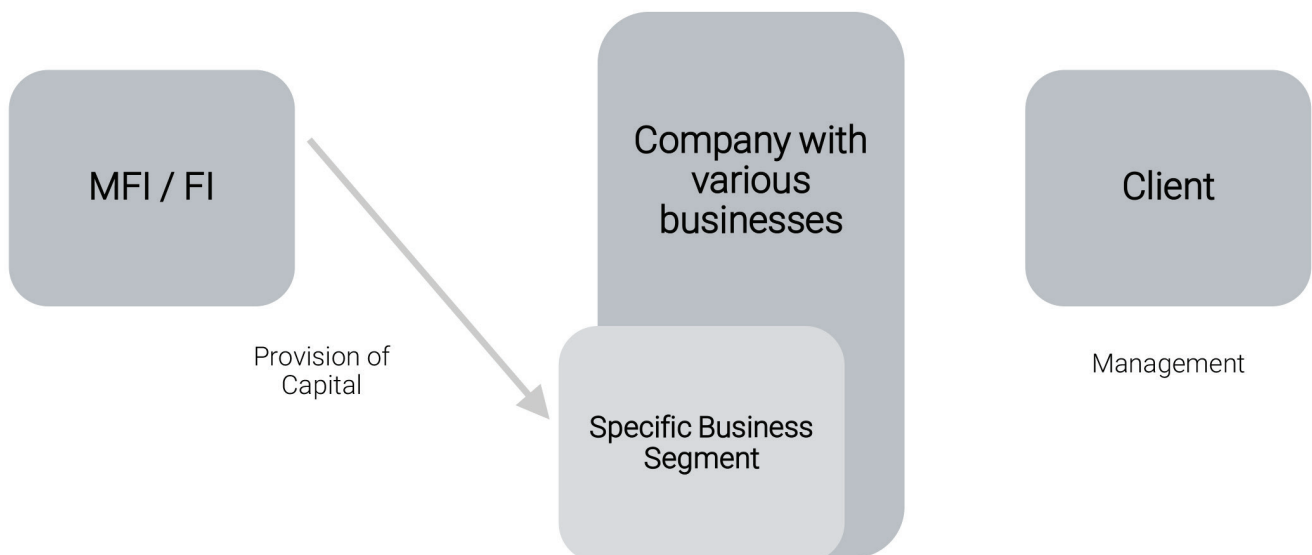
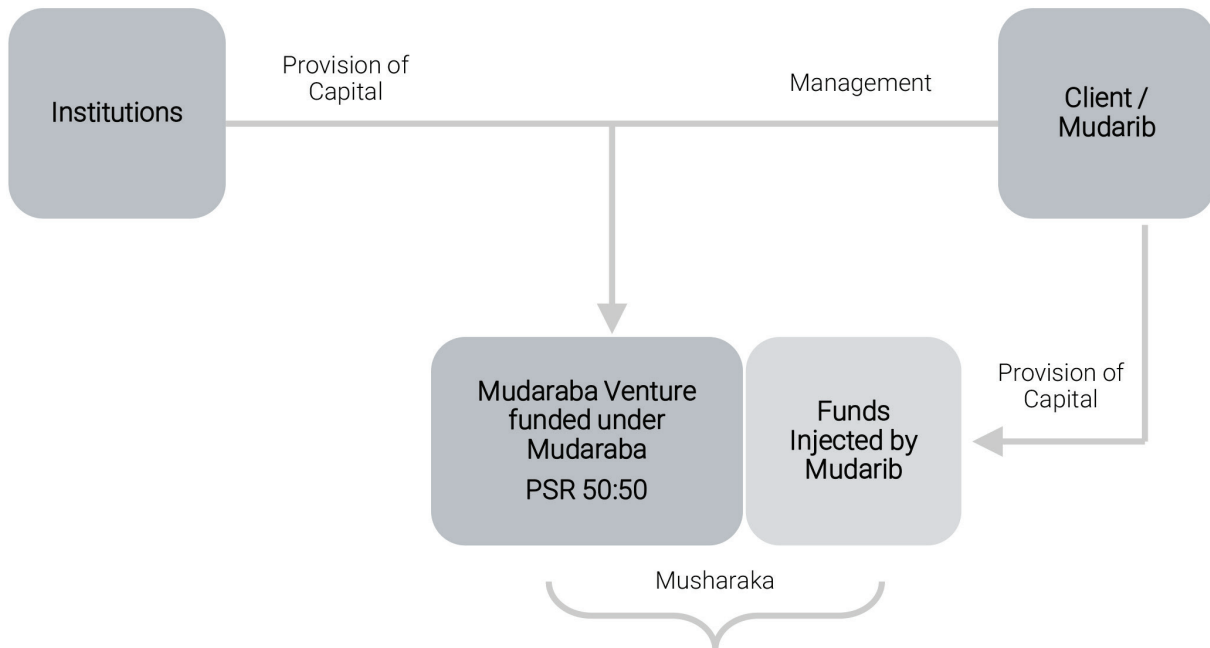


Figure 5. Musharaka between Mudarib and Mudaraba Venture**Figure 6. Mudaraba Venture – Provided Funding for a General Purpose**

7. MUDARABA ACCOUNTING/BOOKKEEPING (INCLUDING WORKED EXAMPLES)

- ▶ The Mudaraba capital is recognized when paid to the Mudarib or placed under his disposal. If the capital is paid in instalments, each instalment is recognized as and when it is paid.
- ▶ Capital provided in cash is measured by the amount paid or amount placed under the disposal of the Mudarib and capital provided in-kind is measured at fair value of the assets. Any difference between fair value and book value is recognized as profit or loss.
- ▶ Expenses incurred are not considered part of the Mudaraba capital, unless otherwise agreed by both parties.
- ▶ If the entire capital is lost without any misconduct or negligence from the Mudarib, the Mudaraba is considered terminated and the MFI/FI, being the capital provider, recognizes it as loss.
- ▶ If the Mudaraba is terminated or liquidated and the capital is not paid back, it is recognized as receivable from the Mudarib.
- ▶ Profits or loss on Mudaraba transactions that commence and end within the same financial period are recognized at the time of liquidation (constructive or actual).
- ▶ The MFI/FI's share of profits on a Mudaraba financing that continues for more than one financial period is recognized to the extent of profit distribution, while the loss is deducted from the Mudaraba capital.

Recording of accounting entries - worked examples

Table 9. Mudaraba Accounting Example

MUDARABAH VENTURE										
Client		Manufacturer Of Plastic Bottles								
Financing Requirement		1,000,000								
Mudaraba		3 Years								
Application Requirement		3 Years projected cashflow feasibility of Mudarabah Venture								
Expected Gross Return from Mudaraba Venture		30%								
Direct Expense of Mudaraba Venture		35%								
Profit Sharing Ratio										
Institution (Rab ul Mal)		60.00%								
Client (Mudarib)		40.00%								
Profit accrual		Monthly Basis								
Profit distribution		Semi Annually								
Mudarabah redemption		Semi Annually (In equal amounts)								
Start Date	Due Dates	No. of days	Expected Return from Mudaraba	Direct Expenses	Net Profit After Expense	Institutions Share	Monthly Accruals	Mudaraba O/S Balance	Mudaraba Repayments	Annual Rate of Return to the Institution
1-Jan-2014	30-Jun-2014	180	150,000	52,500	97,500	58,500	9,750	1,000,000	166,667	11.7%
1-Jul-2014	31-Dec-2014	183	125,000	43,750	81,250	48,750	8,125	833,333	166,667	11.7%
1-Jan-2015	30-Jun-2015	180	100,000	35,000	65,000	39,000	6,500	666,667	166,667	11.7%
1-Jul-2015	31-Dec-2015	183	75,000	26,250	48,750	29,250	4,875	500,000	166,667	11.7%
1-Jan-2016	30-Jun-2016	181	50,000	17,500	32,500	19,500	3,250	333,333	166,667	11.7%
1-Jul-2016	31-Dec-2016	183	25,000	8,750	16,250	9,750	1,625	166,667	166,667	11.7%
Total			525,000	183,750	341,250	204,750			1,000,000	11.7%
In case of Loss at Last Six month of the Mudaraba Venture										
1-Jul-2016	31-Dec-2016	183	(2,083)	8,750	(10,833)	(10,833)		166,667	166,667	3.47%
Total			497,917	183,750	314,167	184,167			1,000,000	9.76%

Disbursement of funds under Mudaraba financing to client for a period of 3 Years:

January 1, 2014

Dr	Mudaraba financing A/c	1,000,000
Cr	Client A/C (P.O/D.D)	1,000,000

Monthly profit accruals*:

January 31, 2014

Dr	Profit receivable under Mudaraba	16,250
Cr	Profit on Mudaraba finance	16,250

*Each month accrual will be posted keeping in view the projected profitability rate

Semi-annual Profit Payment by the client**

June 30, 2014

Dr	Client A/C	97,500
Cr	Profit receivable under Mudaraba	97,500

** Client pays profit amount after every 6 Months and same will be recorded

Semi-annual Mudaraba repayments***

June 30, 2014

Dr	Client A/C	166,667
Cr	Mudaraba financing A/c	166,667

*** Client will repay equal amount of Mudaraba financing after every 6 Months and the entry will be repeated accordingly

Upon maturity of contract, repayment of finance along with profit (in case Mudaraba capital is repaid at the end)

Dr	Client A/C	
Cr	Mudaraba finance A/C	
Cr	Profit receivable under Mudaraba	

8. RISKS AND MITIGATION MEASURES RELATED TO USE OF MUDARABA FINANCING

Product-Specific Risks	Risk Mitigation Measures
<p>I. Equity Investment Risk</p> <p>This type of equity investment is exposed to a combination of risks associated with the Mudarib, business activity and operations. The institutions are also exposed to the risks of asymmetric information in respect of the counterparties, which adversely affects the investment appraisals, hence loss of capital or profit or both.</p>	<p>The mitigation of these risks may require the MFI/FI to take an active role in monitoring the investment as well as using specific risk mitigating structures. For example, the MFI/FI should have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments. There should be well-defined exit strategies in respect of the equity investment activities, including extension and redemption conditions.</p>
<p>II. Agency Risk</p> <p>This risk is particularly present where information asymmetry is high and there is low transparency in financial disclosure by the Mudarib. Risk management for the MFI/FI is further complicated by some additional externalities when the Mudaraba contract is transformed into a debt obligation in the case of proven negligence or misconduct of the Mudarib. As a result, credit risk also becomes applicable.</p>	<p>The MFI/FI should use gross instead of net Mudaraba to mitigate some risk. In addition, the schedule of expenses should be incorporated in the contract to manage the expenses that may or may not be allowed. Therefore, Mudaraba should define profit as “the amount of gross profit available for distribution after deduction of permissible expenses as may be agreed between the client and the Institution in terms of the schedule of expenses defined and attached.”</p> <p>Security to mitigate gross negligence and fraud risk should be obtained from third parties on performance of the Mudarib.</p> <p>General risk mitigation can be achieved by maintaining good quality data on past performances of the counterparty and by determining the probability of default.</p> <p>Often, information about the creditworthiness of the client is gathered through informal sources and local community networks.</p>
<p>III. Fiduciary Risk</p> <p>Fiduciary Risk may arise from the MFI/FI’s failure to perform in accordance with explicit and implicit standards applicable to the fiduciary responsibilities.</p>	<p>Fiduciary risk can be mitigated by adhering to the specific policies and terms stated in the agreement signed with the client</p>
<p>The MFI/FI must ensure that a holistic and robust feasibility and due-diligence framework is in place to facilitate effective decision-making in assessing the viability of the Mudaraba venture.</p>	

9. MUDARABA SHARIA COMPLIANCE CHECKLIST- GUIDANCE FOR SHARIA CONTROLLER/AUDITOR

#	Item	Remarks
	General	
1	Obtain a list of all the Mudaraba transactions entered into by the MFI/FI during the period under review.	
2	Select a sample of the transactions and obtain their respective agreements to check their Sharia compliance.	
3	Ensure that the samples agreements follow the standard agreement as approved by the SGC.	
4	Ensure that all the transactions entered into and their subjects are in accordance with Sharia.	
5	Document the actual transaction flow.	
6	Perform walkthrough test to check that the actual transaction flow is in line with the documented transaction flow.	
	Internal Controls	
7	Ensure that the subject matter of the transaction is held on permissible items.	
8	Ensure that the MFI/FI has properly evaluated the financial position of the client before entering into the Mudaraba contract.	
9	Are there adequate controls implemented to ensure proper transaction flow?	
10	Are there adequate controls implemented to ensure that each step of the standard Mudaraba transaction is followed by the next step?	
11	Ensure that the terms of the agreement are not changed except with the specific approval of the SGC.	
12	Ensure proper documentation of the transaction.	
13	Does the MFI/FI maintain proper feasibility and evaluation of the projects?	
	Legal Rules	
	Capital Specification	

#	Item	Remarks
14	<p>Ensure that the Mudaraba agreement meets the following conditions:</p> <ul style="list-style-type: none"> ▶ Capital of Mudaraba is specific ▶ Capital has been delivered to the client or agent of the client ▶ The profit-sharing ratio is specific for both the MFI/FI (as capital provider) and the client (as Mudarib). 	
	Profit Sharing and Distribution	
15	Ensure that the Mudaraba does not make the client liable to secure the payment of capital or profit.	
16	Ensure that the profit-sharing ratio is specific (in defined terms) and not stipulated as a lumpsum profit.	
17	Ensure that, if the contract is not renewed, the MFI/FI recovers the cash or cash equivalent value of the capital in a manner as agreed in the contract	
18	Inquire from the MFI/FI about cases of loss (if any). Ensure that in case of loss, only the MFI/FI bears the loss and not the client, unless it is proven that the loss was due to negligence or misconduct of the client, in which case the loss shall be suffered by the client as per agreement.	
19	Ensure that there are particular projects underlying the contract. Ensure that the MFI/FI has made arrangements to regularly visit and monitor the projects.	
20	Ensure that MFI/FI does not arrange with the client two accounts of capital based on the condition that the profit earned from one amount would be taken by the client and that earned on the other amount would be taken by the MFI/FI.	
21	Ensure that Mudaraba agreement does not specify any condition that the profit of one financial period would be taken by the client and that of the other financial period would be taken by the MFI/FI.	
22	Ensure that Mudaraba arrangement does not assign any profit from a particular transaction to the client or the MFI/FI.	
23	Ensure that any restrictions imposed on the client to attain the profit are beneficial and not counterproductive to the purpose of the Mudaraba.	
24	Ensure that the MFI/FI does not stipulate that it has a right to work with the client and be involved in the Mudaraba operations.	
25	Ensure that the client does not make any loan, gift or charitable donation out of the Mudaraba funds.	

10. MUDARABA CONTRACTS AND DOCUMENTATION

Facility offer letter – Mudaraba

Dear Sirs,

We refer to your application dated _____ and are pleased to advise you of the facility approval as per the terms given below:

1	Facility type:	Mudaraba
2	Facility amount (\$)	
3	Purpose: (e.g. establishing business of a supermarket)	
4	Commencement date	
5	Profit distribution ratio	
6	Liquidation: actual/constructive (if constructive, mention frequency)	
7	Maturity: (Days/Months/Years)	
8	Redemption Frequency: (e.g. Quarterly/semi-annual, etc.)	
9	Securities: (Promissory Note, other collateral as agreed, any other securities as may reasonably be required by the Institution, etc.).	
10	Processing charges (cost to Mudaraba)	\$_____ (Non- Refundable)
11	Documentation charges (cost to Mudaraba)	Actual
12	Draw down: (facility may be drawn in lumpsum or in tranches)	

Other Terms and Conditions

1. The facility shall be governed by the relevant/applicable rules and regulations of (Country name) including those of the Central Bank of (Country name) (if applicable).
2. The client may not create any charge on the asset(s) offered as security by way of pledge, hypothecation, mortgage or in any other way, created in favour of the Institution, with any other bank, financial institution or any other person in any manner whatsoever.
3. The Mudaraba venture may be inspected by the Institution as and when required and the client shall allow access to and cooperate with the authorized representative of the Institution in carrying out such inspections.
4. The Institution shall inform the client of all expenses incurred on account of documentation, valuation, charge registration or any other costs in relation to the facility mentioned in this letter now or hereafter levied on the Institution in respect of or in connection with the facility and security thereof shall be charged as a cost to the Mudaraba capital (if the Mudaraba is on net basis) or may be reflected on the respective profit-sharing ratios (if the Mudaraba is on gross basis).
5. This facility offer is subject to internal final approvals, satisfactory review of all documentation, securities, necessary formalities and receipt of duplicate copy of this letter duly signed by the authorized signatory evidencing agreement on all terms and conditions.

Please return a signed and accepted copy of this letter within _____ days.

This offer is valid for a period of days from date of this letter. If the facility offered herein is not utilized within the specified period, the facility shall stand withdrawn.

Yours faithfully,

For and on behalf of

_____ [Insert name of Institution]

Acceptance of Terms and Conditions

Date: _____

To: _____ [Insert name and address of the Institution]

Dear Sirs,

Reference your approval of our request dated _____, we hereby accept the facility offer and terms and conditions of the approval provided and request to proceed with the facility. We undertake to abide by the terms of approval. We shall provide a promissory note, surety, and other collateral(s), if required. We also undertake to avail the facilities and meet all documentation, customary and other requirements, in form and substance acceptable to the Institution wherever required.

Yours faithfully,

For and on behalf of

_____ [Insert name(s) of applicant(s)]

Mudaraba financing agreement

(Small Enterprises)

This Mudaraba agreement ("the Agreement") is made on this day _____ of _____, between _____, a company incorporated under the laws of (Country name), having its registered office at _____, through its _____ (hereinafter referred to as the "Institution" or "Capital Provider" which expression shall, where the context so permits, mean and include its successors-in-interest and assigns), of the one part;

and

_____, a sole proprietorship/company/corporation incorporated under the laws of (Country name), having its registered office at _____, through its _____ (hereinafter referred to as the "Client" or "Manager" or "Mudarib" which expression shall, where the context so permits, mean and include its successors-in-interest and assigns), of the other part;

It is agreed by the parties as follows:

The Client and the Institution wish to enter into a Mudaraba for the purpose of carrying out the project described as Project Information in Appendix-1 and the Client has presented to the Institution an application to finance the Project and has satisfied conditions precedent and other formalities to avail such financing.

1. Definitions

The parties agree that the following terms used in this Agreement shall have the following meanings:

"Account" means an account opened with a bank in the name of the client.

"Project Information" means all relevant information and detail provided by the Client for the Project in the form of Appendix-1.

"Cash Flow and Revenue Projection" means financial projections for the Project prepared by the client and annexed as Appendix-2.

"Management Services" means the technical management and supervision services required to ensure the success of the Project.

"Profit" means the amount of gross profit available for distribution after deduction of permissible expenses as may be agreed between the client and the Institution in terms of the Schedule of Expenses as shown in Appendix-3.

"Client Information Form" means the information prepared by the Client as in Appendix-4 disclosing certain information regarding the Client.

"Client Financials" means the balance sheet and profit and loss statement of the Client for the last three years, prepared and presented by the Client in the manner as approved by the Institution.

"Draw Down Dates" means the dates specified in Appendix-5 upon which the Institution is obliged to provide funds by credit to the Account.

2. Investments

The parties agree that a sum of \$_____ (_____ only) required for the Project as estimated by the Client in the Project Information Form shall be supplied by the Institution by way of financing for a period of _____ months hereof and deposited in the Account.

3. Account

3.1. The authorized signatories on the Account shall be as specified in Appendix-6.

3.2. All funds for the purpose of the Project shall be disbursed only through the Account by cheque.

3.3. The Institution shall have the right to refuse the payment of any cheque or transfers from the Account if it reasonably appears to the Institution that such amounts are not included in the Cash Flow and Revenue Projections and do not directly or indirectly relate to the Project.

4. Representations of the Client

The Client represents to the Institution that:

4.1. The Client possesses all necessary authorizations and mechanisms to conduct financing intermediation in respect of this Project.

4.2. The Client is experienced and knowledgeable in all business matters relating to the Project.

4.3. The Client has prepared with all due care the Project Information Form and the Cash Flow and Revenue Projection based on his experience and knowledge and has completed all reasonable investigation to assure that such information and projections are true and correct and disclose all factors relevant to the Institution's evaluation of the Project.

4.4. The Client Financials are true and correct according to generally accepted accounting principles consistently applied, accurately representing the Client's financial status on the dates and the profit and loss for the periods indicated, and no liabilities, fixed or contingent exist at the indicated dates other than as appearing in the Client's Financials.

4.5. The Client has suffered no material adverse change in business operation or financial position since the date of the most recent Client Financials supplied to the Institution.

5. Representation of the Institution

The Institution represents to the client that on the date of this Agreement, the Institution is a corporation organized under the local country laws and possesses all necessary powers and licenses to conduct its business and to finance the Project as provided by this Agreement.

6. General Covenants of the Client

The Client undertakes to the Institution that the Client shall:

6.1. Promptly give notice to the Institution of any change in the information disclosed through the Client Information Form.

- 6.2. Render the Management Services with due care and all reasonable commercial diligence to ensure the success of the Project according to the description of the Project Information Form and the Cash Flow and Revenue Projection.
- 6.3. Utilize the Project investment exclusively for purposes of the Project as specified in the Cash Flow and Revenue Projection.
- 6.4. Disburse all funds for the purpose of the Project only through the Account by cheque or transfer against proper supporting invoices maintained by the Client but available for inspection by the Institution or its agents.
- 6.5. Submit the following to the Institution, prepared according to the instructions of the Institution:
 - 6.5.1. A cash flow and revenue statement of the Project for the previous quarter, with a clear explanation of each variation from the Cash Flow and Revenue Projection, within 30 days of the close of each quarter.
 - 6.5.2. A balance sheet and income statement of the Client prepared in accordance with principles utilized in the Client Financials consistently applied. The annual balance sheet and income statement shall be audited by an independent firm of accountants and audited documents shall be presented to the Institution within 120 days of the close of the Client's accounting year.
 - 6.5.3. Maintain true and correct books of account relating to the Project.
 - 6.5.4. Supply to the Institution any information, material or document relating to the Project or to the Client's financial status and grant the Institution or its agents access to all books and documents relating to the Project and to the Client's financial statements.
 - 6.5.5. Immediately disclose in writing to the Institution any business factors of which the client becomes aware that might adversely affect the success of the Project.
 - 6.5.6. Conduct the Project without violation of the principles of the Sharia.

7. General Covenants of the Institution

The Institution undertakes to the Client that it shall:

- 7.1. Make all payments of Finance required of the Institution under this Agreement to the Account on the Draw Down Dates.
- 7.2. Whenever the circumstances so require, consult with the Client on any matter, with a view to determining the policy to be followed in order to ensure the proper implementation of this Agreement, but without any obligation on the Institution to compromise its rights.
- 7.3. Perform its obligations under this Agreement without violation of the principles of Sharia.

8. Participation in Profit and Payment Schedule

8.1. The participation in profit will be in accordance with the following ratio:

8.1.1. _____% of the profit will be payable to the Client for Management Services.

8.1.2. _____% of the profit will be payable to the Institution.

8.2. It is agreed that the Client (in its capacity as Manager) shall pay to itself and the Institution their respective expected shares of profit as well as redeemed capital to the Institution, whereby the Institution's share will be paid in accordance with the schedule given in Appendix-7.

8.3. On Termination Date:

8.3.1. The accounts of the Mudaraba shall be drawn up in accordance with accepted accounting principles, and the profit, if any, due to the Client and the Institution shall be worked out and paid in the proportion specified above, subject to adjustment of any provisional payments made, plus the amount paid by the Institution after deducting losses, if any.

8.4. The parties agree that tentative payment to the Institution as per agreed ratio of profit distribution should be made (insert frequency) on-account, regardless of the actual profitability, which will be accounted for at the time of each constructive liquidation, or at final settlement.

9. Losses

9.1. Loss in the Project shall be fully borne by the Institution.

9.2. The Client will receive no compensation for his Management Services and will also be liable for bearing loss in proportion to the agreed ratio of profit distribution as agreed above if it is proven that he breached his obligations or is proven to have failed in the discharge of his obligations under this Agreement.

9.3. In the event of the Project showing losses during the currency of this Agreement, the Client shall forthwith give notice of such losses to the Institution together with all accounts and details pertaining thereto and such other information and records as may be required by the Institution. Notwithstanding the above, the Institution shall only be liable for the losses in the manner specified if the said losses have not been caused by misconduct on the part of the Client in carrying out the Project's business and operations or as a result of his negligence or inefficiency, including non-compliance with the terms and conditions of this Agreement

10. Taxation

On behalf of the Project, the Client shall be liable for and shall punctually and regularly pay all taxes, duties, cesses and other charges relating to the Project's business and operations, as and when applicable.

11. Termination

11.1. Subject to other provisions of this Agreement, it is agreed that upon full payment on Termination Date or earlier, if proceeds have been received, the Mudaraba shall stand redeemed.

While the amount invested by the Institution is expected to be redeemed by the due date mentioned above, the accounts of the Mudaraba shall be drawn up within 7 days thereof and the Institution's agreed share of profit shall be promptly paid.

12. Management and Control

Subject only to the express terms of this Agreement, complete management and control of the Project is exclusively vested in the Client and the Client shall be solely responsible for the management and control of the Project.

13. Assumption of Management of the Project by the Institution

13.1. The Institution shall have the right to terminate by notice the powers of the Client to manage the Project and assume the same if the Client violates any obligation(s) hereunder, or if for any cause the results of the Project depart in a materially adverse manner from those projected by the Client in the Cash Flow and Revenue Projections. In such an event:

13.1.1. The Client shall be entitled to receive his share of the profit, if any, until the date of termination stated in the notice. Thereafter, the Institution shall be entitled to the whole profit.

13.1.2. The assumption of management by the Institution shall not discharge the Client of any obligation hereunder other than the obligation to render the Management Services.

13.1.3. The assumption of management by the Institution with respect to the Project shall in no event be deemed to affect the liability of the Client towards the Institution with respect to any other facilities granted under any other agreement between the Client and the Institution whether or not the proceeds of such were employed in connection with the Project.

14. Set-off

The Institution may set-off against any obligation of the Client hereunder, or any other obligation of the Client, the balances of any account maintained by the Client with the Institution.

15. General

The parties agree that this Agreement may be amended or any term or condition waived only in writing, executed by duly authorized persons and that the Appendices of this Agreement shall be considered an integral part thereof.

In Witness Whereof the Client and the Institution have executed this Agreement on the day, month and year hereinabove mentioned.

For and on behalf of

For and on behalf of

_____ [insert name of the Institution]

_____ [Insert name(s) of Client]

Annexes to include:

- Appendix 1 Project information sheet
- Appendix 2 Cashflow and revenue projection
- Appendix 3 Schedule of approved expenses
- Appendix 4 Client information form
- Appendix 5 Draw down dates
- Appendix 6 Authorised signatories
- Appendix 7 Capital redemption and profit payment schedule



Diminishing Musharaka

Diminishing Musharaka (DM) refers to a contract of partnership where one of the partners promises to buy the investment share of the other partner over a period of time as agreed between them until the title to the joint property is completely transferred to the purchasing partner. Since this transaction consists of two parts, i.e. Musharaka in the joint property and sale of one partner's investment to the other, the Sharia rules on contracts do not allow them to be combined into one deal. As such, the buying and selling of the investment should be kept separate from the partnership contract. Therefore, the buying partner can give only an undertaking to purchase the other's investment, independent of the partnership contract.

To effect this transaction, a Musharaka (partnership) is created between the MFI/FI and the client in a property, machinery/equipment or project (e.g. SME). This takes the form of undivided ownership of both the parties. The share of the MFI/FI is divided into several units of equal value, on the understanding that the client would incrementally purchase the units of the share of the MFI/FI over time. This increases the client's share and decreases the MFI/FI share in the joint asset until such time that all the units of the MFI/FI are purchased by the client to make him the sole owner, while ownership of the MFI/FI diminishes to zero.

1. DIMINISHING MUSHARAKA AS A MODE OF FINANCING

- ▶ DM is preferably created on tangible assets. Diminishing Musharaka may be limited to the specified asset(s), not necessarily covering the whole enterprise or business.
- ▶ DM can also be created on a business through a special purpose vehicle (SPV) for a project with the sale of Musharaka units by one party to the other. In this case, the profits generated by the business will be shared.
- ▶ A DM arrangement would consist of the following steps:
 - Creation of joint ownership between/ among the co-owners.
 - Renting out by one co-owner of his undivided share in the asset to the other co-owner(s) against an agreed rent.
 - Incremental selling by one co-owner of his share to the other co-owner(s).
 - Over time, the payment of selling partner's investment decreases, and so does the value of rental, until such time that it diminishes to zero with the complete transfer of ownership from seller to the purchaser.
- ▶ The proportionate share of each co-owner must be known and defined in terms of investment.
- ▶ Expenses incidental to ownership may be borne jointly by the co-owners proportionate to their respective investments.
- ▶ Loss, if any, is borne by the co-owners in the proportionate to their respective investments.
- ▶ The amount of periodic payment continues to decrease with the purchase of ownership units until the purchase of the last unit of the seller's investment.
- ▶ Each periodic payment represents a separate transaction of sale for the respective Musharaka unit and is executed by exchange of offer and acceptance.
- ▶ The sale of units by one co-owner to the other co-owner(s) as aforesaid is documented in such a manner as the parties may mutually agree.
- ▶ Failure to honour the undertaking by the client:
 - In case the client fails to honour his undertaking in relation to the periodic payment and purchase or sale of units, the asset may be sold on the open market and the MFI/FI would be entitled to recover actual loss, defined as the difference between the market price and the price stated in the undertaking, if any, not including the opportunity cost.

- Any gain on the sale of the asset is shared between the MFI/FI and the client in proportion to their respective investments at the time of such sale.
- In addition to the above, the MFI/FI would be entitled to recover all outstanding periodic payments in respect of the period for which the client used or possessed the asset.

2. USES OF DIMINISHING MUSHARAKA

- ▶ Plant and machinery financing
- ▶ Factory/building financing
- ▶ Agricultural farm and non-farm financing
- ▶ Factory sheds/storage facility/livestock shed purchase/construction
- ▶ Commercial/transport vehicle financing
- ▶ Commercial business financing
- ▶ Project financing
- ▶ All other fixed assets, etc.

3. HOW IS DIMINISHING MUSHARAKA DIFFERENT?

DM is a contract that allows a clear exit strategy for an investor through pre-agreed gradual takeover of the equity by the entrepreneur. As a hybrid arrangement between debt and equity, the closest instrument in conventional financing is mezzanine financing, commonly known as convertible debt. A convertible debt is an interest-bearing loan that can be turned into equity (stock ownership) when a milestone is reached (generally upon the occurrence of future financing). A convertible debt gives the lender the best of both worlds, namely security in a debt with the possibility of high returns in the future if the investor exercises his option to convert the debt into equity. Diminishing Musharaka, on the other hand, is an equity instrument that investors enter into to obtain a share of the rental (in the case of asset purchase) or venture profits generated. At the same time, it provides an exit strategy requiring the entrepreneur to repay the principle investment to acquire full ownership.

Diminishing Musharaka enables the investor to benefit from the high-risk/high-return arrangement at the initial stage while ensuring an exit plan. It also assures the entrepreneur that he would not relinquish equity in the long term, as there is a clear pre-agreed exit for the investor. This would motivate the investor to work with the entrepreneur in the short term while ensuring the ownership interest of the entrepreneur in the long term. Convertible bonds, however, provide security to the investor in the short term as a loan while giving him the option to convert it into equity in the future if the investment is successful.

4. IMPACTFUL MUSHARAKA THROUGH ECONOMIC EMPOWERMENT

Like all equity instruments, Diminishing Musharaka facilitates a risk-sharing arrangement between the entrepreneur and the investor. As it is the investor who makes the majority investment in the asset or venture, the investor should ensure all risk mitigation measures, including that relevant Takaful and permits are obtained. As the highest risks are during the initial stages, the investor's role in ensuring that the asset or the venture can generate high returns in a short period of time is critical and it is to his interest to do so, as the profit-sharing ratio will be high initially when he has majority ownership. As the entrepreneur buys over the equity from the investor gradually, his share of profits increases while that of the investor proportionally decreases over time. By the time the investor exits from ownership of the asset or the venture, the entrepreneur would have learnt how to manage it so that he continues to generate profits after the investor exits.

5. RULES APPLICABLE TO DIMINISHING MUSHARAKA

- ▶ In DM, the essence of co-ownership remains the same, while the proportion of co-ownership in an asset(s)/venture may be subject to change by sale/repurchase of DM units between the partners from time to time, provided that the sale/repurchase is neither simultaneous nor contingent, i.e. it does not involve prohibited buyback.
- ▶ If the client wants to purchase units representing

the MFI/FI's ownership in the property earlier than the agreed interval(s), or during the grace period allowed by the MFI/FI, the MFI/FI may sell, and the client may buy, the units at an agreed price.

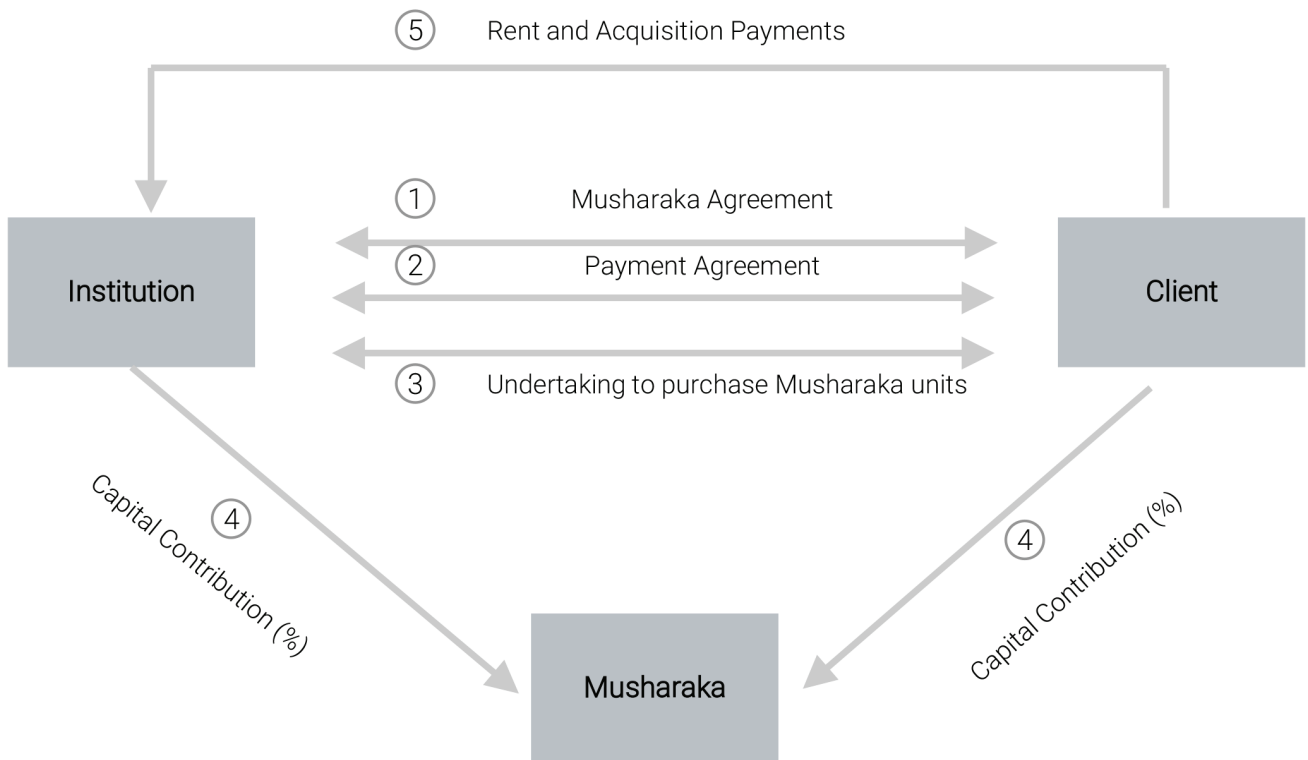
- ▶ The grace period during construction (for developing civil structures) as allowed by the MFI/FI in case of Diminishing Musharaka, may commence from the first draw down on the allocated funds.
- ▶ In case of delay in the purchase of DM units, the MFI/FI may charge/recover rental (profit) on its share in the asset. Recovery through rentals will be part of the MFI/FI's income. Hence, the MFI/FI would continue to accrue profit on units/its share in the asset until such time as the client purchases the same.
- ▶ The DM property (the constructed part only – not land and other assets such as machinery/equipment) must be insured, preferably through Takaful.
- ▶ Takaful insurance is an ownership-related expense and should, therefore, be borne by the MFI/FI and the client in proportion to their respective ownership shares of the asset. However, the MFI/FI may recover the cost related to its contribution through supplementary rentals.
- ▶ The DM rentals commence from the date the usufruct of the assets is transferred to the client.
- ▶ The rental may be calculated in reference to a well-known benchmark as per prevailing market practices/dynamics, e.g. Daily Inter Bank Offer Rate (DIBOR) or at the rate agreed upon when the transaction is established, subject to a floor and cap. The MFI/FI may agree on a rental other than the mentioned hereabove. However, the amount of rental for the first period should be specified at the beginning.
- ▶ The minimum Security Deposit, in addition to Promissory Note, may be agreed upon with the Client per the MFI/FI's own standard procedure. All other terms and conditions of the co-ownership, Ijara and sale remain applicable during different stages in the process of the DM arrangement.

6. STAGES OF DIMINISHING MUSHARAKA

- ▶ The client identifies the asset/venture and approaches the MFI/FI with the request for financing.
- ▶ The MFI/FI enters into a Musharaka agreement with the client and both of them pay their respective shares to the seller of the asset/venture. The share of the MFI/FI is represented by the number of units of equal value determined by dividing the investment of the EE by the number of instalments over which the investment of the MFI/FI is to be purchased.
- ▶ Each unit's purchase price could be based on the market value of the asset/venture at the time of purchase (face value). However, the parties may agree to a uniform price that is included in the payment agreement, which is the standard practice of financial institutions to avoid complicating the structure of the instrument and the cost of revaluation every time the unit is purchased.
- ▶ In case the MFI/FI's ownership is created in an asset already owned by the client, such ownership is reflected through execution of purchase receipt/documents.
- ▶ The Musharaka agreement sets out the terms and conditions upon which the MFI/FI and client agree to become co-owners enjoying ownership rights in an asset/venture.
- ▶ Purchase receipt/documents: The receipt/documents evidence the partial sale of the asset owned by the client against consideration paid by the MFI/FI.
- ▶ Upon execution of the Musharaka agreement, the MFI/FI and the client agree through a payment agreement that in consideration of the MFI/FI's Musharaka share, the client's rights in respect of the Musharaka asset is maintained and the client enjoys exclusive use and occupation of the Musharaka asset against the due payments.
- ▶ The payment agreement sets out the terms and conditions under which the client makes payments to the MFI/FI in respect of the use and occupation of the Musharaka asset to the extent represented by the MFI/FI's share in the Musharaka.

- ▶ Every time units are purchased by the client, the payment (price of the unit(s) and the rental) would diminish as the client's share in the joint property increases while the MFI/FI's share decreases in value.
- ▶ Similarly, the payment of Takaful/insurance and other expenses are also distributed between the partners in proportion to their respective shares in the asset.
- ▶ On payment of the unit price and rentals, the ownership of the asset is gradually transferred to the client. Each unit purchase must be effected by an offer and acceptance on the specific date. Upon purchasing all units, the client eventually becomes the sole owner of the asset.

Figure 7. Mudaraba Venture – Provided Funding for a General Purpose



7. DM ACCOUNTING/BOOKKEEPING (INCLUDING WORKED EXAMPLES)

Given that DM combines features of Ijara and Musharaka, its accounting treatment follows the course discussed under the respective discussion on each of those products.

Table 10. Mudaraba Accounting Example

Small Enterprise Finance – Agricultural Services Company Diminishing Musharakah													
Asset Description	Combined harvester (Used) for Wheat and Rice												
Asset Specification	John Deere S 660												
Applicant	XXXX												
Value of Assets	250,000												
Customer Share	25.00%	62,500											
Bank/SFD Share	75.00%	187,500	625		Per month profit								
Tenure (Years)	3.0	36	Months										
Grace Period	6 Months												
Grace Period Profit	9,375												
Insurance of Asset	3.00%	7,500	7,250	7,000									
Bank/NGO/SFD Ins. Share	5,626		5,438	5,250									
Apply Profit Rate	10.00%											Penalty	57,604
Disbursement Date	01-Feb-2014												
1st Installment Date	01-Aug-2014												
Unit Price Institution Investment	6,250												
Unit Price Grace Period Profit	313												
Ins #	Due Date	Unit Price (Musharika)	Unit Price (Grace)	Total Unit Price	Rent	Insur.	Monthly Rentals	Monthly Payments	O/S Musharika Investment	O/S Grace	O/S Insurance	Buy Out Price	
									187,500	9,375	5,625		
1	01-08-2014	6,250	313	6,563	1,609	469	2,078	8,641	181,250	9,063	5,156	207,734	
2	01-09-2014	6,250	313	6,563	1,553	469	2,022	8,585	175,000	8,750	4,688	200,522	
3	01-10-2014	6,250	313	6,563	1,497	469	1,966	8,529	168,750	8,438	4,219	193,310	
4	01-11-2014	6,250	313	6,563	1,441	469	1,910	8,473	162,500	8,125	3,750	186,098	
5	01-12-2014	6,250	313	6,563	1,385	469	1,854	8,417	156,250	7,813	3,281	178,885	
6	01-01-2015	6,250	313	6,563	1,329	469	1,798	8,361	150,000	7,500	2,813	171,673	
7	01-02-2015	6,250	313	6,563	1,273	469	1,742	8,305	143,750	7,188	2,344	164,461	
8	01-03-2015	6,250	313	6,563	1,217	469	1,686	8,249	137,500	6,875	1,875	157,249	
9	01-04-2015	6,250	313	6,563	1,161	469	1,630	8,193	131,250	6,563	1,406	150,036	
10	01-05-2015	6,250	313	6,563	1,105	469	1,574	8,137	125,000	6,250	938	142,824	
26	01-09-2016	6,250	313	6,563	301	438	738	7,301	25,000	1,250	4,375	38,426	
27	01-10-2016	6,250	313	6,563	245	438	682	7,245	18,750	938	3,938	31,245	
28	01-11-2016	6,250	313	6,563	189	438	627	7,189	12,500	625	3,500	24,064	
29	01-12-2016	6,250	313	6,563	133	438	571	7,133	6,250	313	3,063	16,883	
30	01-01-2017	6,250	313	6,563	78	438	515	7,078	0	0	2,625	9,703	
Grand Total		187,500	9,375	196,875	25,026	13,688	38,713	235,588					

Processing charges at the time of initiation of proposal

Dr	Client non-chequing account	xxxx
Cr	Processing fee – Diminishing Musharaka	xxxx

Scenario 1: In case of Advance payment for the procurement of assets

Dr	Advance against Diminishing Musharaka	187,500
Cr	Client non-chequing account	187,500
Dr	Client non-chequing account	187,500
Cr	Client account / P.O / DD	187,500

1. Accrual of grace period profit @ 10%

Dr	Grace period profit receivable on DM	313
Cr	Income on grace period DM	313

(This entry is posted every month until asset is operative. It is accumulated and made part of the monthly instalment)

2. At the time of creation of Diminishing Musharaka, the transaction is accounted for as follows: (when DM is operative)

Dr	Diminishing Musharaka	187,500
Cr	Advance against Diminishing Musharaka	187,500

Scenario 2: Where no Advance payment is involved, and asset is available immediately in operative condition

Dr	Diminishing Musharaka	187,500
Cr	Client non-chequing account	187,500
Dr	Client non-chequing account	187,500
Cr	Client account / P.O / DD	187,500

3. Takaful/insurance of the Musharaka asset is arranged. However, the MFI/FI pays the premium up to its share in the Musharaka asset and the client pays his share of the premium as per the ratio in Musharaka assets:

Dr	Prepaid Takaful/insurance (DM)	5,625
Cr	Client non-chequing account	5,625
Dr	Client non-chequing account	7,500
Cr	P.O / DD (Remittance)	7,500

(Total premium payment of Musharaka asset including client share of 25%)

Monthly Income and Expense Accruals

Income Accrual:

Dr	Profit receivable on Diminishing Musharaka	1,609
Cr	Profit on Diminishing Musharaka	1,609

(This is due to the asset's operative condition, whereas grace period profit would be added in the Musharaka unit price)

Insurance expense accrual

Dr	Takaful/insurance expense (DM)	469
Cr	Prepaid Takaful/insurance (DM)	469

Monthly Instalments

At the time of payment of instalments, the transaction is accounted for as follows:

Dr	Client non-chequing account	8,641
Cr	Diminishing Musharaka	6,250
Cr	Grace period profit receivable on DM	313
Cr	Profit receivable on Diminishing Musharaka	1,609
Cr.	Takaful/insurance income:	469

(These entries will be repeated every month until the maturity date of the DM)

In case of full prepayment (early termination) (suppose at 6th instalment)

Dr	Client non-chequing account	171,674
Cr	Diminishing Musharaka	150,000
Cr	Grace period profit receivable on DM	7,500
Cr	Prepaid Takaful/insurance	2,813
Cr	Accrued profit on Diminishing Musharaka	8,361
Cr	Termination Income (suppose 2% on 150,000)	3,000

Treatment of donation on delayed payment (e.g. 2% pm, delay of 1st instalment by 10 days)

Dr	Client non-chequing account	56
Cr	Charity fund account	56

8. RISKS AND MITIGATION MEASURES RELATED TO USE OF DIMINISHING MUSHARAKA FINANCING

Product-Specific Risks	Risk Mitigation Measures
<p>I. Credit Risk</p> <p>The client may be either unable to purchase units or pay the rentals on due dates. In such circumstances, the MFI/FI may end up selling or leasing the repossessed asset (due to default of the client) at a price lower than the original contractual price. The client may be unable to pay the future rentals that are “accelerated” or declared immediately due upon default by the client. The MFI/FI may have to bear the potential loss due to a fair value of the asset at maturity that falls below its residual value estimated at inception (low fair value).</p>	<ol style="list-style-type: none"> 1. The risk can be mitigated by gathering as much information about the client’s existing and potential ventures and ensuring that the data remains up-to-date so that it can monitor progress. The repayment dates should match the cashflow of the venture. 2. Provision of a clause in the agreement that the asset would be possessed by the MFI/FI in such cases. The asset is then sold on the market, which may enable the MFI/FI to recover its investment. However, the price realized would have to be accepted by the MFI/FI, even if it is lower than the loss it sustains. In case of any capital gain, such gain would be divided between the two parties as per their respective shares in the joint property at the time the MFI/FI possessed it.
<p>II. Operational Risks</p> <p>Any violation of the approved operating procedure that results in Sharia non-compliance risk, hence loss of income. Similarly, combining sale and lease contracts also raises a Sharia non-compliance risk.</p>	<ol style="list-style-type: none"> 1. Top management (including the Sharia governance body of the MFI/FI) must ensure that a proper infrastructure and system exist for sound processes to be observed. 2. Capacity building and dedicated training programmes would help too.
<p>III. Market Risk</p> <p>Macro- and microeconomy factors may create uncertainty, which may result in a market risk due to change in prices/rentals and policies.</p>	<p>The market risk is managed by negotiating for rentals higher than the prevailing market price at the time of entering into the DM and/or by clearly stipulating the redetermination of rentals after a specified time during the tenor of the agreement within a specific floor and ceiling bracket.</p>

9. DIMINISHING MUSHARAKA SHARIA COMPLIANCE CHECKLIST- GUIDANCE FOR SHARIA CONTROLLER/AUDITOR:

#	Item	Remarks
	General	
1	Obtain a list of all the Diminishing Musharaka transactions entered into by the MFI/ FI during the period under review.	
2	Select a sample of the transactions and obtain their respective agreements to check their Sharia compliance.	
3	Ensure that the sampled agreements follow the standard agreement as approved by the SGC.	
4	Ensure that all the transactions entered into are in accordance with the contracts.	
5	Document the actual transaction flow.	
6	Perform walkthrough test to check that the actual transaction flow is in line with the documented transaction flow.	
	Internal Controls	
7	Does the MFI/FI ensure that the subject matter of the transaction is held on permissible items?	
8	Are adequate controls implemented to ensure proper transaction flow?	
9	Are there adequate controls implemented to ensure that each step of the standard Musharaka transaction is followed by the next step?	
10	Does the MFI/FI ensure that the terms of the agreement are not changed except with the specific approval of the SGC?	
11	Does the MFI/FI ensure that losses are shared in the ratio of capital contribution?	
12	Has the MFI/FI ensured proper documentation of the transaction?	
	Legal Rules	
13	Ensure that the Musharaka contract is not a mere loan-financing operation but, rather, a proper partnership arrangement.	
14	Document the nature of Musharaka arrangement.	
15	Ensure that there exists a binding promise from one of the partners to acquire the equity shares gradually according to the market value or price agreed at the time of acquisition or at the time of contract.	
16	Ensure that the cost of Takaful/insurance and maintenance of the Musharaka is not borne by one partner but jointly by the partners of the Musharaka in proportion to the shares in the asset held.	
17	Review and ensure that no indemnification or security is sought by the MFI/FI for losses incurred during the normal course of business in any capacity, as this would be against the principles of Musharaka. A partner is a trustee of the funds in his hands from the Musharaka and would only indemnify in case of fraud, misconduct or negligence. To avoid any loss due to negligence or wilful default, security or guarantee from a guarantor may be taken.	
18	In case of more than one partner on either side, inquire from the MFI/FI about any cases where the Musharaka arrangement was terminated/rescinded. In such cases, ensure that it was done with the consent of all other partners and not unilaterally.	

10. DM CONTRACTS AND DOCUMENTATION

Facility offer letter – Diminishing Musharaka

Date: _____

To: _____ [Insert name and address of the applicant(s)]

Dear Sirs,

We refer to your application dated _____ and are pleased to advise you of the facility approval as per the terms given below:

1	Facility type	Diminishing Musharaka
2	Facility amount (\$)	
3	Purpose	
4	Asset details	
5	Profit rate	
6	Contribution of the applicant (% of the total value of the asset)	
7	Revision of profit rate, if any	As agreed in the Musharaka agreement
8	Facility tenor/expiry	
9	Payment: (e.g. Principal: 3 years through monthly instalments falling due on ____, with a one year grace period and Profit: Monthly instalments starting immediately after draw down date on ____)	
10	Securities: (Mortgage/pledge/hypothecation of the underlying asset, direct debit instructions/post-dated cheques and any other securities as required by the Institution)	
11	Comprehensive Takaful/insurance: (Asset insurance; Life insurance, if required; insurance for default)	
12	Specific Terms and Conditions: (if any)	

Other Terms and Conditions

1. The facility shall be governed by the relevant/applicable rules and regulations of (Country name) including those of the Central Bank of (Country name) (if applicable).
2. The client may not create any charge on the asset(s) offered as security by way of pledge, hypothecation, mortgage or in any other way, created in favour of the Institution, with any other bank, financial institution or any other person in any manner whatsoever.
3. The asset may be inspected by the Institution as and when required by it and the client shall allow access to and cooperate with the authorized representative of the Institution in carrying out such inspections.
4. All expenses incurred on account of documentation, valuation, charge registration or any other costs in relation to the facility mentioned in this letter now or hereafter levied on the Institution in respect of or in connection with the facility and security thereof shall be payable by the client in proportion to its share in the Musharaka asset.
5. The Institution will require evidence by way of invoices, or otherwise, from the client that the asset(s) financing is utilized for acquiring the asset(s) in terms of the Musharaka agreement.
6. This facility offer is subject to internal final approvals, satisfactory review of all documentation, securities, necessary formalities and receipt of duplicate copy of this letter duly signed by the authorized signatory evidencing agreement on all terms and conditions.

Please return a signed and accepted copy of this letter within _____ days.

This offer is valid for a period of days from date of this letter. If the facility offered herein is not utilized within the specified period, the facility shall stand withdrawn.

Yours faithfully, for and on behalf of

_____ [Insert name of Institution]

Acceptance of Terms and Conditions

Date: _____

To: _____ [Insert name and address of the Institution]

Dear Sirs,

Reference your approval of our request dated _____, we hereby accept the facility offer and terms and conditions of the approval provided and request to proceed with the facility. We undertake to abide by the terms of approval. We shall provide a promissory note, surety, and other collateral(s), if required. We also undertake to avail the facilities and meet all documentation, customary and other requirements, in form and substance acceptable to the Institution wherever required.

Yours faithfully,

For and on behalf of

_____ [Insert name(s) of applicant(s)]

Diminishing Musharaka agreement

Micro and Small Enterprises (delete as appropriate)

This Diminishing Musharaka agreement (“the Agreement”) is made on this _____ day of _____ between _____, a _____ company incorporated under the laws of (Country name), having its registered office at _____, through its _____ (hereinafter referred to as the “Institution” which expression shall, where the context so permits, mean and include its successors-in-interest and assigns), of the one part;

and

_____, a sole proprietorship/company/corporation registered under the laws of (Country name) and having its place of business/ registered office at _____ (hereinafter referred to as the “Client”, which expression shall where the context so permits mean and include its legal heirs, successors-in-interest and assigns), of the second part.

It is agreed by the parties as follows:

1. Purpose and Definitions

1.1. Purpose

- 1.1.1. This Agreement sets out the terms and conditions under which the Institution and the Client have agreed to enter into a Musharaka.
- 1.1.2. Regardless of proportion of ownership share, the entire Musharaka asset shall be occupied and used by the Client against monthly/quarterly/semi-annual payments (delete as appropriate).
- 1.1.3. It is further understood between the parties that the has made a binding promise/ undertaking to buy out the Institution’s shares in the Musharaka Asset from time to time.
- 1.1.4. Now, on the request of the Client, the Institution has agreed to enter in to a Musharaka arrangement to purchase the “Musharaka Asset(s)”, fully described in the schedule provided at the end, which the Client will buy from the Institution on Diminishing-Musharaka basis.

1.2. The terms defined in the Musharaka Agreement shall have the same meanings as in this Agreement.

- 1.2.1. “Monthly/quarterly/semi-annual (delete as appropriate) Payment Agreement” means the agreement between the Institution and the Client allowing the Client to occupy/utilize the Institution’s shares in the Musharaka Assets and pay the instalments in the agreed manner provided in Appendix-1.
- 1.2.2. “Buyout Payment Date(s)” means the date(s) on which the Client shall buy the Musharaka Units from time to time from the Institution as set out in Appendix-3.
- 1.2.3. “Musharaka Units” and “Buyout Price” mean the number of units of the Institution’s share and value of each unit and amount to be paid by the Client to the Institution to purchase the Musharaka Units of Institution’s share as set out in Appendix-3.
- 1.2.4. “Outstanding Buyout Price” means the aggregate Buyout Price minus the total amounts of Buyout Price already paid by the Client as per Appendix-4. In the event of termination under

Clause 5, only the “Schedule of Outstanding Buyout Price (Applicable upon Termination)” shall apply.

- 1.2.5. “Term” means the period of validity of the Agreement commencing from the effective date up to the payment date of the last Buyout Price.
 - 1.2.6. “Undertaking to Purchase” Means the Client’s undertaking as set out in Appendix-2 to purchase Musharaka units from the Institution from time to time towards purchasing the total Musharaka units of the Institution
2. The Client represents that the Client has satisfied himself as to the quality, specifications and market value of the Musharaka Asset(s) and has requested the Institution to participate in buying the Musharaka Asset(s) at the agreed price where the Client is prepared to participate to the extent of _____ % in purchasing the Musharaka Asset(s) and shall make \$_____ (_____ only) available to the Institution in this regard at the time of signing this Agreement.
 3. Based on the representations of the Client, the Institution has agreed to enter into the Musharaka and purchase the Musharaka Asset(s).
 4. After the acquisition of the Musharaka Asset(s), the Client shall purchase the share of the Institution in the Musharaka Asset(s) through Musharaka Units from the Institution in accordance with the following:
 - 4.1. The Client shall purchase the Musharaka Units from the Institution and make corresponding payments in accordance with Appendix-1.
 - 4.2. The Client may, at any time during the term of this Agreement, purchase all the Institution’s remaining Musharaka Units at their applicable Buyout Prices subject to the provisions of this Agreement.
 - 4.3. The Client shall serve upon the Institution a prior written notice of his intention to purchase all or any of the remaining Musharaka Units.
 - 4.4. In case the Client acquires all the remaining Musharaka Units by payment of the aggregate amount of applicable Buyout Prices, this Agreement shall stand terminated subject to the fulfilment of all the obligations and outstanding dues of the Client.
 5. In case of default by the Client on fulfilling any of his obligations under this Agreement, the Institution may terminate this Agreement by serving a notice on the Client. In such a situation, the Client undertakes to purchase all the outstanding Musharaka Units according to the following:
 - 5.1. Upon a notice of termination being issued by the Institution under Clause 5, the Client hereby agrees and undertakes to purchase the remaining Musharaka Units from the Institution immediately.
 - 5.2. The remaining Musharaka Units shall be purchased by the Client at the Outstanding Buyout Prices (Applicable only Upon Termination) as set out in Appendix-4.
 6. As security for all obligations of the Client and payment of the rentals in accordance with this Agreement, the Client shall, at the time of execution of this Agreement, create/execute the following for the Institution:
 - 6.1. A Demand Promissory note in favour of the Institution for the amount and term of the Institution’s Musharaka Investment.

- 6.2. Such other securities and such further documents to secure the Client's obligations as the Institution may require the Client to furnish from time to time.
7. Until such time that the Client completes the purchase of all the Musharaka Units of the Institution, the Client will continue to rent the Institution's share in the Musharaka Assets(s).
8. The Payment Agreement shall form an integral part of this Agreement.
9. In the event of default under Clause-5, the Institution may, at its discretion, proceed to enforce the security interest on account of the Musharaka Asset(s) for the recovery of the amounts due to the Institution.
10. The Client covenants and undertakes the following to the Institution as long as it remains obliged under the Agreement:
 - 10.1. The Client shall inform the Institution of any Event of Default or any event, which with the giving of notice or lapse of time or both, would constitute an Event of Default forthwith upon becoming aware thereof.
 - 10.2. The Client shall comprehensively cover the Musharaka Asset with an insurance company offering protection, preferably under the Takaful system. In case Takaful is not available, the Musharaka Asset(s) shall be comprehensively insured in the manner and with an insurance company to the satisfaction of the Institution. However, the contribution/premium of the insurance cover shall be paid by the Institution and Client in proportion to their respective shares in the Musharaka Asset over the term of the Agreement.
11. Dispute resolution shall be under the laws of (Country name), with Sharia-related matters being considered in line with AAOIFI standards.
12. Force Majeure: Any delays or failure by the Client in the performance hereunder, and to the extent it is caused by occurrences or circumstances beyond the Client's reasonable control, including but not limited to, acts of God, fire, strikes or other labour disturbances, riots, civil commotion, war (declared or not), sabotage or any other causes similar to those herein specified that cannot be controlled by the Client shall be considered Force Majeure. The Client affected by such events shall promptly inform the Institution of the occurrence of such events and shall furnish proof of details of the occurrence and reasons for its non-performance of whole or part of this Agreement. The parties shall by consultation between them decide whether to terminate this Agreement, discharge part of the obligations of the affected Party or extend its obligations on a best-effort basis.
13. The above represents the entire understanding of the parties on the subject and may only be modified/ amended in writing by authorized representatives of both the parties.

SCHEDULE

Description of the Musharaka Asset(s)

In Witness Whereof the Client and the Institution have executed this Agreement on the day, month and year hereinabove mentioned.

For and on behalf of

For and on behalf of

_____ [insert name of the Institution]

_____ [Insert name(s) of Client]

Witnesses:

Appendix 1 - Payment agreement

Monthly/quarterly/semi-annual (delete as appropriate) Payment Agreement (Rent and Musharaka Units)

(To be executed at the time when the Asset is operative)

This Payment Agreement is made on this _____ day of _____ between _____, a _____ company incorporated under the laws of the (local country), having its registered office at _____, through its _____ (hereinafter referred to as the "Institution" which expression shall, where the context so permits, mean and include its successors-in-interest and assigns), of the one part;

and

_____, a sole proprietorship/company/corporation registered under the laws of (Country name) and having its place of business/ registered office at (hereinafter referred to as the "Client", which expression shall, where the context so permits, mean and include its legal heirs, successors-in-interest and assigns), of the second part.

Whereas, the Parties have agreed that the Client shall occupy/utilize the Musharaka Assets to the extent of the Institution's share; until such time that the client purchases all the Musharaka units of the Institution, the Client shall pay rent to Institution for the use of latter's ownership share in the Asset. The total payment made by Client shall be in accordance with schedule below and consist of rent plus purchase price of Musharaka units as per the terms and conditions of the Musharaka Agreement dated _____.

Due Date	Rent (\$) for the Leased Musharaka Unit (s)	Price of Musharaka Unit (\$)	Total Payment (\$)

In witness whereof, the parties to this Payment Agreement have caused this agreement to be duly executed on the place, date and year first aforementioned.

For and on behalf of

For and on behalf of

_____ [insert name of the Institution]

_____ [Insert name(s) of Client]

Appendix 2 - Undertaking to purchase Musharaka units

(To be executed at the time when asset is operative)

Date: _____

To: _____ [Insert name and address of the Institution]

Dear Sirs,

I/We refer to the Musharaka Agreement dated _____ and the Payment Agreement dated _____ between the Institution and myself/ourselves.

NOW, THEREFORE, THIS LETTER WITNESSES AS FOLLOWS:

1. I/we hereby irrevocably undertake that I/we shall purchase at least one Musharaka unit every month/ quarter/6 months (*delete as appropriate*) for \$_____ per unit from the Institution towards purchasing the total number of units owned by the Institution in the Musharaka Asset. Additionally, I/we will duly pay the Institution all amounts of rental as long as I/we am/are in occupation of the Musharaka Asset pursuant to the Agreement.
2. Any failure on my/our part to purchase the Musharaka Units at the above mentioned price and/ or to pay the outstanding amounts shall entitle the Institution, at its discretion, to serve a _____ days' notice for rectification of the situation and thereafter to proceed to enforce the security interest in the Musharaka Asset for recovery of the amounts due to the Institution under the Agreement and the Payment Agreement, including the remaining Musharaka Units and accrued and unpaid payments, if applicable, plus any costs, taxes and other dues payable and applicable to the Musharaka Asset.

Yours faithfully,

For and on behalf of

_____ [Insert name(s) of Client(s)]

Appendix 3 - Value of Musharaka unit and schedule of buyout prices

Musharaka Units of the Share of Institution

Number of Musharaka Units:

Value of each Musharaka Unit:

Buyout Price

Buyout Price	Buyout Payment Date

For and on behalf of

For and on behalf of

_____ [insert name of the Institution]

_____ [Insert name(s) of Client]

Appendix 4 - Schedule of outstanding buyout prices

Applicable only upon termination pursuant to Clause 5

Buyout Price	Buyout Payment Date

For and on behalf of

For and on behalf of

_____ [insert name of the Institution]

_____ [Insert name(s) of Client]

FINANCIAL INSTITUTION PARTNERS REFERENCE:

IRADA Credit Policy (2016)

Zitouna Tamkeen Manual of Procedures

Akhwat Manual of Procedures

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