

Value Proposition of Shari'ah Contracts Relating to Islamic Capital Market Products

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Industry**

By

Dr Bashir Aliyu Umar

Deputy Chairman, CBN Financial Regulation Advisory Council of Experts

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Value Proposition of Islamic Finance

- Derived from the Higher Objectives and Intents of the Shari'ah (Maqasid al Shari'ah)
- The Higher Objectives and Intents of the Shari'ah are:
 - General
 - Specific

Maqasid Al Shari'ah

- *Maqāsid al Sharī'ah* are the existential and real aims of the Sharī'ah. They are the objectives and wisdoms that are regarded by the Lawgiver as fulfilling the aim of the Shariah in general or particular terms, and will lead to achieving the overall interests of Muslims (Al Yubi).
- Ibn Taymiyyah: The fundamental objective of the Sharī'ah is bringing about benefit and maximising it, and eradicating harm and minimising it.
- Benefit and Harm are regarded on three levels which are the levels of the Maqasid:

Levels of the Maqasid

Dharúrí (Absolutely Necessary)

- Protection of the Religion
- Protection of Life
- Protection of Intellect
- Protection of Progeny
- Protection of Wealth

Hájí (Needs)

- Alleviation of Hardship
- Relief of Distress

Tahsíní (Embellishment)

- Overall improvement of the Shari'ah and of those who adopt it.

Specific Intents of the Shari'ah Relating to Wealth

- Wealth Generation
 - Enterprise is encouraged (al Jumu'ah; al Muzzammil)
 - Funds need to be mobilised (Umar on trading with the wealth of orphans)
 - Assets not to be left idle (Muzara'ah)
- Wealth Protection
 - Criminalising transgression against the wealth of others (Hadith of Abu Bakra)
 - Prohibiting squandering the wealth of others unjustly – prohibition of Riba, Gharar, cheating, unethical practices etc.
- Judicious Utilisation of Wealth
- Wealth Redistribution

Specific Intents of the Shari'ah Relating to Wealth

- Judicious Utilisation of Wealth
 - Regarding wealth as a trust
 - Right of the community in private wealth
 - Avoiding extravagance
 - Avoiding utilisation of wealth to bring mischief and disorder for the community and for the environment
- Wealth Redistribution
 - Lifting people out of poverty
 - Tools of Islamic social finance.

Classification of Contracts in Islamic Finance



Classification of Contracts in Islamic Finance (cont'd): Exchange-Based Contracts

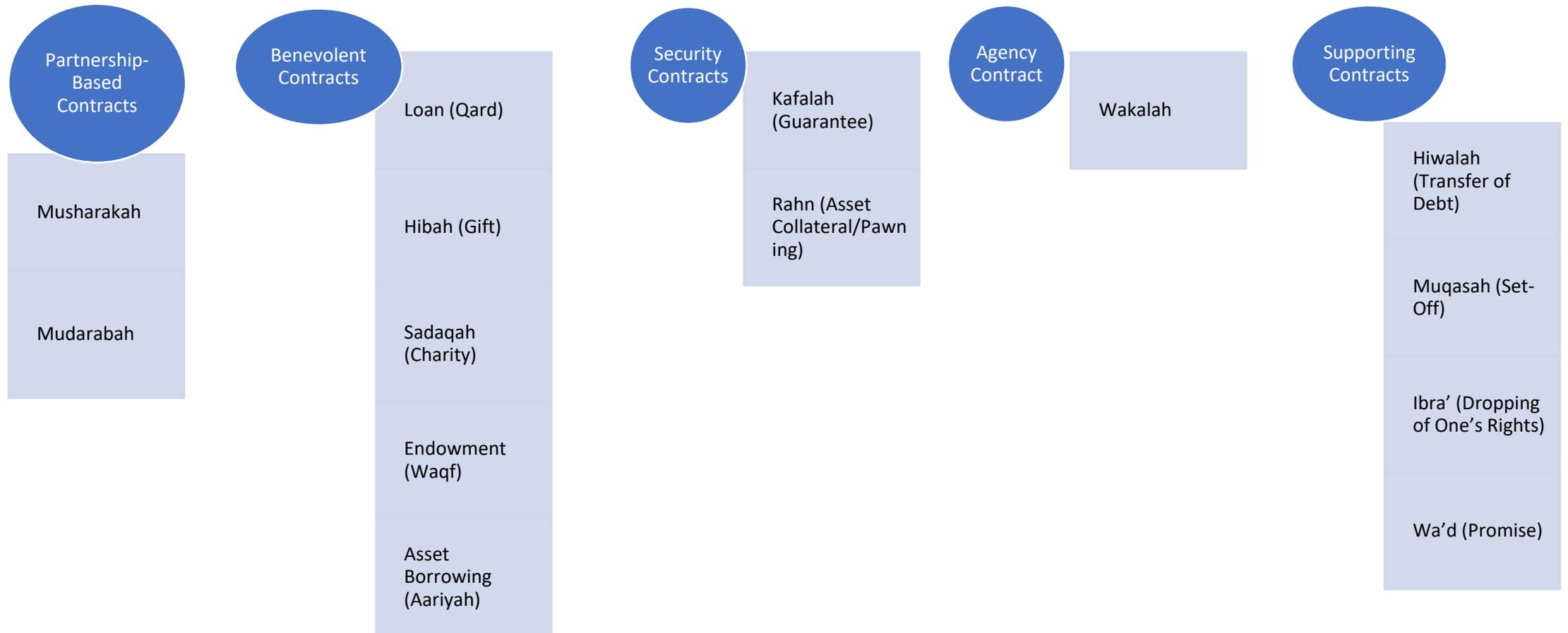
Sale Contract

- Murabahah (mark-up sale) – ordinary and to the purchase orderer (MPO)
- Salam (Deferred delivery sale)– ordinary and parallel
- Istisna (manufacturing sale) – ordinary and parallel
- Sarf – Sale of gold, silver and currencies
- Bay Aajil – Deferred payment sale
- Tawarruq – Cash Procurement

Lease Contract

- Ijarah – operating, financial and fil dhimmah

Classification of Contracts in Islamic Finance (cont'd)



Murabahah

Meaning: Sale of commodity or asset at its cost price with the addition of a mark-up as profit, where both the cost price and the profit are known to both the seller and the buyer.

Translated as Mark-up sale or Cost plus Mark-up sale.

It is a trust-sale – thus the necessity for disclosure.

Value Proposition of Murabahah

- Positive impact on the real economy through:
 - Facilitation of asset acquisition
 - Facilitation of trade financing – promoting cross-border trade and flow of funds
 - Basis for structuring Sukuk, an innovative asset class using real assets as underlying asset.
 - Basis for structuring financial assets using *Tawarruq*
 - Malaysian GII Certificates
 - ICD *Murabahah Sukuk*
 - Creation of financial assets as components of an asset pool that satisfies conditions for tradability like in IILM Sukuk – a ratio of 51% non-financial and 49% financial assets.
 - Source of financing for Shari'ah compliant individuals and institutions of the society

Salam and Its Value Proposition

- Pre-Paid Forward Sale
- Elements: Contract, Parties (*Muslim* or *Rabb al Salam* (Buyer), *Muslim Ilaih* (Seller); Subject Matter (*Salam* Capital, Object of Sale in *Salam – Muslim Fih*)
- Form of Contract: *Salam*, *Salaf*, Sale or any term indicating sale of a prescribed commodity for deferred delivery in exchange for immediate payment of price.

Salam and Its Value Proposition

- Promotion of financial inclusion
- Agriculture Financing and access to finance by rural communities
- *Salam* Bonds (Sukuk) – Salam-Based Securitisation

Sukuk al Salam: Permissible with the Salam Commodity as the underlying asset and the Sukuk proceeds from the certificates are the Salam Capital.

The Sukuk cannot be tradable bonds because they represent a debt.

Examples are the Central Bank of Bahrain Salam Sukuk and Central Bank of the Gambia Sukuk al Salam

Salam Sukuk as MM instruments, with Strategic Grains Reserve as underlying asset?

Istisna' and Its Value Proposition

- *Istisna'*: Contract of sale of specified items to be manufactured or constructed with an obligation on the part of the manufacturer or contractor to deliver them to the customer upon completion
- Applications
 - Real Estate Project Financing
 - Financing of Government Projects
 - *Istisna'* Sukuk
- Value Proposition
 - Closing housing deficit
 - Infrastructure financing
 - Creation of new asset classes – iREITs.

Ijarah and Its Value Proposition

- **Ijarah of Usufruct (*Ijaratul 'Ain*)**

- A sale of the usufruct of an asset or property. The asset or property leased belongs to the Lessor. The Lessor has the right to repossess the property when the Lessee defaults.

- **Service Ijarah (*Ijaratul Manfa'a*)**

- Hiring of the services of a person

- **Forward Ijarah**

- Contract of lease of the usufruct of an asset not yet identified but undertaken to be provided by the lessor according to agreed specifications.
- Example is the FGN Sukuk (I, II and III)

Ijarah and Its Value Proposition

- Application of *Ijarah*
 - Asset and equipment financing
 - *Sukuk Ijarah*
- Value Proposition of *Ijarah*
 - Infrastructure financing and closing infrastructure deficit especially in developing and emerging economies
 - New asset class
 - Strengthening the real economy

Partnership-Based Contracts and their Value Proposition

- *Mushárah*
- *Mudárah*
- *Musáqah*
- *Muzárah*
- *Mughárasah*

Application of Musharaka

- Musharaka on the Asset Side
- Trade finance
- Project finance
- Import/Export Finance
- Running Business and working capital finance
- Securitisation on Musharaka Basis
- Musharaka is used by Islamic Mutual Funds, Private Equity and Venture capital entities

Mudaraba and Its Value Proposition

- A form of Musharaka (Partnership)
- One of the partners is an entrepreneur and the other(s) are contributors of capital.
- No right for the capital contributor to participate in management except with mutual consent
- It is a non-binding contract unless
 - the entrepreneur starts executing the venture, or
 - It is restricted to a time period, then it becomes a binding contract
- Profit in the venture is shared between the managing partner (mudarib) and the capital contributors on a pre-agreed profit sharing ratio.
- Loss is borne by the capital owners and the mudarib suffers for his work
- Negligence, breach or misconduct of the mudarib if proven makes him liable for the loss.
- There is no guarantee of capital or profit in Mudaraba

Applications of Mudaraba

- Mudarabah Sukuk
- Islamic funds
- Takaful Management and investment
- Basis for managing pension funds

Value Proposition of Partnership-Based Contracts

- Unlocking the values of idle assets
- Providing job opportunities to entrepreneurs with no access to finance
- Facilitates the creation and growth of start-ups.
- Diversification of risks through new asset classes

Supporting Contracts - *Wakalah*

- **Definition** :A contract of appointment of an agent where a person appoints another as his agent to act on his behalf.
- Applications
 - Widely used as supporting contract for Wakalah Sukuk, e.g. Government of Malaysia *Wakálah Global Sukúk* (2011).

Conclusion

- Islamic financial contracts achieve the higher intents and objectives of the Shari'ah regarding wealth and property
- The value proposition of the contracts are the underlying factors for the phenomenal growth of global Islamic finance assets and the resilience of the global Islamic financial services industry
- The Securities and Exchange Commission did the right thing in integrating Islamic Capital Market in its Capital Market Master Plan
- The Pension industry starts to benefit from a lot from the value proposition of Islamic financial contracts.