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**Question#1: How can Salam be applied to modern banking system in Pakistan? Give practical examples.**

**Answer: Salam - Mode of Financing**

It is evident from the foregoing discussion that Salam was allowed by Sharia to fulfil the needs of farmers and traders. Therefore, it is basically a mode of financing for small farmers and traders. This mode of financing can be used by the modern banks and financial institutions, especially to finance the agricultural sector. As pointed out earlier, the price in Salam may be fixed at a lower rate than the price of those commodities delivered at spot. In this way, the difference between the two prices may be a valid profit for the banks or financial institutions. In order to ensure that the seller shall deliver the commodity on the agreed date, they can also ask him to furnish a security, which may be in the form of a guarantee or in the form of mortgage or hypothecation.11 In the case of default in delivery, the guarantor may be asked to deliver the same commodity, and if there is a mortgage, the buyer / the financier can sell the mortgaged property and the sale proceeds can be used either to realize the required commodity by purchasing it from the market, or to recover the price advanced by him.

The only problem in Salam which may agitate the modern banks and financial institutions is that they will receive certain commodities from their clients, and will not receive money. Being conversant with dealing in money only, it seems to be cumbersome for them to receive different commodities from different clients and to sell them in the market. They cannot sell those commodities before they are actually delivered to them, because it is prohibited in Sharia. But whenever we talk about the Islamic modes of financing, one basic point should never be ignored. The point is that the concept of the financial institutions dealing in money only is foreign to Islamic Sharia. If these institutions want to earn a halal profit, they shall have to deal in commodities in one way or the other, because no profit is allowed in Sharia on advancing loans only. Therefore, the establishment of an Islamic economy requires a basic change in the approach and in the outlook of the financial institutions. They shall have to establish a special cell for dealing in commodities. If such a special cell is established, it should not be difficult to purchase commodities through Salam and to sell them in the spot markets.

However, there are two other ways of benefiting from the contract of Salam.

Firstly, after purchasing a commodity by way of Salam, the financial institutions may sell it through a parallel contract of Salam for the same date of delivery. The period of Salam in the second (parallel) transaction being shorter, the price may be a little higher than the price of the first transaction, and the difference between the two prices shall be the profit earned by the institution. The shorter the period of Salam, the higher the price, and the greater the profit. In this way the institutions may manage their short term financing portfolios.

Secondly, if a parallel contract of Salam is not feasible for one reason or another, they can obtain a promise to purchase from a third party. This promise should be unilateral from the expected buyer. Being merely a promise, and not the actual sale, their buyers will not have to pay the price in advance. Therefore, a higher price may be fixed and as soon as the commodity is received by the institution, it will be sold to the third party at a pre-agreed price, according to the terms of the promise.

# A third option is sometimes proposed that, at the date of delivery, the commodity is sold back to the seller at a higher price. But this suggestion is not in line with the dictates of Sharia. It is never permitted by the Sharia that the purchased commodity is sold back to the seller before the buyer takes its delivery, and if it is done at a higher price it will be tantamount to riba which is totally prohibited. Even if it is sold back to the seller after taking delivery from him, it cannot be pre-arranged at the time of original sale. Therefore, this proposal is not acceptable at all. **Parallel Salam - Explained**

Since the modern Islamic Banks and Financial Institutions are using the instrument of parallel Salam, some rules for the validity of this arrangement are necessary to observe:

1. In an arrangement of parallel Salam, the bank enters into two different contracts. In one of them, the bank is the buyer and in the second one the bank is the seller. Each one of these contracts must be independent of the other. They cannot be tied up in a manner that the rights and obligations of one contract are dependent on the rights and obligations of the parallel contract. Each contract should have its own force and its performance should not be contingent on the other.

For example, if A has purchased from B 1000 bags of wheat by way of Salam to be delivered on 31 December, a can contract a parallel Salam with C to deliver to him 1000 bags of wheat on 31 December. But while contracting parallel Salam with C, the delivery of wheat to C cannot be conditioned with taking delivery from B. Therefore, even if B did not deliver wheat on 31 December, A is duty bound to deliver 1000 bags of wheat to C. He can seek whatever recourse he has against B, but he cannot rid himself from his liability to deliver wheat to C.

Similarly, if B has delivered defective goods which do not conform with the agreed specifications, A is still obligated to deliver the goods to C according to the specifications agreed with him.

2. Parallel Salam is allowed with a third party only. The seller in the first contract cannot be made purchaser in the parallel contract of Salam, because it will be a buy-back contract, which is not permissible in Sharia. Even if the purchaser in the second contract is a separate legal entity, but it is fully owned by the seller in the first contract the arrangement will not be allowed, because in practical terms it will amount to ‘buy-back’ arrangement. For example, a has purchased 1000 bags of wheat by way of Salam from B, a joint stock company. B has a subsidiary C, which is a separate legal entity but is fully owned by B. A cannot contract the parallel Salam with C. However, if C is not wholly owned by B, a can contract parallel Salam with it, even if some share-holders are common between B and C.

**Question#2: How is the car financing/home financing offered by Islamic banks different from commercial banks? How do Islamic banks justify their approach?**

**Answer:** In the recent times past, Islamic Finance has gained a lot of ground within Pakistan. As an Islamic country, the majority of our population is Muslim and thus this factor has allowed financial solutions based on Islamic principles to gain a strong foothold because people think it as a modus operando of following what our religions teaches us and acting upon Allah’s commandments. [Auto Finance](https://smartchoice.pk/banking/car-finance) is one of the many other Islamic financial solutions being made available to the public by various banks in Pakistan. How Islamic auto finance works differently in contrast to conventional auto finance is majorly based upon the factor of interest. Whilst conventional financial solutions have practices that include interest, whereas Islamic finance practices do not indulge into any practices that include interest. The presiding principle in Islamic finance is that all forms of interest are forbidden. Hence Islamic finance model works on profit sharing in which the bank and the customer agree to share the risk of any investment. However Islamic auto finance basically works on Ijarah principle of Islamic financial methods that do not include profit sharing as that’s only done in Mushraka or Mod araba. Ijarah is such a financial transaction in which an asset is given to the person by the financial authority I.e. bank and is an installment based leasing agreement in which the owner ship of the asset remains with the bank until the installments are fully paid. Hence it’s a type of a hire purchase where the user reaps the benefits of the asset and ownership is transferred to the user when he has fully paid the outstanding amount of the asset. Some of the terms and conditions that apply to ijarah agreements are as follows:

1) The leased asset such as car should be transferred to the lessee upon the maturity of the agreement and the asset should be in such a condition that it’s fit for usage and working in the required tasks.

2) The amount and duration of the installments should be agreed upon in advance by both the lessor and lessee. However, the timing and amounts don’t need to be uniform.

3) The duration of lease must be specified.

4) The terms and conditions of the usage of the leased asset must be stated.

5) The lessor should have legal ownership and possession of the asset before leasing it.

6) The leased asset should continue to exist during the period of lease. Any items that can be consumed during usage cannot be leased.

7) If the installment is delayed due to any reason then the ijarah agreement may be terminated right away.

8) The lessor can claim for any damages to the leased asset caused by the negligence of the lessee.

## So in a nutshell, you have to pay a decided amount as down payment and the rest has to be paid in installments. In Ijarah, the bank and the person purchase a car together. Now suppose the Bank has paid 85% of the total value of the car. Thus you’ll have to make two types of payments to the bank: a) Since you own only 15% of the car at the time of the agreement, you have to pay the installments to acquire the 85% of the bank’s share in the car which will enable you to become the owner of the asset. b) You have to pay rent for using 85% of the bank’s investment in your car. This will decrease with time as you’ll be acquiring a bigger share in the car with time and the rent depends upon the bank’s existing share in the asset. To make it even more clear, let’s take an example. You are buying a new Suzuki WagonR VXR which costs a total of PKR 959,000 for a tenure of 5 years and your security deposit aka down payment is set at 15% which comes out to be PKR 143,850. There’s a small processing fee as well. If you’ve selected 5-year plan, then you’ll be paying PKR 20,850 as installments over the course of 60 months. After you’ve completed the installments, you may transfer the car to your own name. We hope this article clarifies how the concept of Ijarah works.

## **How do Islamic banks justify their approach?**

## **Understanding what the Qur’an is**

The name *Qur’an* derives from the word *qara’a,*which means ‘to read’. For Muslims, the Qur’an holy Scriptures are proof of the prophecy of Mohammed, the most authoritative guide for Muslims and the first source of the Sharia on which Sharia law is based.

The Qur’an contains 114 *suras* (chapters) and 6,235 *ayat*(verses) and consists of manifest revelation, which is defined as communication from God to the Prophet Mohammed.

‘So how does this relate to finance?’, you ask. Well, the Qur’an is based on Sharia law and Sharia law is what dictates the laws of Islamic finance. For example, Sharia law prohibits Muslims entering into interest-bearing loans.

**Establishing the meaning of Murabaha**

The term *murabaha*refers to a form of trade credit or loan in which the Islamic bank takes constructive or physical ownership of the asset. The asset is then subsequently sold on to a buyer for a profit and that person is allowed to pay the bank over a set number of payments.

**Running through the term Riba**

The word *riba*in Islamic law means an addition over and above principal. So riba is the addition in the amount of the principal amount of a loan according to the time for which it’s loaned and the amount of the loan. In other words, it’s the equivalent of interest, but financial systems based on Sharia law strive to eliminate the payment and receipt of interest in all forms.

**Running the risk with risk**

When a Western bank or finance house invests in a project, the investor (the bank or finance house) is assured of a predetermined rate of interest and the investee bears all risk. The investor receives a predetermined return regardless of whether the project succeeds or fails.

This situation doesn’t apply in Islamic banking, which promotes risk-sharing between an investor and an investee: the unjust distribution of risk that occurs in Western banking is prohibited. In Islamic banking, the investor and the investee share the results of the project in an equitable way. Where a project makes a profit, both parties share in this profit in predetermined proportions. On the flip side, if a project makes a loss, the investor bears the loss by way of no repayments, with the investee bearing the loss by receiving no wage or salary.

**Looking at leasing issues**

In the West, companies often lease assets to use in their business. The leasing agreement usually makes provisions for the lessee (the company leasing the equipment) to pay the lessor (the owner of the equipment) periodic payments, which contain the capital element and the interest element. Islamic finance prohibits interest-bearing finance and has its own the equivalent of lease finance.

During the period of the lease the leasing company still owns the asset but the lessee has the right to use it. When the leasing agreement expires, the right to use the asset goes back to the lessor.