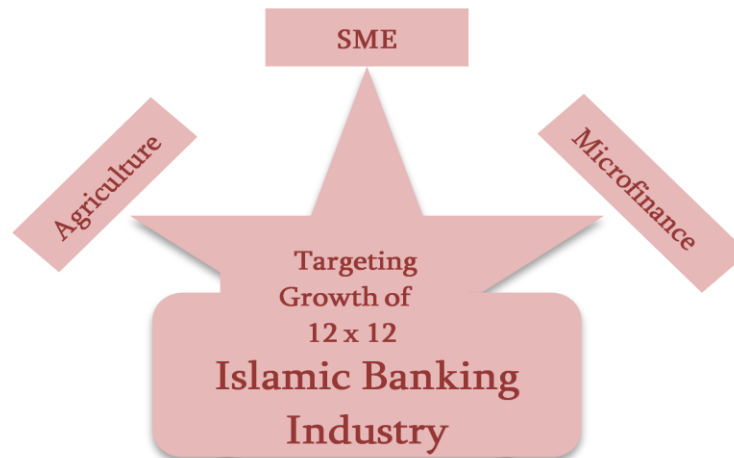


Handbook on Islamic SME Financing



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BACKGROUND

One of the important characteristics of a flourishing and growing economy is a blooming SMEs sector. Small and medium enterprises play an important role in the development of a country. SMEs contribute to economic growth in various ways like as by creating employment for rural and urban growing labor force, providing desirable sustainability and innovation in the economy as a whole. Further, a large number of people rely on this sector directly or indirectly. Most of the current larger enterprises have their origin in small and medium enterprises.

The SME sector itself can be classified into micro enterprises, small enterprises and medium enterprises. These are the starting point of development in the economies towards industrialization. However, SMEs have their significant effect on the income distribution, tax revenue, and employment, efficient utilization of resources and stability of family income.

SMEs play significant contribution in the transition of agriculture-based economies to industrial ones furnishing plain opportunities for processing activities which can generate sustainable source of revenue and enhance the development process. SMEs shore up the expansion of systemic productive capability. They help to absorb productive resources at all levels of the economy and add to the formation of flexible economic systems in which small and large firms are interlinked. Such linkages are very crucial for the attraction of foreign investment. Investing transnational corporations look for sound domestic suppliers for their supply chains.

Globally, this sector is the major growing force behind the fastest growing economy of China, in terms of contribution to the national GDP, scale of assets, diversification of products, and the creation of employment. Similarly, the role of SMEs is well acknowledged in other countries such as Japan, Korea, and all other industrialized economies in terms of economic development.

There are also some hidden and apparent obstacles in the path of growth of small and medium enterprises in Pakistan. The most important are; political instability, law and order situation, financial constraints, energy crisis, taxation problems, labor issues, lack of coordination and regular information exchange mechanism among institutions, etc.

INTRODUCTION- SMEs IN PAKISTAN

Defining SME as per Prudential Regulations

In Pakistan, definition of SME varies from institution to institution. As per Prudential regulations, SME is an entity which fulfills all the following characteristics.

	Trading	Manufacturing	Services
No. of Employees up to	50	250	250
Total Assets at cost up to	Rs.50 M	Rs.100 M	Rs. 50 M
Total Sales Turnover up to	Rs.300 M	Rs.300 M	Rs. 300 M

A Composition of Financing to SMEs:

The banking industry's exposure¹ towards SME sector is the second largest after corporate finance. At the end of fourth quarter of 2008, the SME sector's outstanding credit stood at Rs. 383 Billion. About 48% of this amount has been availed by the Manufacturing SMEs, followed by 36.4% amount by the Trading SMEs and the rest by the Services SMEs. The share of short term loans (upto one year) constitutes about 70.9% and long term loans (exceeding 3 years) were about 19 % and the rest was the share of Medium term Loans (1-3 years).

The major reasons for this haphazard distribution remain following factors:

- SMEs lack of capital for inventory and day to day operations
- Lack of objectively defined plans amongst most of the SMEs for the future expansion of capacity.

The number of borrowers has shown promising momentum in past few years. At the end of December 2007, SME borrowers stood at 185,039, while at end of March 2006 the number of borrowers remained at 161,008. Though the increase in the number of borrowers may not be highly impressive; however, it is still satisfactory keeping in view the overall SME financing scenario in Pakistan. Almost 14.93% growth in the number of borrowers was recorded from the period from March 2006 to December 2007.

¹ Developmental Finance-quarterly Review-December 2008

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As per SBP review of SMEs-2008, the total NPLs of the SME sector as on 31.12.07 stand at Rs.41.3 billion which constitutes 9.5% of total outstanding SME Finance at the end of Dec, 2007. Whereas SME NPLs constitute 20.5% share in total NPLs of Rs.201.3 billion of banking industry at the end of Dec, 2007 (*Courtesy SBP Review on SMEs 2008*). A close look at the SME sector NPLs behavior reveals that they are in the range of Rs.35 billion to Rs.41 billion for the period March 2006 to December 2008. As can be easily witnessed the percentage change in same period remains at almost zero. This clearly indicates that over the years the absolute amount of SME finance has increased but NPLs have remained at the same level ranging between 20-26% of the NPLs of the industry.

SME Financing Portfolio		
S.N	Group of Banks	Amount outstanding (Million rupees)
Loans to Small & Medium Enterprises (As of November 30, 2008)		
1	Public Sector Banks	391,79
2	Private Sector Banks	311,644
3	Specialized Banks	9,411
4	Foreign Banks	2,816
Total of Banks		363,050
5	DFIs	503
Grand Total		363,554

PRUDENTIAL REGULATIONS FOR SME FINANCING

Following are the Prudential Regulations² developed by SBP for Conventional SME Financing. The same will also be applicable on Islamic Financing. However, other regulations issued by SBP from time to time specifically for IBIs are also applicable in addition to these PRs.

R-1 “Source and Capacity of Repayment and Cash flow -Backed Lending”

Banks shall specifically identify the sources of repayment and assess the repayment capacity of the borrower on the basis of assets conversion cycle and expected future cash flows. The banks should be able to identify the key drivers of their borrowers’ businesses, the key risks to their businesses and their risk mitigants. The rationale and parameters used to project the future cash flows shall be documented and annexed with the cash flow analysis undertaken by the bank. It is recognized that a large number of SMEs will not be able to prepare future cash flows due to lack of sophistication and financial expertise. It is expected that in such cases banks shall assist the borrowers in obtaining the required information and no SME shall be declined access to credit merely on this ground.

R-2 “Personal Guarantees”

All facilities, except those secured against liquid assets, extended to SMEs shall be backed by the personal guarantees of the owners of the SMEs. In case of limited companies, guarantees of all directors other than nominee directors shall be obtained.

R-3 “Limit on Clean Facilities”

In order to encourage cash flow based lending, banks are allowed to take clean exposure, i.e., facilities secured solely against personal guarantees, on a SME up to Rs 3 million provided that funded exposure should not exceed Rs 2 million. Before taking clean exposure, banks shall obtain a declaration from the SME that it has not availed clean facilities from any other bank to ensure that the accumulated clean exposure of banks a SME does not exceed the prescribed limit mentioned above. It may be noted that the clean exposure above to an SME entity, will not include the clean consumer financing limits (Credit Card and Personal Loans etc.) allowed to the sponsors of the said SME under Prudential Regulations for Consumer Financing.

² A complete set of Prudential Regulations for SME is available on SBP’s website at: www.sbp.org.pk . However, all other instruction issued by SBP from time to time would also be applicable.

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R-4 “Securities”

Subject to the relaxation in Regulation R-3, for facilities upto Rs 3 million, all facilities over and above this limit shall be appropriately secured as per satisfaction of the banks.

R-5 “Margin Requirement”

1. Banks are free to determine the margin requirements on facilities provided by them to their clients taking into account the risk profile of the clients in order to secure their interests. However, this relaxation shall not apply in case of items, import of which is banned by the Government.
2. Banks will continue to observe margin restrictions on shares / TFCs as per existing instructions under Prudential Regulations for Corporate/ Commercial Banking (R-6). However, It has been decided to withdraw cash margin restriction for opening of import letters of credit with immediate effect as per BPRD Circular No. 12 of 2009 dated June 12, 2009.
3. State Bank of Pakistan shall continue to exercise its powers for fixation / reinstatement of margin requirements on financing facilities being provided by banks/DFIs for various purposes including Import Letter of Credit on a particular item(s), as and when required.
4. In addition to above, the restrictions prescribed under paragraph 1.A of Regulation R-6 of the Prudential Regulations for Corporate / Commercial Banking will also be applicable in case of SMEs Financing.

R-6 “Per Party Exposure Limit”

The maximum exposure of a bank on a single SME shall not exceed Rs 75 million. The total facilities (including leased assets) availed by a single SME from the financial institutions should not exceed Rs 150 million provided that the facilities excluding leased assets shall not exceed Rs 100 million. It is expected that SMEs approaching this limit should have achieved certain sophistication as they migrate into larger firms and should be able to meet the requirements of Prudential Regulations for Corporate / Commercial Banking.

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R-7 “Aggregate Exposure of a Bank on SME Sector”

The aggregate exposure of a bank / DFI on SME sector shall not exceed the limits as specified below:

%age of classified SME Financing to Total Portfolio of SME Financing	Maximum Limit
Below 5%	No limit
Below 10%	3 times of the equity
Below 15%	2 times of the equity
Upto and above 15%	Upto the equity

R-8 “Minimum Conditions for taking Exposure”

- CIB report for exposure exceeding Rs. 0.5M
- Defaulters may be extended financing subject to recording of reasons and justifications for taking exposure on them
- Financial Accounts where exposure exceeds Rs. 10 M or SME is a limited company

R-9 “Proper Utilization of Financing”

The banks should ensure that the financing have been properly utilized by the SMEs and for the same purposes for which they were acquired. The banks should develop and implement an appropriate system for monitoring the utilization of such financing.

R-10 “Restriction on Facilities to Related Parties”

The bank shall not take any exposure on a SME in which any of its director, major shareholder holding 5% or more of the share capital of the bank, its Chief Executive or an employee or any family member of these persons is interested.

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R-11 “Classification and Provisioning for Assets

Subjective and objective classification of loans has to be done. Time Based Criteria for Classification of Short & Long term facilities.

Category	Overdue period	*Provision
S/S	90 Days	25%
D/F	180 Days	50%
Loss	One year	100%
*Trade Bills to be classified loss after 180 days. Outstanding amount less liquid assets realizable without recourse to a court of law and FSV.		

Restructuring of financing

- **Restructuring of bad debts**
 - Restructuring of bad debts can be done with 10% cash
 - Behavior for 1 year has to be positive to qualify for declassification
- **Restructuring of regular debts**
 - Banks can restructure loans without the above conditionalities; however, this will provide a subjective base for classification.

Banks shall classify their loans / advances portfolio and make provisions in accordance with the criteria prescribed above. Moreover, where banks wish to avail the benefit of collateral held against loans / advances, they can consider the value, determined in accordance with the guidelines (mentioned in PRs) of assets mortgaged / pledged with them, for deduction from the outstanding principal amount of loan / advance against which such assets are mortgaged / pledged, before making any provision. The value of the mortgaged / pledged assets, other than liquid assets, to be considered for this purpose shall be the forced sale value. Further, Forced Sale Value (FSV) once determined, shall remain valid for three years from the date of valuation during which period the underlying collateral will not be revalued for provisioning purpose. The adjustment factors of 80%, 70% and 50% shall be applied on the value so determined for the purpose of determining provisioning requirement in 1st, 2nd and 3rd year of valuation, respectively. Thereafter, the assets shall be revalued and the adjustment factor of 50% shall be applied for all subsequent years. However, the FSV of the collateral shall be restricted to fresh revaluation or previous value, whichever is less.

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Other requirements

- There is no debt-equity and current ratio for SMEs
- An SME, who is willing to fulfill the requirements laid down in Prudential Regulations for Corporate / Commercial Banking, may be allowed higher exposure limit as allowed for corporate entities.
- SBP does not require a minimum banker-customer relationship.

Verification by Auditors

The external auditors as a part of their annual audits of banks / DFIs shall verify that all requirements of Regulation R-11 for classification and provisioning for assets have been complied with. The State Bank of Pakistan shall also check the adequacy of provisioning during on-site inspection.

IMPORTANCE IN LIGHT OF STRATEGIC PLAN FOR ISLAMIC BANKING

Islamic banking and finance is making serious inroads in the present day modern financial centres. The unique dimensions of Islamic financial products and the overwhelming growth in this sector necessitate an effective planning process to chart out strategic targets and to pursue a smooth and forward-looking progress of the industry. Keeping in view the local market conditions and global trends, State Bank of Pakistan has recently issued a Strategic Plan for Islamic Banking Industry of Pakistan.

The strategy objectives stand on five pillars which are Extension of Outreach, Shariah Compliance Mechanism, Strengthening of Regulatory Framework, Capacity Building and Internal & External Relations. In terms of this Plan, Islamic banking industry in Pakistan is envisioned to have 12% share in the overall assets of banking industry by the year 2012. This will be achieved through increasing outreach in current urban consumer and corporate markets and extending the market to cover new segments of Islamic Micro Finance, Agriculture Finance and SME Finance. SBP will also play a role in development of Islamic finance industry globally and will become one of the main hubs for attracting international Islamic investments.

Being a major tool in development and progress of any economy, growth of SME sector is of vital importance. IBIs can take the lead by emphasizing decisive interest in SME sector of the economy. Government has been playing its part for the development of SME over the last decade or so. In order to tap this sector, SBP developed a strategic financial roadmap document for SME finance in Pakistan, for next five years, known as SME Finance Strategy of SBP. Primarily this strategy deliberates upon the various issues associated with SME sector which hinder the growth of finances in this sector. This strategy presents a comprehensive framework of solutions and suggestion of how to improve financing activities in SME sector through involvement of banks.

According to strategic plan for Islamic Banking Industry of Pakistan, a targeted market share of 12% is achievable through increasing the coverage of the existing banking segments and through entering into new segments of microfinance, agriculture, infrastructure and SME finance.

Entrepreneurs in SME sector are more inclined towards using Shariah-compliant products and services provided that required products are available with competitive features and pricing. Currently most of the banks offering Islamic banking products are represented in

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this sector. Product development is not an issue for this sector as majority of the transactions are Murabaha based, structure of which is approved by the respective Shariah Advisor. SBP's guidelines are primarily aimed at introducing the elements that are peculiar to Islamic banking and ensuring Shariah compliance. It is estimated that this SME sector will take a share of around 20% in the Islamic banks' financing portfolio by 2012. The expected volumes in this sector are provided in the following table:

(Rs. in Million)

SME Sector	2008	2009	2010	2011	2012
Expected Volumes	27,000	50,000	82,000	120,000	147,000
% of Islamic Banking Financing	15%	18%	20%	20%	20%
Annual Growth Rate	-	85.2%	64.0%	46.3%	22.5%

The extension in outreach will ensure that the targeted volumes are met and that such a growth rate is achieved which is comparable to the best in class jurisdictions. However this growth has to be backed with a strong Shariah compliance mechanism and a strong regulatory framework in order to make it sustainable on the long term basis.

SCOPE OF ISLAMIC BANKING OVER CONVENTIONAL BANKING IN CURRENT FINANCIAL CRISES

The most prominent benefit of preferring Islamic banking (IB) over conventional banking is the elimination of risk of misuse of banks funds. The mandatory purchase & sale of assets ensures vigor in economic activity. It also shuts the doors for the possibility of using fresh financing to pay off old stuck-up non-performing loans in which all the conventional banks are stuck due to which the NPL portfolio is always on the rise. Note that one of the major reasons for huge outstanding portfolio of NPLs at various banks remains the misuse of the facility extended. Whereas the very nature of IB products (*Murabaha, Ijara, Istisna, Salam, Wakala Istismaar, Sukuk etc.*) makes them an excellent banking tool in this era of high inflation, economic distress, political instability etc. The underlying involvement of “asset” itself in every transaction ensures that the funds lent through any IB product are utilized for the purpose for which they were sought, thereby eliminating the risk of their misuse for any other purpose. In case of any Islamic banking product, physical sale & purchase of the asset for which a facility is extended is made mandatory.

Furthermore, IB can be an ideal solution to the recent global economic slump being witnessed in the developed western part of the world, where banks have almost become bankrupt due to the crises. In fact people at the helm of affairs at Federal Reserve Bank and Bank of England have even considered it worthwhile to study the IB as an alternate solution to their economic woes. Popularity of IB products in developed western part of the world can be judged from the fact that large banks have started designing & extending IB products to the clients who insist to prefer IB over conventional banking. The Sukuk issuance by Central bank of Japan remains one of the most popular IB products in any of the developed country.

In the industrial development of a country, importance of the SME sector cannot be overemphasized. SMEs constitute nearly 90% of all the enterprises in Pakistan; employ 80% of the non-agricultural labor force; and their share in the annual GDP is 40%, approximately. However, unlike large enterprises in the formal sector, a small and medium enterprise is constrained by financial and other resources which make it imperative that there should be Shariah-compliant financial solution/ mechanism through which it may get support in different functions of business.

PROPOSED PRODUCTS FOR ISLAMIC SME FINANCING

According to Strategic plan for Islamic Banking Industry, we are committed to develop the SME sector for achieving higher growth leading to extend the outreach of the Shariah compliant products. This will be achieved by providing conducive business environment, greater access to Shariah compliant financing and marketing and innovation in this sector.

In Pakistan, following the main priority sector for SME:

- Sports Goods
- Dairy industry
- Textile Industry
- Livestock and cattle farming
- Fisheries
- Light Engineering
- Medical Equipment
- Auto Financing
- Bio gas plants
- Fishing Boats & Engines
- Furniture Industry
- Housing Sector
- Carpets
- Metal products
- Leather industry
- Edibles

All above mentioned sectors can be financed by providing Shariah-compliant alternatives. In this way, banks will be able to fulfill the demand of those customers who are looking for Islamic financial solution in term of financing.

a. Need for Risk Management³

Risk Management process involves identification, measurement, monitoring and controlling risks. Risk taking decisions must be in line with the business strategy and objectives and the expected payoffs compensate for the risks taken.

The need for risk management is an everyday business. The success or failure of every business is largely affected by the ability to manage the risks associated with it and to

^{3 3} www.sbp.org.pk/departments/ibd/Presentations/RISKMANAGEMENT-Mujeeb.Beig.ppt

minimize them as much as possible. A wide range of instruments have been designed in the conventional system of finance to address the issue. The need for risk management in Islamic finance is not an exception. However, due to its own structure and objectives, the Islamic system of finance may reject some of these tools of risk management due to their involvement in *riba*, *gharar* or excessive speculation.

Risk management serves several important functions including:

- Implementation of strategy.
- Development of competitive advantage.
- Measure of capital adequacy.
- Aid to decision making & to pricing decisions
- Reporting and control of risks and management of portfolio of transactions.

The main purpose of risk management is to ensure that all contracts documentation comply with Shariah rules and principles particularly with regard to formation, termination and elements possibly affecting contract performance such as fraud, misrepresentation, duress or any other rights and obligations. Bank shall undertake a Shariah compliance review at least annually, performed either by a separate Shariah audit department or as part of the existing internal audit function by persons having the required knowledge and expertise for the purpose.



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Following are some proposed products for SME under Islamic mode of financing⁴:

Products	Modes
Working Capital Financing	Murabaha, Salam, Istisna
SME Trade Finance <ul style="list-style-type: none"> ▪ Letter of Credit ▪ Export Credit Financing ▪ Bank Guarantee ▪ Bills of Exchange Purchased ▪ Trust Receipts 	Murabaha, Salam, Istisna Other modes ⁵ like Kafalah, Wakalah, Hawala may be uses)
Asset Acquisition and Business Expansion <ul style="list-style-type: none"> ▪ SME Auto (Transport sector-Buses, Coaches or Trolleys or Oil tankers, Fleet Car Finance) ▪ Plant Factory financing ▪ Equipment Financing(Photo copier, X-ray, digital lab) 	Ijarah, Diminishing Musharaka
<ul style="list-style-type: none"> • Development of Rural Areas Infrastructure as required by local government. This may include schools, hospitals, roads, power houses targeting rural areas. • Housing Sector Development and construction of houses, godowns and commercial buildings. 	Istisna, Diminishing Musharaka
<ul style="list-style-type: none"> • Financing the productive activities particularly agriculture, agro-based industries. • Financing for stable commodities market. 	Salam

⁴ Details of Islamic Modes of Financing are taken from IBCC presentations made by renowned resource persons.

⁵ These Islamic modes are also defined in Instructions and Guidelines on Shariah Compliance vide IBD Circular No. 02 of 2008.

MURABAHA FINANCING

Islam prohibits charging interest on money, but permits charging profit on sale of goods. Therefore, sale-based transaction is used instead of loan-based transaction for financing purchase of assets by Islamic banking cliental. Murabaha is the most common mode used by IBIs all over the world. It is a particular kind of sale where the seller discloses its cost and profit charged thereon.

The bank purchases certain goods as per client's demand and sells them to the client on a cost plus profit basis. The bank's cost includes all direct expenses incurred in acquisition of goods such as invoice price, transportation, LC charges, marine/in-transit insurance, sale tax, etc.

The payment of Murabaha price may be made

- At spot at time of sale.
- In installments.
- In lump sum (Bullet) after a certain time period.

a. Transaction Structure

This transaction is completed with a prior promise to buy, submitted by a person interested in acquiring goods through the institution. It is a contract wherein the bank, upon request by the customer, purchases an asset from the supplier/vendor and sells the same to the customer either against immediate payment or on a deferred payment basis. As the bank does not have the expertise to identify the goods and negotiate an efficient price, this is done by execution of Agency Agreement between the bank and the customer. Agency Agreement is not the condition of the Murabaha if the bank can make direct purchases from the supplier. However, according to Shariah perspective, it is preferable to appoint the Agent other than customer. A Murabaha transaction follows the following flow:

- i. Client approaches the bank for facility through Murabaha.
- ii. Client and bank sign an agreement for Murabaha Financing.
- iii. Client submits the purchase requisition to the bank.
- iv. Client appointed as agent to purchase goods on bank's behalf.
- v. Bank gives money to supplier through client's account for purchase of goods.
- vi. Client purchases as agent goods on bank's behalf and takes their possession.
- vii. Client makes an offer to purchase the goods from bank through a declaration..
- viii. Bank accepts the offer and sale is concluded.
- ix. Client pays agreed price to bank according to an agreed schedule. Usually on a deferred payment basis (Murabaha)



Points to be considered while Approving a Financing to SMEs:

It is essential that the transaction between two parties must be genuine, not fictitious. It should exclude any prior contractual relationship between the customer and original supplier. Nature of the business should be Halal and in scope of the Murabaha and covered under SME business under Prudential Regulations.

b. Securities against Murabaha Price

The institution may ask the customer to furnish a security to its satisfaction for prompt payment of the deferred price. However, it is also permissible that the customer furnishes a security at earlier stages but after the Murabaha price is determined. Further, it is preferable not to take interest-bearing instruments as securities. Bank can obtain any of the following securities from its client depending upon the kind of financing, amount of facility and credibility of the customer:

- Hypothecation Charge on assets
- Pledge of goods and/or marketable securities
- Lien on deposits
- Mortgage charge on movable and immovable properties
- Bank guarantees
- Personal guarantees

In addition to above, the Bank may obtain any other security mutually agreed between bank and client.

Rise in Prices

- If there is a rise in prices and the amount escalates for which financing is availed then the transaction can only be executed if the bank has been informed and the bank subsequently accepts the same.
- The bank reserves the right to reject the purchases if made other than agreed price.

c. Murabaha Agreements

Normally following agreements are required for Murabaha transaction.

- Master Murabaha Financing Agreement(MMFA)
- Agency Agreement
- Order form

- Murabaha Agreement (Declaration)
- Demand Promissory Note
- Payment Schedule

d. Important Characteristics for Murabaha Transaction

- It is essential for the sale transaction that the commodities must be existing, owned by the bank and must be in his physical or constructive possession. Therefore, it is necessary that the bank must have assumed the risks of ownerships before selling the commodities to the buyer/consumer.
- Murabaha can be affected on tangible goods & commodities.
- The bank must ensure that the seller is third party and not the customer himself or his agent.
- If the bank has appointed an agent, the purchase of goods by or for and on behalf of the bank and the ultimate sale of such goods to the customer shall all be independent of each other and shall be separately documented.
- Providing insurance cover while acquiring ownerships of the goods is the responsibility of Bank. However, the client may be appointed as agent for this purpose. It is permissible to build the cost of insurance into the cost of goods being sold by Murabaha.
- A proper Offer & acceptance has to take place through declaration to conclude Murabaha contract.
- The price of goods and Bank's profit on Murabaha Transaction should be fixed and known to both parties at the time of contract. The cost and profit element of the selling price must be separately identified.
- The bank reserves the right to reject the purchases if made other than agreed price.
- The payment of Murabaha subject matter should preferably be made by the financier directly to the supplier.
- The Bank's representative interacting with the client must ensure that all relevant documents are received by the Bank in order to confirm the execution of sale by the supplier.
- The buyer may be required to furnish security in the form of pledge, hypothecation, lien mortgage or any other form of encumbrance on asset.
- If the supplier is nominated by the client him/her-self, guarantee for good performance can be demanded.
- Certain amount (called Hamish Jiddiyyah) may be received from the customer in advance as a form of security deposit. In case of breach of promise Hamish Jiddiyyah can be used to recover actual damage however it cannot be used for covering the Cost of Funds / Opportunity Cost.
- In case of late payment or default by the client, he would be liable to pay amount that will go to the charity fund of the bank, as per Charity Policy approved by the .
- Murabaha transaction cannot be carried out on items of gold, silver or currencies.

- Buy-back arrangement is prohibited.
- It is not allowed to buy goods from the company wholly owned by the client.
- It is not permissible to transfer a contract that has been executed before between client and supplier. However revocation of prior contract between the supplier and the client can allow the institution to enter in Murabaha. The Bank must ensure that the party from whom the item is bought is a third party and not the *customer* or his *agent*. In this manner the transaction can be saved from *Bai Inah (Buy Back)* which is not allowed in Shariah.
- It is not permissible to extend the date of payment of Murabaha price in exchange for an additional payment in case of rescheduling.
- Once the sale transaction has been concluded, the selling price determined cannot be changed.
- A Murabaha contract shall not be rolled-over because the goods once sold by the bank become property of the client.
- The promissory note or bill of exchange or any evidence of indebtedness cannot be assigned or transferred on the price different from its face value.
- The mortgagee or charge holder shall not derive any financial benefit from security furnished by customer.

e. Application of Murabaha

Working Capital: Murabaha can be used to facilitate the Working Capital needs such as purchase of raw materials etc.

Trade Finance: It can be used to finance import & export for the benefit of the industry.

Consumer Finance: SME consumer durables can be offered through Murabaha financing.

f. Accounting Treatment of Murabaha Transactions

There may be three different cases for payment of Murabaha pricing.

i. Bullet Payment

If Murabaha price is paid in one bullet payment, price can simply be calculated as following:

Murabaha Price = Principal + Principal x Profit Rate x No. of days

ii. Payment in Equal Installments

In this case, each payment is comprised of a portion of principal & profit. The payment is calculated by using IRR (Internal Rate of Return) formula

Installment = $[(\text{principal} \times \text{rate}) / (1 - (1 / (1 + \text{rate})^n))]$

Murabaha Price = Installment x n

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iii. Unequal installments

In such a way, profit part of the selling price is paid over the total tenor of the transaction , whereas the principle amount is paid at maturity. Price is calculated as following:

1. Murabaha Price = Principal amount+ Principal x Profit rate x No. of days(b/w disbursement & maturity)
2. Interim Installment = Principal x Profit rate x No. of days(days per period)

Accounting Treatment for Murabaha under IFAS-1

In case of Bullet Payment:

- 1- Payment to the customer for the purchase of goods on behalf of bank or directly to the supplier(vendor) by the bank :

Advance against Murabaha	Dr	
Customer A/C		Cr

- 2- At the time of sale of goods to the customers with signing of Declaration by the bank and the client:

Murabaha	Dr	
Murabaha Profit Receivable	Dr	
Advance against Murabaha		Cr
Deferred Murabaha Income		Cr

- 3- At the time of Booking of Accrual @ profit rate each month the following entry would be passed*.

[(amount x Profit rate) x 30 / 365]

Deferred Murabaha Income	Dr	
Murabaha Income		Cr

*this entry will be passed at the end of each month till maturity.

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- 4- On Maturity of Murabaha transaction and at the time of receiving of final payment following entry would be passed:

Customer A/C	Dr	
Murabaha		Cr
Murabaha Profit Receivable		Cr

h. Risk Management

Risks	Solution
Agency Risk	Pre-inspection and direct payment to the vendor.
Ownership Transfer/Asset Risk	Takaful of goods during transit and induce customer to submit declaration immediately after the purchase of goods.
Default Risk	Obtain Shariah compliant collateral and adapt staggered payments.
Price Risk	Time lag between purchase and offer acceptance should be minimum.
Liquidity Risk	Make separate pools for different maturities considering their different maturity dates.
Profitability Risk	A charity may be imposed to discourage a delay to make Murabaha repayments.
Shariah Non-Compliance Risk	Ensure that relevant staff has appropriate training and has proper knowledge of Shariah principles. Checklist of the sequence may be followed.
Legal Risk	Proper documentation and timely checking is required.

IJARAH BASED FINANCING

Ijarah can be defined as “transferring of usufruct (body) of an asset to another person for an agreed period, at an agreed consideration”. The asset should be valuable, identified and quantified. Anything which cannot be used without consuming cannot be leased out. e.g. Money, Wheat etc.

a. Basic Rules of Ijarah

- In Ijarah financing, all liabilities of ownership are borne by lessor, since corpus of leased property remains in the ownership of the seller.
- Period of lease must be determined in clear terms at the time of contract
- Lease for specific purpose only be done, if no specific purpose is identified in the agreement, then it can be used for any purpose for which it is used in normal course
- The lessee is liable to compensate the lessor for any harm to the leased asset caused by any misuse or negligence. The leased asset shall remain in the risk of the lessor throughout the lease period.

Determination of Rental

The rental must be determined at the time of contract for the whole period of lease. It is permissible that different amounts of rent are 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 affecting a lease. The determination of rental on the basis of the aggregate cost incurred in the purchase of the asset by the lessor, as normally done in financial leases, is not against the rules of Shariah.

- The lessor cannot increase the rent unilaterally, and any agreement to this effect is void.
- The rent or any part thereof may be payable in advance before the delivery of the asset to the lessee.
- The lease period shall commence from the date on which the leased asset has been delivered to the lessee.

The commencement of lease

Unlike the contract of sale, the agreement of Ijarah can be effected for a future date. Hence, it is different from Murabaha. Rent should be charged after the delivery of the leased asset to the lessee and not from the day the price has been paid. If the supplier has delayed the delivery after receiving the full price, the lessee should not be liable for the rent of the period of delay.

Expenses consequent to ownership to the lessor

As the lessor is the owner of the asset, he is liable to pay all the expenses incurred in the process of its purchase and its import to the country of the lessor for example expenses of freight and customs duty etc.

Lessee as Ameen

The lessee is responsible for any loss caused to the asset by his misuse or negligence. He can also be made liable to any normally occurring wear and tear.

Variable Rentals in Long Term Leases

In this case the lessor has two options:

1. A lease contract can have a condition that the rent shall be increased according to a specified proportion (e.g. 5%) after a specified period (like one year).
2. He can contract lease for a shorter period after which the parties can renew the lease at new terms and by mutual consent.

Termination of Lease

If the lessee contravenes any term of the agreement, the lessor has a right to terminate the lease contract unilaterally. If not then it can be terminated through mutual consent only. However, in such a case he cannot charge rentals of remaining period.

Takaful of the assets

If the leased property is insured under the Islamic mode of Takaful, it should be at the expense of the lessor and not at the expense of the lessee.

The residual value of the leased asset

Through a mutual agreement of Lease, after the expiry of the lease period, the corpus of the leased asset cannot be transferred to the lessee, otherwise it becomes hire purchase. It is a well-settled rule of Islamic jurisprudence that one transaction cannot be tied up with another transaction so as to make the former a pre-condition for the other. However, the lessor may enter into a unilateral undertaking to sell the leased asset to the lessee at the end of the lease period. This undertaking will be binding on the lessor only.

Ijarah Wa Iqtina

The lessor may sign a separate promise to gift the leased asset to the lessee at the end of the lease period, subject to his payment of all amounts of rent. The validity of this arrangement is subject to two basic conditions:

- Firstly, the agreement of Ijarah itself should not be subjected to signing this promise of sale or gift.

- Secondly, the promise should be unilateral and binding on the promisor only.

Sub-Lease

If the leased asset is used differently by different users, the lessee cannot sub-lease the leased asset except with the express permission of the lessor.

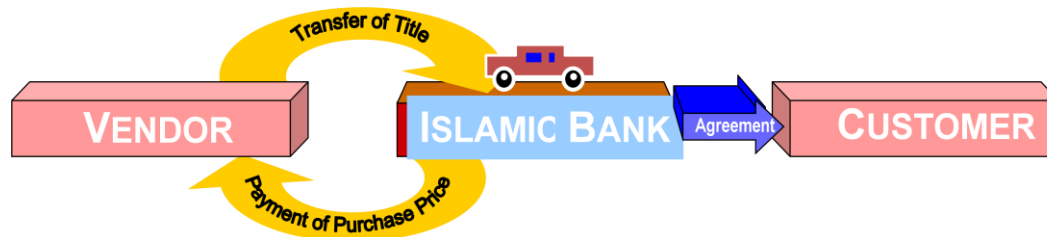
Ijarah and Ijarah Muntahia Bittamleek

Ijarah Muntahia Bittamleek ends up with the transfer of ownership of leased assets to the lessee. There are several types of Ijarah Muntahia Bittamleek. These are characterized based on the method by which the ownership transfers to the user:

- For no consideration (through a gift)
- For token consideration
- For price specified in the lease
- For remaining amount (if lease is terminated before period)
- Gradual transfer

b.Process flow of Ijarah

1. The customer approaches the Bank with the request for financing
2. The Bank purchases the item required for leasing and receives title of ownership from the vendor
3. The Bank makes payment to the vendor.



4. The Bank leases the asset to the customer
5. The customer makes periodic payments as per the contract
6. The asset title transfers to the customer based on the conditions of the agreements.



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c.Direct Lease Documents

- Letter of Request
- Lease Application Form
- Credit Memorandum
- Offer Letter
- Acceptance.
- Undertaking to Purchase Leased Asset
- Lease Agreement
- Letter of Continuity
- Promissory Note
- Insurance Agency Agreement
- Undertaking to Pay Taxes
- Prudential Undertaking
- Insurance Claim Undertaking
- Authorization to take possession
- Personal Guarantee
- Post Dated Cheques
- Promise to Sell

d. Accounting Treatment of Ijarah Transactions

Rental Calculation

$$\text{Rent} = (\text{asset cost paid by the bank} \times \text{rate}) / [1 - (1/(1+\text{rate})^n)]$$

Rentals are to be recognized as income on accrual basis in a systematic manner over the lease period, whereas carrying costs, including depreciation, incurred in earning the Ijarah income are recognized as an expense in the Income statement.

Accounting Treatment under IFAS-2:

Following accounting entries are passed under IFAS-2:

1. At the time of payment to the client for the purchase of asset on behalf of bank or directly to the supplier by the bank

Cash	Dr	
Security Deposit		Cr

2. When asset is delivered to Lessee

Asset acquired for Ijarah	Dr	
Advance against Ijarah		Cr

3. Accrual of income when it is due(Ijarah rentals are considered as income)

Rental Receivable	Dr	
Rental Income		Cr

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4. Recording of Depreciation expense for Ijarah Asset

Depreciation Expense	Dr	
Accumulated Depreciation		Cr

5. At the time of receiving of Rental following entry would be passed:

Customer A/C	Dr	
Ijarah Rental Receivable		Cr

6. At the time of maturity of Ijarah Contract

Security Deposit	Dr	
Customer A/C		Cr

e. Risk Management

Risks	Solution
Repayment/default Risk	Risk can be mitigated by market value of Ijarah asset which may be reposed & collateralized.
Price Risk	It must be ensured that promise to Ijarah is properly documented and legally enforceable.
Residual Value Risk	It is mitigated by the market value of the asset which is reposed.
Early Termination Risk	Mitigated by taking a profit on the sale in case of early termination.
Legal Risk	Proper documentation and timely checking is required.

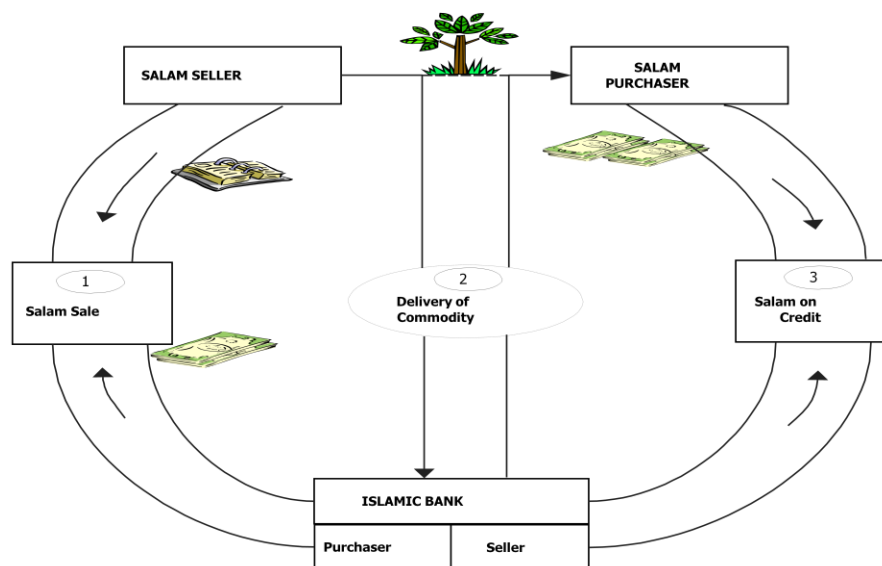
SALAM BASED FINANCING

The seller undertakes to supply specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. The price is paid immediately in cash but the supply of purchased goods is deferred to a fixed date. **The seller gets in advance the money he wants in exchange of his obligation to deliver the commodity later.**

- He benefits from the Salam sale by covering his financial needs whether these are personal expenses or expenses for productive or trading activity.
- The purchaser or the Bank gets the commodity it is planning to trade on the time it decides.
- The Bank will also benefit from the cheap prices because usually the Salam sale is cheaper than the cash sale. This way the Bank will also be secured against the fluctuations of price.

Parallel Salam

- The Bank being the purchaser of Salam commodity can further sell on Parallel Salam in a similar manner as it has previously purchased on first Salam without making one contract dependent on the other. However, in such case, the date of delivery shall not be earlier than the date of receipt of such commodity.
- The Bank also has the option of waiting to receive the commodity and then sell it for cash or deferred payment.



Salam based Financial products

- Agriculture financing
- Working Capital Financing
- Commercial and industrial financing
- Export financing
- Operations and capital cost financing

a.BASIC RULES OF SALAM

Purchase Price of Salam

- The amount of Salam financing should be known to all the parties. It may be in form of fungible goods, livestock and usufruct of an asset. Generally it should be fixed in terms of cash.
- Purchase price in Salam must be fully advanced to the seller at the commencement of the contract.

Specification of Commodity

- The commodity (Al-Muslam fihi) should be known. It must be monitored by specifications to the maximum possible degree, only negligible variation is tolerated.
- It must also be ensured that the commodity is possible to be delivered when it is due.
- Only those goods can be sold through Salam contract in which the quality and quantity can be exactly specified. In other words it can be done only in such items which can be weighed, measured or counted.
- Salam can only be carried out in the items in which variations in numbers make no difference.
- Salam is not permitted for anything specific like “this car”. Nor it is permitted for anything for which the seller may not be held responsible, like land, buildings or trees or for articles whose values change according to subjective assessment, like jewellery and antiques.

Delivery Conditions

- Due date of delivery must be agreed at the commencement of the contract.
- The place of delivery should also be known. If it is not known, the place where the contract took place shall be considered to be the place of delivery, unless it is

impracticable. In such a case, the place of delivery shall be decided according to customary practices.

- Before delivery, goods will remain at the risk of seller.
- After delivery, risk will be transferred to the purchaser.
- Possession of goods can be physical or constructive.
- Transferring of risk and authority of use and utilization / consumption are the basic ingredients of constructive possession.

Salam on Existing Commodities

- Salam sale is impermissible on existing commodities or on land and real estates because the description of the land or the real estate entails the location.
- There must be two separate and independent contracts, one where the Bank acts as buyer and other in which it is a seller.
- The two contracts cannot be tied up and performance of one should not be contingent on other.
- Salam arrangement cannot be used as a buy back facility where the seller in the first contract is also the purchaser in the second.
- Even if the purchaser in the second contract is a separate legal entity but owned by the seller in the first contract, it would not tantamount to a valid Parallel Salam agreement.

Agency Contract

- If the bank has no expertise to sell the commodities received under Salam contract, then the bank can appoint the customer as its agent to sell the commodity in the market / third party, subject to Salam agreement and Agency agreement are separate from each other.
- A price must be determined in agency agreement on which the agent will sell the commodity but if the price is increased, the benefit can be given to the agent.

Revoking Salam Contract

- Once agreed upon, a Salam contract cannot be revoked unilaterally by any party.
- It can be cancelled or partially cancelled with mutual consent by returning the actual or proportionate amount of price paid.

Security in Salam

- Delivery of the commodity can be secured through a pledge or a guarantee or any other means of securing payment.

Sale before Possession

- Commodity purchased under Salam cannot be sold earlier than taking possession thereof. However, a very small school of thought is of the view that this restriction should apply to the food commodities only.
- These commodities can, however, be sold under parallel Salam or may be promised to be sold at a future date.

Replacement of Items

- If, due to any unforeseen reason, it is not possible to deliver the commodity on the due date, it is permissible to change the commodity with mutual consent except for currency, gold or silver.
- The market value of such substituted goods shall not be higher than the market value of the originally agreed commodity, at the time of delivery.
- If the seller offers better quality goods by his own, the buyer shall preferably accept the same. However, in case of inferior quality of goods he has an option to accept the goods or reject the same.

In case of Default

- No penalty can be stipulated in the contract.
- If the seller fails to perform his obligation, due to insolvency or genuine reasons, he should be given an extension in the delivery time.
- If the total or partial quantity is not available on due date, the customer has an option to wait for the time when the commodity becomes available or he can get his money back.
- Replacement of commodity may also be mutually agreed.

b. Accounting Treatment

1. Entry, at the time of signing contract and raising money to client as Salam Financing.

Salam Financing	Dr	
Cash		Cr

2. At the time of signing Parallel Salam with another client.:

Cash	Dr	
Parallel Salam Financing		Cr

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3. When goods are received from client-I

Salam Goods	Dr	
Salam Financing		Cr

4. Goods are given to client-II (Parallel Salam)

Parallel Salam	Dr	
Salam Goods		Cr
Profit & Loss A/C		Cr

c. Risk Management of Salam

Risks	Solution
Price Risk	Bank can do parallel Salam and can also take “promise to purchase” from the third party.
Quality Risk	Bank has the option of not accepting the goods of inferior quality.
Default Risk	A security in form of guarantee, mortgage or hypothecation can be obtained.
Storage Risk	Parallel Salam can cater this.
Non Performance Risk	In case of an adverse situation, to avoid losses, ensure the delivery or promise to purchase from a third party.
Operational Risk	Ensure that relevant staff has checked documentation and have proper knowledge of Shariah principles.
Liquidity Risk	Accepting Partial delivery from the seller/supplier of asset/commodity, so as to generate cash in order to meet liquidity requirements.

DIMINISHING MUSHARAKA

It is a form of partnership in which one of the partner promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him.

This mode is based on Shirkat-ul-Milk which means joint ownership in a property. It has three components:

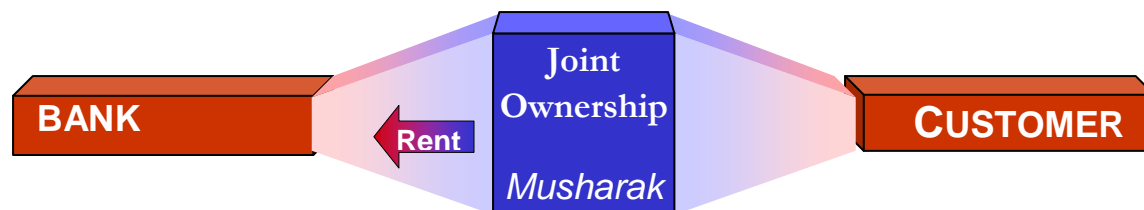
- Joint ownership of the Bank and customer
- Customer as a lessee uses the share of the bank
- Redemption of the share of the Bank by the customer

Mode of Fixed Asset Financing

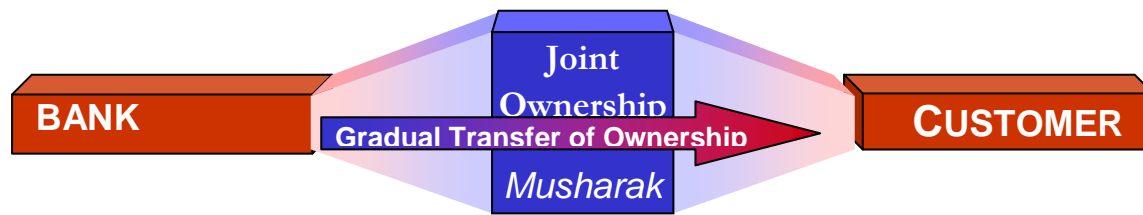
Diminishing Musharakah is commonly used for the purpose of financing of fixed assets by various Islamic banks.

- House financing
- Car Financing
- Plant and machinery financing
- Factory/Building financing
- Agriculture land financing
- All other fixed Assets

a. BASIC TRANSACTION STRUCTURE



- The customer approaches the Bank with the request for Project/Machinery/House financing
- The Bank enters into a Musharakah (Joint Ownership) agreement with the customer and both of them pay their respective shares to the seller of the asset. Bank and client invest funds to purchase an asset (Land, building, equipment, machinery) and will enter into a Musharaka agreement and the shares of the bank and client will be established. The shares will be represented by No. of units, unit amount and bank/client's shares in percentage will also be identified.
- Customer pays rent for the use of banks share in the property
- Ownership of the asset is gradually transferred to the customer upon payment of asset price.



Documents

- Musharaka Agreement
- Payment Agreement
- Undertaking to purchase Musharaka Units
- Undertaking to Sell Musharaka Units
- Unit Sale Receipt

Bank and client will enter into a Payment Agreement under which the client will make monthly/quarterly, semi annually payments to the bank for usage of bank's share.

This amount will be calculated by the client according to pre-agreed formula.

The client will undertake to purchase Bank's units at face value over the transaction tenure through undertaking.

House Financing Based on Diminishing Musharakah

The arrangement is composed of the following transactions

1. To create joint ownership in property
2. Giving share of financier to client on rent
3. Promise of client to purchase units of share of financier
4. Purchase of financier's units
5. Adjustment of rental according of share of financier in property

Diminishing Musharakah can be used for financing with the following conditions

- The agreements of joint purchase, Lease and selling of units should not be tied-up together
- At the time of purchase, sale should be effected through offer and acceptance
- Preferable to purchase each unit on market value, but permissible to purchase at agreed price

Capital

In Musharaka, the capital is specific, existent and under disposal. It is invalid to establish a Musharaka on non-existent fund or debt. The partners may have varying shares in capital subject to agreement. The capital of Musharakah is money and valuables. It may consist of

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merchandise or operating assets on condition that these are valued at the time of contract and the value is agreed upon.

In Diminishing Musharaka it is necessary that buying and selling of equity should not be stipulated in the partnership contract. In other words, the buying partner is allowed to give only a promise to buy. The buying and selling agreement must be independent of the partnership contract. It is not permitted that one contract be entered in to as a condition for concluding the other.

c. Accounting Treatment of Diminishing Musharaka Transaction

i. Entry at the time of disbursement of funds

Diminishing Musharaka Financing	Dr	
Customer's A/c		Cr

ii. At the time of monthly accrual

Profit Receivable	Dr	
Income on D.M		Cr

iii. Entry at the time of recovery of installment

Customer A/c	Dr	
Profit Receivable D.M Financing		Cr

iv. For Delayed Payment

Customer A/C	Dr	
Charity Payable		Cr

d. Risk Management

Risks	Solution
Ownership Asset Risk	This risk can be mitigated through Takaful coverage of an asset.
Counter Party Risk	This can be mitigated as asset value as collateral.
Capital Impairment Risk	This can be catered through Takaful of goods through transit.
Cancellation Risk	The bank must obtain collateral to reduce this risk.
Legal Risk	Proper documentation and timely checking is required.

ISTISNA FINANCING

There are three basic conditions for validity of a sale in Shariah:

- The purchased commodity must be existing;
- The seller should have acquired the ownership of that commodity; and
- The commodity must be in the physical or constructive possession of the seller.

Further, there are only two exceptions to this principle in Shariah:

- Salam; and
- Istisna.

Istisna is a sale transaction where a commodity is transacted before it is manufactured. *It is an order to a manufacturer to manufacture a specific commodity for a purchaser.* The manufacturer uses his own material to manufacture the required goods. In this mode of financing, price must be fixed with consent of all parties involved.

It can be used for financing where production and value addition is required. Unlike Murabaha that can only be used to finance purchasing of assets, Istisna can full fill all Working Capital Requirement of the SME sector.

a. FLOW OF ISTISNA TRANSACTION

1. The purchaser expresses his desire to purchase an asset from bank and an Istisna sale contract is entered between bank and purchaser in which the bank promises to deliver the commodity on a specific future date.
2. The bank and the purchaser enter into a contract to sell the asset to be delivered on a specified due date.
3. The bank enters into a parallel Istisna contract with a manufacturer to manufacture an asset to be delivered at a due date in conjunction with the first Istisna contract.
4. The seller delivers the asset either to the bank or the purchaser, if authorized by the bank. In case the seller delivers directly to the purchaser an agency agreement is entered into between bank and the purchaser.

b. ISTISNA BASED FINANCIAL PRODUCTS FOR SME

Istisna mode of financing may be used for following financial products:

- Financing technology industries.
- Working capital and export financing.
- Financing construction industry such as apartment buildings, hospitals, schools and universities.
- Housing finance schemes.

c.BASIC RULES OF ISTISNA

Contract

- The parties can enter into a contract before the seller assumes the title of the goods to be manufactured.
- The seller (manufacturer) can use any price quotations obtained by the customer if he has not issued any purchase orders or entered into a manufacturing contract.

Subject Matter

- Istisna contract is valid for objects that can be manufactured. It is invalid for natural products whose sale on liability is a Salam and not Istisna.
- The specifications demanded by the buyer are the most important as the commodity subject of contract is a liability debt
- It cannot be stipulated in an Istisna contract that the seller / manufacturer will not be responsible for any defects.
- The parties may agree for a period during which the manufacturer will be responsible for any defects or the maintenance of the subject matter.

Use of Material

- Manufacturer has to use its own materials to manufacture / construct the goods

Existing Assets

- It is not permissible that the subject-matter of an Istisna contract be an existing and identified capital asset. For example, it is invalid for the Bank to conclude a contract to sell a particular designated car or factory on the basis of Istisna.

Mode of Payment

- In the Istisna contract, the price may be advanced or deferred in lump sum or in installments as agreed at the time of contract.
- The price and mode of payment must be known at the conclusion of the contract. It should be in form of cash or in form of tangible goods or usufruct of an asset other than the asset being manufactured.

Price

- Istisna contract has a fixed price and any profit and loss relates to the manufacturer. If any discount is received on the raw materials, the additional profits relates to the manufacturer.
- A contract of Istisna cannot be drawn up on the basis of a Murabaha sale, for example, by determining the price of Istisna on a cost-plus basis.

- The Istisna is not confined to what the manufacturer makes after the contract but the manufacturer will be satisfying his obligation if he brings in an article conforming to all the specifications. In other words, contract is binding according to specifications.
- If not specifically prohibited in the contract, the seller may contract someone else to manufacture the same.
- He may subcontract on the basis of Ijarah (Ujrah), employment or on the basis of parallel Istisna.

Penalty and Bonus

- A clause may be inserted stipulating an agreed amount of money for compensating the purchaser adequately if the manufacturer is late in delivering the asset or providing a bonus to the manufacturer if he delivers the asset earlier.
- Such penalty is permissible only if the delay is not caused by intervening contingencies (force majeure). However, it is not permitted to stipulate a penalty clause against the purchaser for default on payment.

Rebate

- A voluntary rebate for early payment is permissible provided it is not agreed in the contract and it is not a business norm or an implied condition of the contract.

Security Deposit

- The Bank may, acting either in the capacity of the manufacturer or of the purchaser, give or demand urboun (security deposit / advance money) as a guarantee, which may be considered as part of the price and may be forfeited if the contract is rescinded.

Guarantee

The Bank may, acting either in the capacity of the manufacturer or of the purchaser, give or demand a guarantee, to cover the risks relating to fulfillment of contracts.

Amendments and Changes Orders

- Amendments and change orders in respect of work, with mutual consent, are allowed and necessary changes may be agreed in the selling price accordingly.
- No changes and amendments should be made in respect of price adjusting for a rescheduling the payment period.

Force Majeure

- Mutually agreed adjustments in work schedule and payment terms are allowed in case of force majeure. But no price adjustment should be made in respect of change in repayment schedule.
- Other contractors / sub-contractors may be involved in the process, in order to complete an incomplete work.

Separate Contracts for Parallel Istisna

- A clear Istisna contract shall be entered into between the Bank and the customer, whereby on the other hand the Bank may enter into a Parallel Istisna with the third party (Contractor), but this contract shall not be tied up with the first contract.
- It is permissible to state in a contract of Istisna that the manufacturer will act as the agent of the purchaser to sell the subject-matter.
- This may either be used in case of exports etc. or in case when there is a delay on the part of the purchaser in taking delivery of the subject-matter within a particular period of time.

Delivery

- Before delivery, goods will remain at the risk of seller. After delivery, risk will be transferred to the purchaser.
- Possession of goods can be physical or constructive. Transferring of risk and authority of use and utilization / consumption are the basic ingredients of constructive possession.
- If manufactured goods are delivered before agreed date, purchaser should accept the same if the goods meet the specifications. He can refuse to accept the goods earlier than the due date, if he has a justifiable reason for that.

d. Accounting Treatment of Istisna Transaction

Entry at the time of disbursement of Istisna financing

Istisna Financing	Dr	
Customer's A/c		Cr

ii. At the time of receipt of Installment amount:

Customer's A/c	Dr	
Istisna Financing		Cr
Profit Receivable		

e. Risk Management

Risks	Solutions
Delivery Risk	Bank can reduce the Istisna price according to the Istisna agreement.
Ownership of the Material	Security would be available with the bank.
Default Risk	The bank must obtain sufficient collateral.
Non-performance Risk	The bank can terminate the Istisna agreement and can demand the price back from the manufacturer.
Quality Risk	Khiyar-e-aib may be exercised.
Order cancellation Risk	Bank must obtained sufficient collaterals.

PROJECT FINANCING

Project Financing can be done through various modes of finance. Currently Ijarah is the most popular mode of finance for undertaking long term project finance. However, Ijarah can only be used if the asset is already in place. In case the project needs to be constructed Ijarah cannot be used very effectively.

MURABAHA –ISTISNA FINANCING

Customer especially exporters sometimes needs financing for processing of raw material. In Pakistan textile composite units purchase cotton to manufacture finished cloth. These units cannot rely on Murabaha Finance, since their main raw materials also include labour and overhead expenses. Murabaha alone cannot fulfil their requirements.

These exporters can be financed using the following Islamic Financing instruments:

- Istisna
- Murabaha
- Wakalah

a.FLOW OF TRANSACTION

1. Having the LC in hand, the exporter primarily needs funds to
 - Purchase raw material
 - To manufacture the finished product
2. The Bank fulfils the need of the exporter by providing funding
3. This funding is provided under the following two agreements:
 - ✓ Murabaha
 - ✓ Istisna
4. Murabaha is provided for purchase of Raw Material
5. Istisna is provided to manufacture the required goods

The process will consist of the following steps

1. The Bank will finance the purchase of Raw Material through a Murabaha transaction.
2. It will also give funds to the customer under a separate Istisna agreement to manufacture and deliver the goods to the bank as per Istisna agreement.
3. Once the goods are manufactured they will become the property of the Bank.
4. The Bank will appoint the exporter as its agent to export the goods on its behalf under a Wakalah agreement.
5. The Wakalah agreement is required because under Istisna the customer is liable to deliver goods to the bank.

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6. The exporter will now export the goods, acting as the Bank's agent.
7. The export proceeds will be remitted to the Bank Which will deduct from the proceeds
 - a. The cost of goods (Istisna price)
 - b. And profit
8. Client will pay Murabaha price to the Bank.

Further Instructions issued by State bank of Pakistan would be applicable to all banks offering Islamic SME Financing from time to time.

The effective management of Islamic SMEs financing would contribute significantly to the overall growth and profitability of banks. The only thing required is the considerable research and analysis into the credit management methods by which bank can assess and monitor business financing, manage business financing risks, and price their products. There should be intensive scrutiny of the kinds of business financial information that banks use in making financing decisions. Banks have traditionally relied on a combination of documentary sources of information, interviews and visits, and the personal knowledge and expertise of managers in assessing and monitoring SME financing. However, when assessing comparatively small and straightforward business credit applications banks may largely rely on standardized credit scoring techniques (quantifying such things as the characteristics, assets, and cash flows of businesses/owners). Using such techniques and regionalizing business-banking operations generally can significantly reduce the processing costs too. Standardized computer-based assessment may also be more accurate and fairer than reliance on the personal judgments of local bank managers. As a result, banks may now be able to offer more financing, faster and in larger amounts, and reduce previously high security requirements.
