# Frequently Asked Questions – Corporate Finance

## Question

Can you give an example of how Salam can be used in Agriculture?

Salam is used in financing goods and services that are not ready for spot sale and will have to be delivered later. Islamic principles for sale do not allow selling a commodity whose possession is not with the seller at the time of sale, but Salam is an exception this rule along with another sale contract which is known as 'Istisna'.

In Salam, payment is in full at spot, but the delivery is deferred. It is used in special cases to facilitate transactions. In current practice, it is used in agriculture financing.

For example, if a farmer needs to grow a crop and needs financing to buy seeds and fertilizer, he can be facilitated by an Islamic bank using the contract of Salam. The bank will buy the crop in specified quantity with specified quality and standards from the farmer. The bank will pay the price at spot for the purchased crop. However, in Salam contract, the farmer (seller of the crop in this case) has the chance to provide the subject matter of sale (crop) at a specified future date.

Islamic bank will then resale the crop to another farmer at a higher price by entering into another Salam contract. Since, it is a Salam contract; hence, the Islamic bank will deliver the subject matter (crop) at a specified future date, but will receive the payment at spot.

On the maturity dates, the sellers in Salam contract, farmer in first Salam and bank in second parallel Salam will deliver the subject matter (crop) to the buyer. It is to be noted that Islamic bank usually supplies the same crop to the farmer in parallel Salam which it received from the farmer who obtained finance from it originally. But, in case, the maturity dates do not match or the same crop cannot be supplied to the buyer in Parallel Salam by the Islamic bank, then, the Islamic bank will still have to supply the subject matter as specified in the contract on the delivery date by purchasing new crop in the specified form from the market. Hence, it is important that the subject matter of sale in a Salam transaction should exist in the market right from the date of Salam sale to the delivery date.

Question

Can you give an example of how Salam can be used in Trade Finance?

Salam is used in financing goods and services that are not ready for spot sale and will have to be delivered later. Islamic principles for sale do not allow selling a commodity whose possession is not with the seller at the time of sale, but Salam is an exception this rule along with another sale contract which is known as 'Istisna'.

In Salam, payment is in full at spot, but the delivery is deferred. It is used in special cases to facilitate transactions. In current practice, it can also be used in trade finance.

E.g. If someone wants to discount $1,000 and spot rate for a USD is Rs 85. Instead of discounting the bill and paying $950 to the customer and pocketing $50 interest in lieu of waiting to receive $1,000 when the bill matures in let's say 3 months, the Islamic bank buys USD at Rs 80 from the customer and pays the customer at spot in full (which is a requirement of a Salam transaction) the amount in PKR i.e. PKR 80,000. When the bill matures in 3 months, the Islamic bank has USD 1,000 which may worth PKR 85,000 if spot rate remained stable or if PKR depreciates in value against USD, the gain to Islamic bank increases hence forth.

Question

How can raw material purchase be financed using Murabaha?

Murabaha is a sale transaction. Technically, Murabaha Muajjal it is a deferred payment sale. The following example shows how it works in Islamic Banking for the purchase of raw materials:

Islamic bank and the client sign a Master Murabaha Finance Agreement and an agency agreement. The customer undertakes to purchase the raw material from the bank. It is a one-sided promise and undertaking. According to the agency agreement, the customer purchases raw material from the supplier on bank's behalf. The bank pays the supplier and obtains title and physical/constructive possession of the raw materials. The customer signs a declaration that he has purchased the raw materials on bank's behalf and now he is willing to purchase the raw material. After offer and acceptance, sale is executed and the customer pays the agreed price to the bank.

Question

How can a heavy industrial equipment purchase be financed using Diminishing Musharakah?

In Diminishing Musharakah, the customer approaches the bank for joint purchase of heavy industrial equipment. The seller of the property is paid by the bank and the bank and the customer enter into a Musharakah Agreement.

It is referred to as 'Diminishing Musharakah' because of the arrangement, the ownership stake of the tenant increases and that of the bank decreases or diminishes with the passage of time. The rent decreases as the ownership stake of tenant increases.

The share of the bank in heavy industrial equipment is divided into units. These units are purchased by the customer periodically until he has purchased all units and becomes the sole owner of the heavy industrial equipment. The risk of damage to the heavy industrial equipment is borne by the bank and the customer, according to the stake in the heavy industrial equipment at the time of disaster.

Question

How can a movable or immovable property be financed using Ijarah?

Ijarah means to give something on rent. In Ijarah, right of use of a property is transferred to another person for a consideration. The lease period starts when the asset has been delivered by the lessee in a usable condition. The bank (Lessor) bears the ownership related costs and the customer (Lessee) bears the usage related costs. If the asset is destroyed or becomes unusable, the bank stops taking rent and does not charge rent for that period. The asset/property remains in the ownership of the bank until the bank sells the asset to the customer via a separate agreement.

The process flow is as follows:

The customer approaches the bank for obtaining an asset on lease. The customer undertakes to make periodic lease payments for the lease period. Bank receives the title of the asset and pays the vendor. Lease agreement is signed whereby the bank leases the asset and the customer starts using the asset and pays rent for each period. In the end, the customer can purchase the asset from the bank by way of a separate purchase agreement.