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بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

# Exploring Islamic Banking Solutions for SMEs

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&

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# Presentation Outline

- Introduction to Islamic banking
- Overview of SME sector
- Financing needs of SMEs
- Islamic retail banking solutions for SME
- Short term Financing Needs
- Long term Financing Needs
- Trade Finance solutions
- Investment and liquidity management solutions
- SME focus approach



## Strategic Direction for Islamic Banking

### Objectives of Islamic Banking Product

- **Equitable Distribution & Circulation of Wealth in the society**
- **Avoid all Impermissible transactions**
  - Riba (Riba Al Nase'ah / Riba Al Fadhl)**
  - Maysir / Gambling**
  - Gharar (Al Jahalah, Bai Qablal Qubz etc).**
  - Uqood-e-Fasida**
- **Promote participation based & asset Backed Financing**
- **Fulfilling halal Customer Needs**
- **Ensuring Shari'a Compliance in all transactions**



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## Islamic Banking – What to offer

- NO Compromise on Shariah Compliance
- Products to fit all type of halal Customers' need
- Easy of use
- Innovative & Value added Products
- Halal Returns for investment
- Halal & Riba Free Business solutions
- Create Awareness and educate



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# **Shariah Framework**

**Basic Permissibility &  
Prohibition:**

**A solid foundation for a  
stable economic system**





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## Guidelines for Commercial Dealings

**Allah (SWT) has ordained in Holy Quran**

وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا

**“Allah has permitted trade and prohibited Riba”**



## Prohibitions in Commercial Dealings

### 1. All type of Riba

- ✓ Riba Al Nase'ah
- ✓ Riba Al Fadl

### 2. Maysir / Gambling

### 3. Gharar (transaction with uncertainty)

Bai Qablal Qubz, Short sale, Future sale, Bai Dain /Sale of debt,sale of artificial instruments like derivatives/options etc



**Thus, Islamic banking system has a clear mandate to promote real economic activity by refraining from all prohibited transactions**



# Sources of Shariah

- 1. The Holy Qur'an**
- 2. The Sunnah of the Holy Prophet (SAW)**
- 3. Ijma' (consensus of the Ummah)**
- 4. Qiyas (Anology)**



## Prohibition of Riba in the Qur'an

### Al Baqarah 275

الَّذِينَ يَأْكُلُونَ الرِّبَا لَا يَقُومُونَ إِلَّا كَمَا يَقُومُ الَّذِي  
يَتَخَبَّطُهُ الشَّيْطَانُ مِنَ الْمَسِّ ذَلِكَ بِأَنَّهُمْ قَالُوا إِنَّمَا الْبَيْعُ  
مِثْلُ الرِّبَا وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا فَمَنْ جَاءَهُ مَوْعِظَةٌ  
مِّن رَّبِّهِ فَانْتَهَى فَلَهُ مَا سَلَفَ وَأَمْرُهُ إِلَى اللَّهِ وَمَنْ عَادَ  
فَأُولَٰئِكَ أَصْحَابُ النَّارِ هُمْ فِيهَا خَالِدُونَ

“Those who devour Riba shall rise up before Allah like men whom Shaitan has demented by his touch; for they claim that trading is like Riba. *But Allah has permitted trading and forbidden Riba.* He that receives an admonition from his Rabb and mends his ways may keep what he has already earned; his faith is in the hand of Allah. But he that pays no heed shall be among the people of fire and shall remain in it forever.”

## Prohibition of Riba in the Qur'an

### Al Baqarah 278 - 279

يَا أَيُّهَا الَّذِينَ ءَامَنُوا اتَّقُوا اللَّهَ وَذَرُوا مَا بَقِيَ مِنَ الرِّبَا إِن كُنتُمْ  
مُؤْمِنِينَ ﴿٢٧٨﴾ فَإِن لَّمْ تَفْعَلُوا فَأْذَنُوا بِحَرْبٍ مِّنَ اللَّهِ وَرَسُولِهِ ۖ وَإِن  
تُبْتَغُوا فَلََكُمْ رَأْسُ أََمْوَالِكُمْ لَا تَظْلِمُونَ وَلَا تُظْلَمُونَ ﴿٢٧٩﴾

“O you who believe, Fear Allah and give up what remains of your demand for Interest, if you are indeed a believer. If you do not, then you are warned of the declaration of war from Allah and His Messenger; But if you turn back you shall have your principal: Deal not unjustly and you shall not be dealt with unjustly.”



## Prohibition of Riba in Ahadith

**From Hazrat Jabir Ibn-e-Abdullah (RA):**

**The Prophet, peace be on him, cursed :**

- **The receiver and the payer of interest,**
- **The one who records it and**
- **The witnesses to the transaction**

**And said: "They are all alike [in guilt]."**

**(Muslim, Tirmidhi and Musnad Ahmad)**



## Definition of Riba

كل قرض جر منفعة فهو ربا

قرض کے ذریعے حاصل ہونے والی کسی بھی قسم کی منفعت ربا ہے

**Any debt that pull any kind of profit, that increase is Riba**



# Distinguishing Features

**We find the differences are on three levels:**

## **1. Conceptual & Socio-religious level**

- not money lenders
- cannot deal with interest & non permissible industries

## **2. Business model & Governing framework**

- IB actively participates in trade and production process
- Governing framework in terms of Shariah Advisor &/or SSB



# Distinguishing Features

## 3. Product Level Implementation

- usually asset backed & involve trading/renting of asset & participation on profit & loss basis
- Implementation is not just a mere change of paper work and terms but it involves
  - having the right intention,
  - the correct sequence of steps and timing of execution
  - clarity of roles



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## WHAT SME IS?

In Pakistan, definition of SME varies from institution to institution.

As per Prudential Regulations of SBP, SME is an entity which fulfills all the following characteristics.

	<b>TRADING</b>	<b>MANUFACTURING</b>	<b>SERVICES</b>
Total assets excluding land & building	50	100	50
Total no. of employees	50	250	250
Sales	300 M	300 M	300 M



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## SMEs Contribution in Global Economy

	<b>SME Contribution to Economic Development (%)</b>			
	<b>Korea</b>	<b>Japan</b>	<b>China</b>	<b>Pakistan</b>
Total Business	99.16	99.00	99.40	90.00
GDP	46.00	51.00	50.00	30.00
Employment	72.25	80.00	73.00	80.00
Exports	39.60	38.00	60.00	25.00



**3.2 Million SMEs**

**Contribution to GDP**  
**30 %**

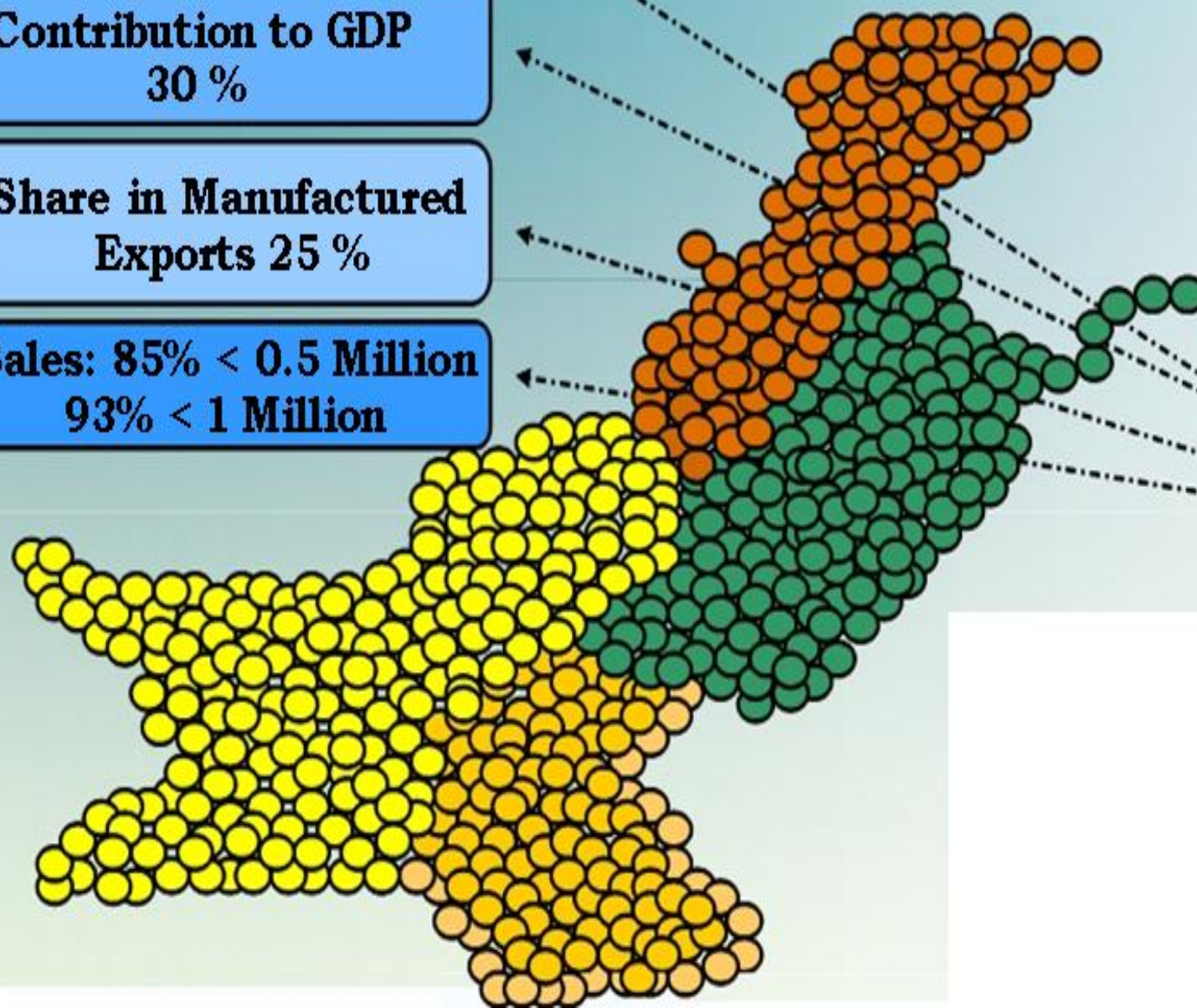
**Share in Manufactured**  
**Exports 25 %**

**Sales: 85% < 0.5 Million**  
**93% < 1 Million**

**Provincial Distribution**  
**of Establishments**

**17.83%** **65.26%**

**14.21%** **2.10%**



**SME**



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## Significance of SME Sector Growth

### **For The Economy:**

- Backbone of Economies: Significant contribution towards GDP (30%), Exports (25%), Improving the Balance of Payment situation, Boosting Industrialization Process
- Employment Generation, Poverty Alleviation, Reducing Income Inequality

### **For The Banks:**

- Diversification of Assets Portfolio
- Better Margins
- Potential Business Opportunity; Huge Target Market
- Low Loan Loss Ratio on Deposits.



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## IMPORTANCE OF SME (An untapped & misunderstood sector)





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## Challenges in SME Financing

- No Documentation- Free Style working behavior
- No Recording of transactions-Verbal commitments
- No succession planning
- Less educated
- Avoid paying taxes
- No sharing of information
- Highly reliant on informal financing sources
- Informal financing cost is high but willing to bear to avoid documentation



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## Continued..

- Not able to address their own process hindrances
- Limited exposure of broader spectrum of business
- Cursing External factors as the cause of their stagnant situation
- Non availability of problem solving skills
- No awareness of growth prospects (Local & International)
- No knowledge of SME products & services as it is a new concept



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# Financing Needs of SMEs

Long Term  
Financing  
Needs



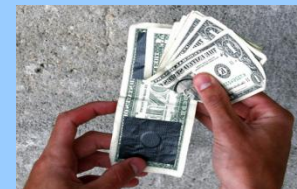
Short Term  
Financing Needs



Trade Finance  
Needs



Investment and fund  
management needs





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# Islamic Banking Products

- Islamic banking now offers a complete range of Retail banking solutions for **SME** to cater their **Financing & banking needs**

## Financing Side modes

- Murabaha
- Salam
- Istisna
- Tijarah
- Diminishing Musharakah
- Ijarah
- Mudarabah
- Musharakah





## Focus on SME needs

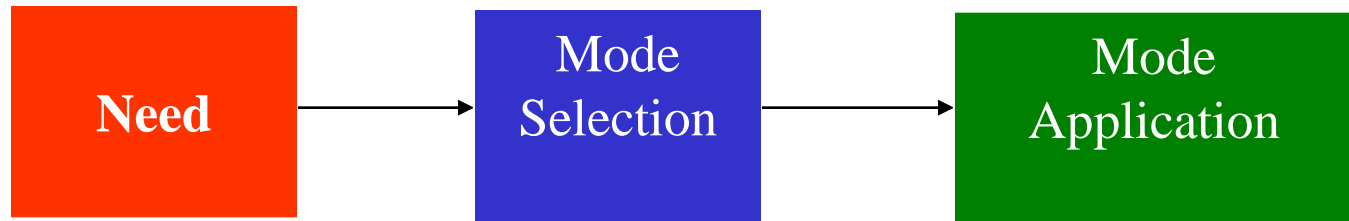
- For Islamic Banking solution – the center of focus is:
  - ✓ **Need of the Customer**
  - ✓ Business Cycle / Purchase Process of the customer
  - ✓ Tenure of Financing required (Long or Short term)
  - ✓ Rate of Financing (Fixed or Variable)
  - ✓ Payment Flexibility (e.g. early termination)



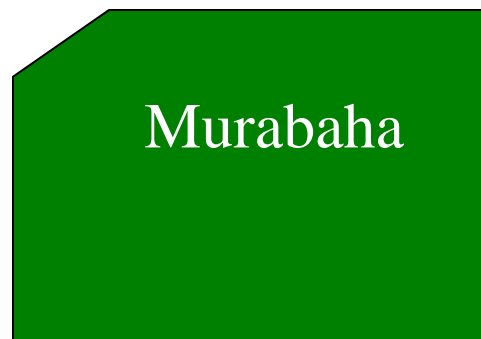


# Application of Mode

- Based on the criteria for selection of modes, the appropriate mode(s) is/(are) applied to fulfill the customer's need.



## Example





## SMEs Sector

### Key points

- Over 230,000 entities
- Total revenue of over \$1.2 billion
- Involved in wholesale trading, retailing, manufacturing, processing and services
- 30 per cent of the UAE's GDP, including the contribution from the oil sector.
- 70 to 80 per cent of UAE's non-oil GDP
- Still underserved by banking
- Higher demand for Islamic retail banking solutions



## Short Term Financing Needs

1. Raw Material
2. Overheads / Utilities
3. Finished Goods
4. Trade receivable financing
5. Rental financing

### Islamic Banking solutions

- Murabaha - for working capital financing
- Salam/Istisna - for overheads, utilities & receivable
- Tijarah - for finished goods & receivables
- Lease & Sub Lease – for rental financing



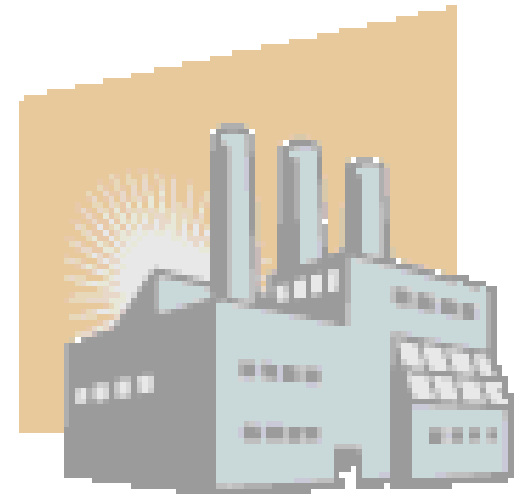
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# Long Term Financing Needs

- Acquisition/replacement/expansion of fixed assets, plant & machinery
- New Project
- Securitization

## Islamic Banking Solutions offered

- Ijarah
- Diminishing Musharakah
- Sukuk & syndicated project financing





## Trade Finance Needs - Import

- Documentary Credits
- Sight LC / Usance LC
- Forward Cover
- Shipping Guarantees

### **Islamic Banking Solutions offered**

- Murabaha/Ijarah for retirement of sight LC
- Musawamah for Usance LC
- Wa'ad for forward cover
- Kafalah for Shipping Guarantee





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# MURABAHA



# Murabaha

Murabaha is a particular kind of sale where the transaction is done on a “cost plus profit” basis i.e. the seller discloses the cost to the buyer and adds a certain profit to it to arrive at the final selling price.

- Payment of Murabaha price may be:
  - 1) At spot
  - 2) In installments
  - 3) In lump sum after a certain time



# Murabaha

## **Do NOTs for Murabaha financing:**

- Re-negotiation of price and roll over of Murabaha are not permitted.
- Discounting of Murabaha instrument is not permitted.

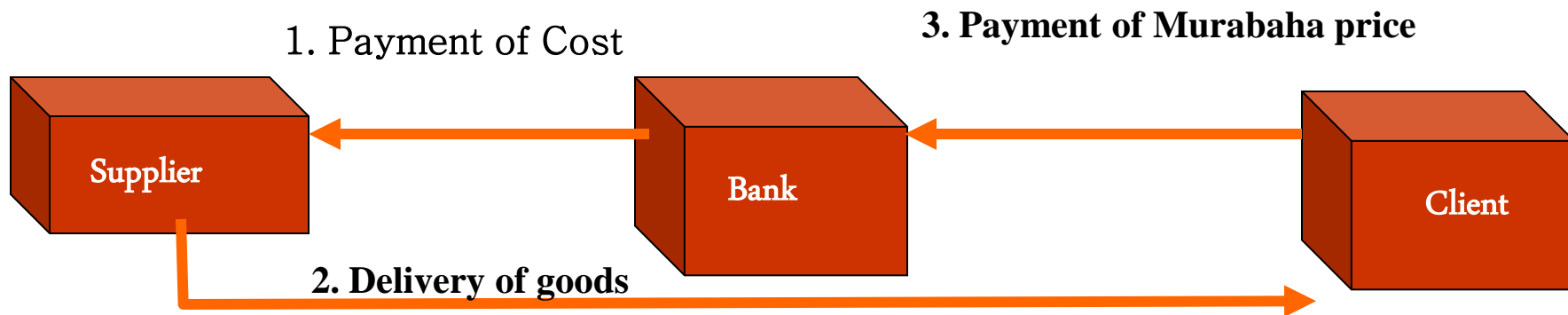




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## Murabaha – Key features

Underlying principle	Cost plus sales
Tenure	Short term - upto 1 year
Rate	Fixed
Prepayment Discount	No
Rescheduling of Price	No
Uses	Purchase of Raw material/ Fixed asset





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# **Step by step Murabaha financing**



# Murabaha

1. Client and bank sign an agreement to enter into Murabaha (MMFA).





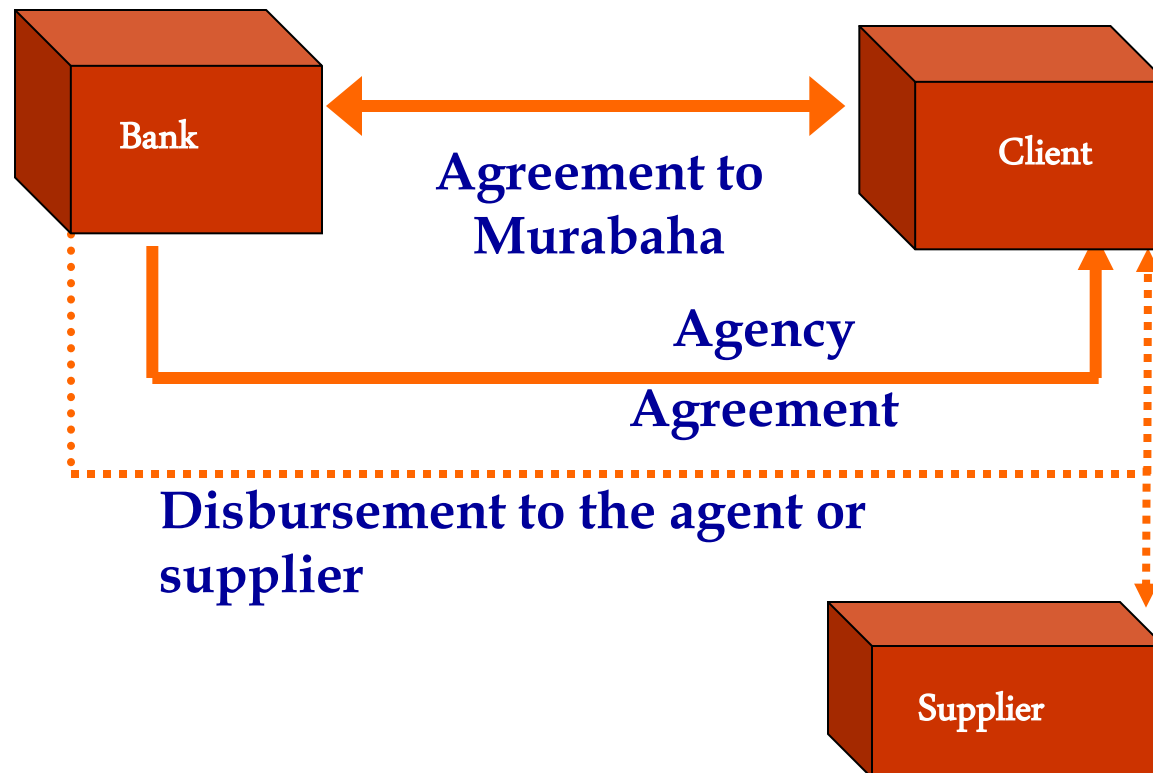
# Murabaha

## 2. Client appointed as agent to purchase goods on bank's behalf



# Murabaha

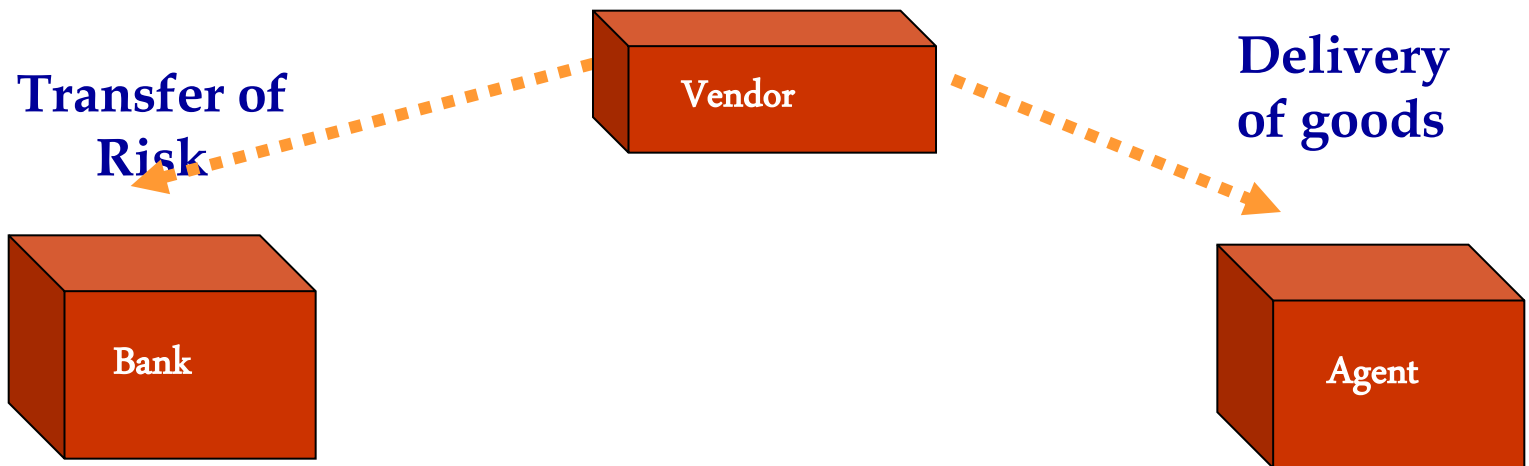
## 3. Bank gives money to agent/supplier for purchase of goods.





# Murabaha

## 4. The agent takes possession of goods on bank's behalf and provides Declaration.





# Murabaha

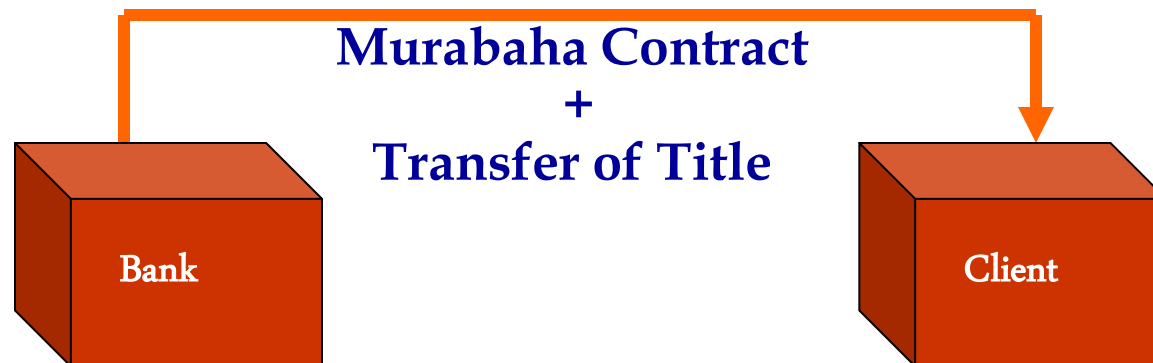
**5(a). Client makes an offer to purchase the goods from bank through a Murabaha Contract**





# Murabaha

**5(b). Bank accepts the offer and sale is concluded.**







# Murabaha

**6. Client pays agreed price to bank according to an agreed schedule. Usually on a deferred payment basis (Bai Muajjal)**





# Murabaha Documentation

There are a number of documents involved in a Murabaha financing transaction. The most essential of these documents are:

- Master Murabaha Financing Agreement
- Agency Agreement
- Order Form
- Declaration & Murabaha Contract
- Purchase Evidences
- Demand Promissory Note
- Payment Schedule



# Issues in Murabaha

- 1. Timing of 'Offer & Acceptance'**
- 2. Rollover in Murabaha**
- 3. Rebate on Early payment**
- 4. Penalty in Late payment**
- 5. Subject Matter**
- 6. Purchase Evidence**
- 7. Direct Payment**
- 8. Profit recognition**
- 9. Training of Customer & Bank staff**
- 10. Process of Murabaha differ from product to products**



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# ISTISNA



## Istisna

- ❖ This product is an order to manufacture wherein; Customer will commit to manufacture/ provide specified items at a tentative date for IB.
- ❖ For this purpose IB will disburse the required financing amount in Customer's account.
- ❖ Funds may be used at the Customer's discretion.



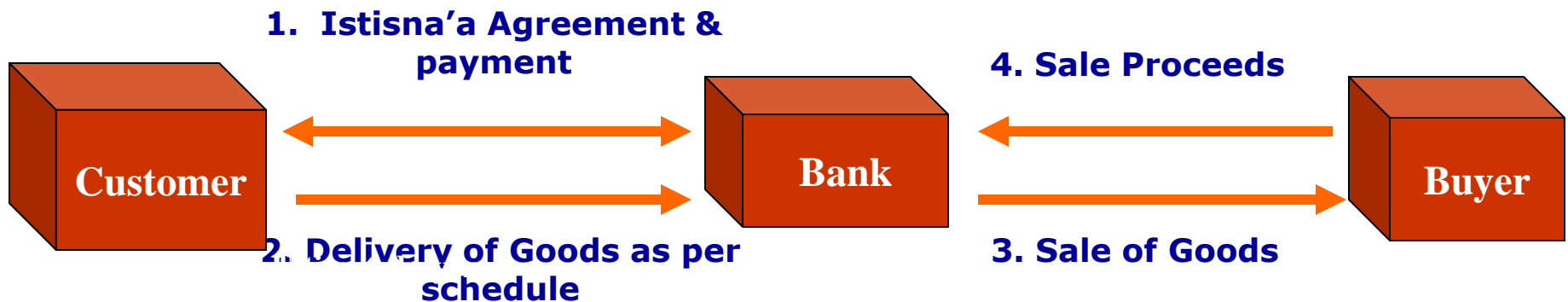
## Istisna

- ❖ Upon delivery of the specified items (Constructive possession through physical inspection), IB will appoint the Customer as its agent to sell the goods to its buyers.
- ❖ Customer will adjust the financing through the sale proceeds of the specified items.
- ❖ The Customer will ensure that in case of Credit Sales, goods are sold to Credible Buyers and will guarantee payments on due dates.



## Istisna - features

Underlying principle	Made to order
Tenure	Short Term
Rate	Fixed
Rescheduling of Price	Possible in some cases
Uses	Order to manufacture goods/assets



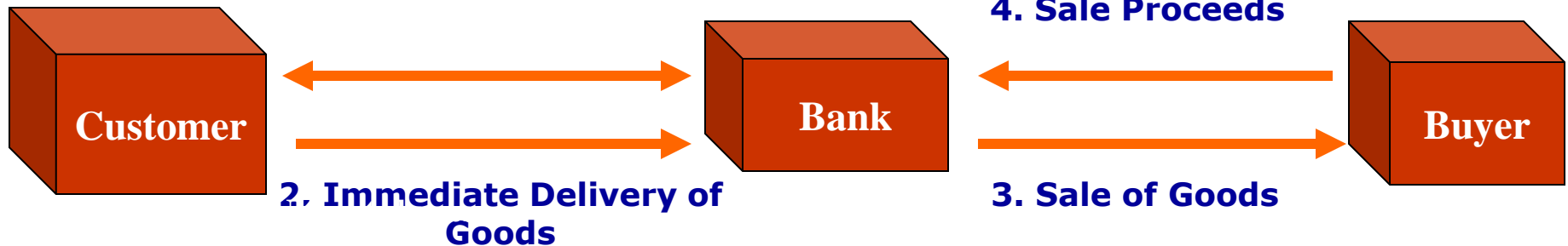


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## Tijarah - features

Underlying principle	Finished Good Purchase
Tenure	Short Term
Rate	Fixed
Rescheduling of Price	Agency incentive possible
Uses	Finished good & receivable financing

### 1. Sale Agreement & payment



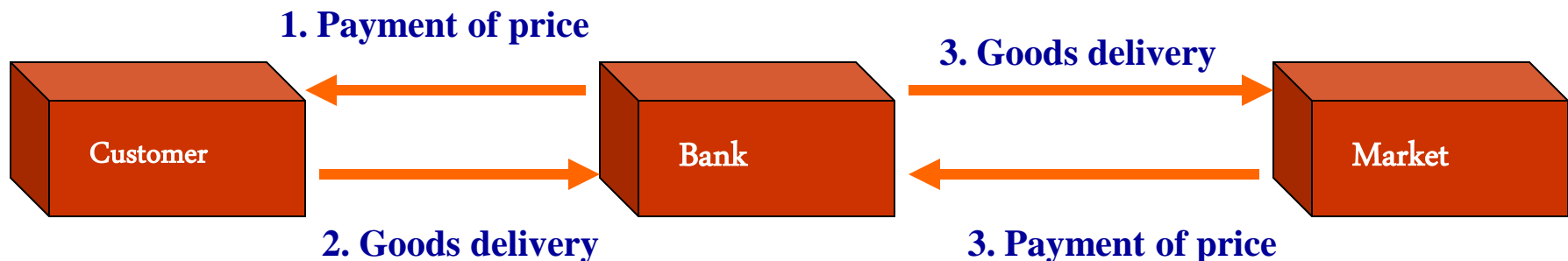




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## Salam - features

Underlying principle	Advance payment purchase
Tenure	Short Term
Rate	Fixed
Rescheduling of Price	No
Uses	Purchase of Agricultural/ Homogenous Commodities

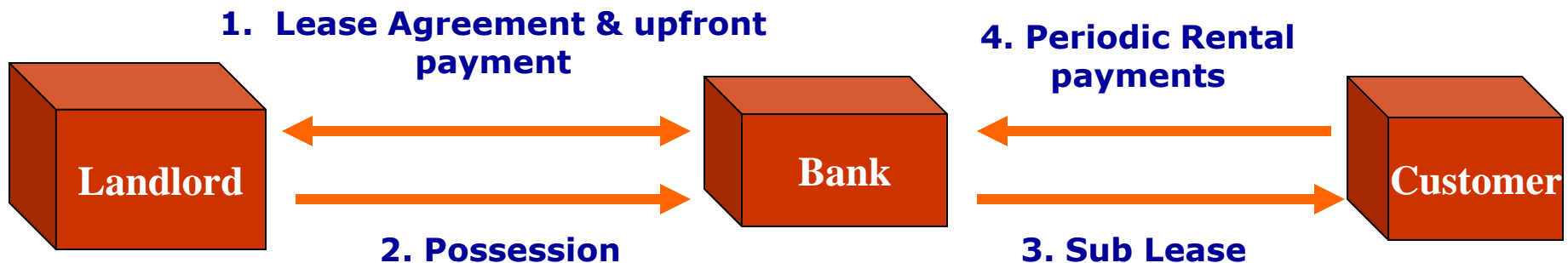




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## Lease & Sub lease - features

Underlying principle	Operating Lease
Tenure	Short Term
Rate	Fixed / variable
Uses	Rental financing





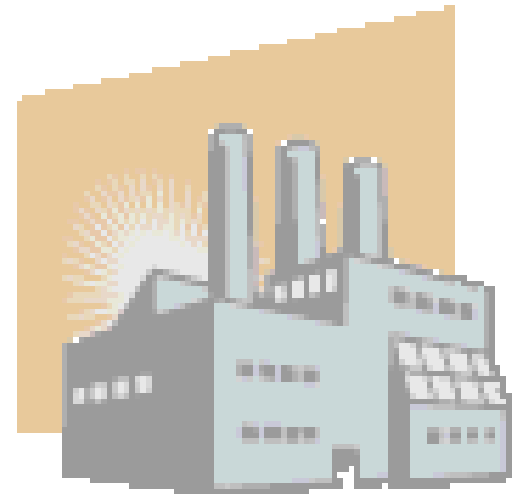
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# Long Term Financing Needs

- Acquisition/replacement/expansion of fixed assets, plant & machinery

## Islamic Banking solutions

1. Ijarah
2. Diminishing Musharakah





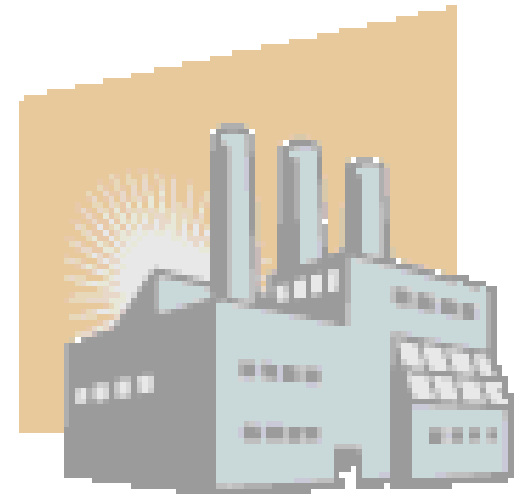
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# Long term Financing Needs

- Acquisition/replacement/expansion of fixed assets, plant & machinery

## Islamic Banking solutions:

1. Ijarah
2. Diminishing Musharakah
3. Sukuk





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# IJARAH



# Ijarah

- Ijarah is a term of Islamic Fiqh
- Literally, it means “To give something on rent”
- The term “Ijarah” is used in two situations:
  1. It means ‘To employ the services of a person on wages’ e.g. “A” hires a porter at the airport to carry his luggage
  2. Another type of Ijarah relates to paying rent for use of an asset or property defined as “LAND” in Islamic Economics



## Ijarah as a mode of financing

- Ijarah is an Islamic alternative of Leasing.
- Leasing backed by an acceptable contract is an acceptable transaction under Shariah.
- The question of whether or not the transaction of leasing is Shariah compliant depends on the terms and conditions of the contract.
- Several characteristics of conventional agreements may not conform to Shariah thus making the transaction un-Islamic and thereby invoking a prohibition.



## Ijarah-Key Difference

- Risk and rewards of ownership lies with the owner i.e. any loss to the asset beyond the control of the lessee should be borne by the Lessor.
- Late payment penalty cannot be charged to the income of the Lessor.
- Rentals start after delivery of asset in workable/usable condition.
- Lease and Sale agreement should be separate and non contingent.





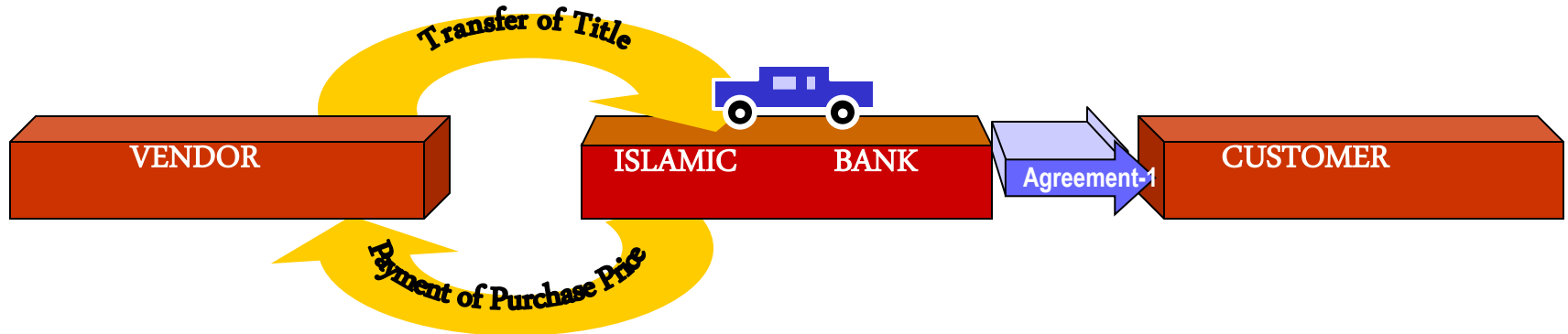
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# Process of Ijarah



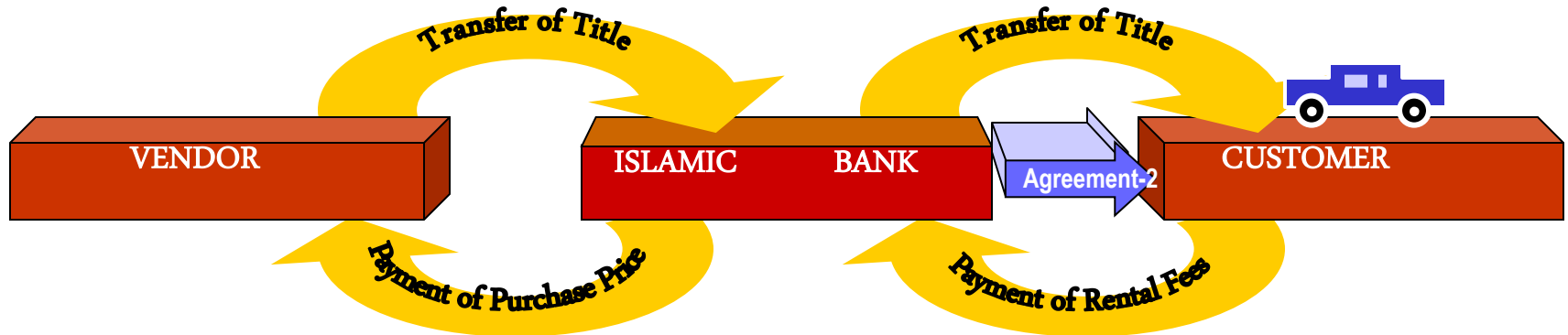
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# Ijarah



- The customer approaches the Bank with the request for financing and enters into a promise to lease agreement.
- The Bank purchases the item required for leasing and receives title of ownership from the vendor
- The Bank makes payment to the vendor

# Ijarah as a mode of financing



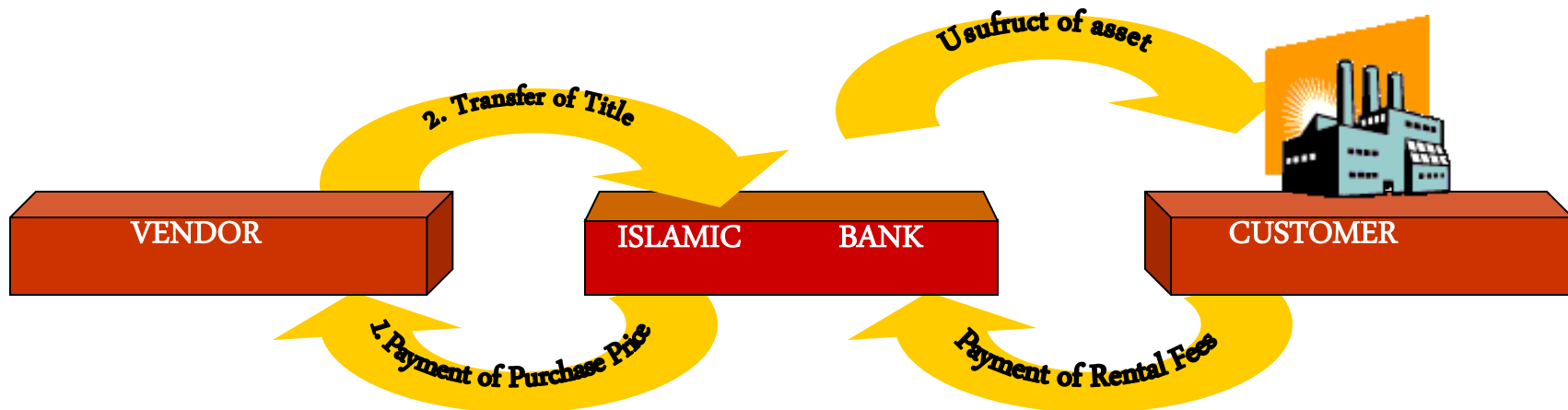
- The Bank leases the asset to the customer after execution of lease agreement.
- The customer makes periodic payments as per the contract
- At the end the Title can be transferred to the customer via separate Sale agreement.



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# IJARAH

Tenure	Long Term
Rate	Fixed / Variable
Early Termination	Yes
Uses	Fixed Assets Financing





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# Ijarah Documentation



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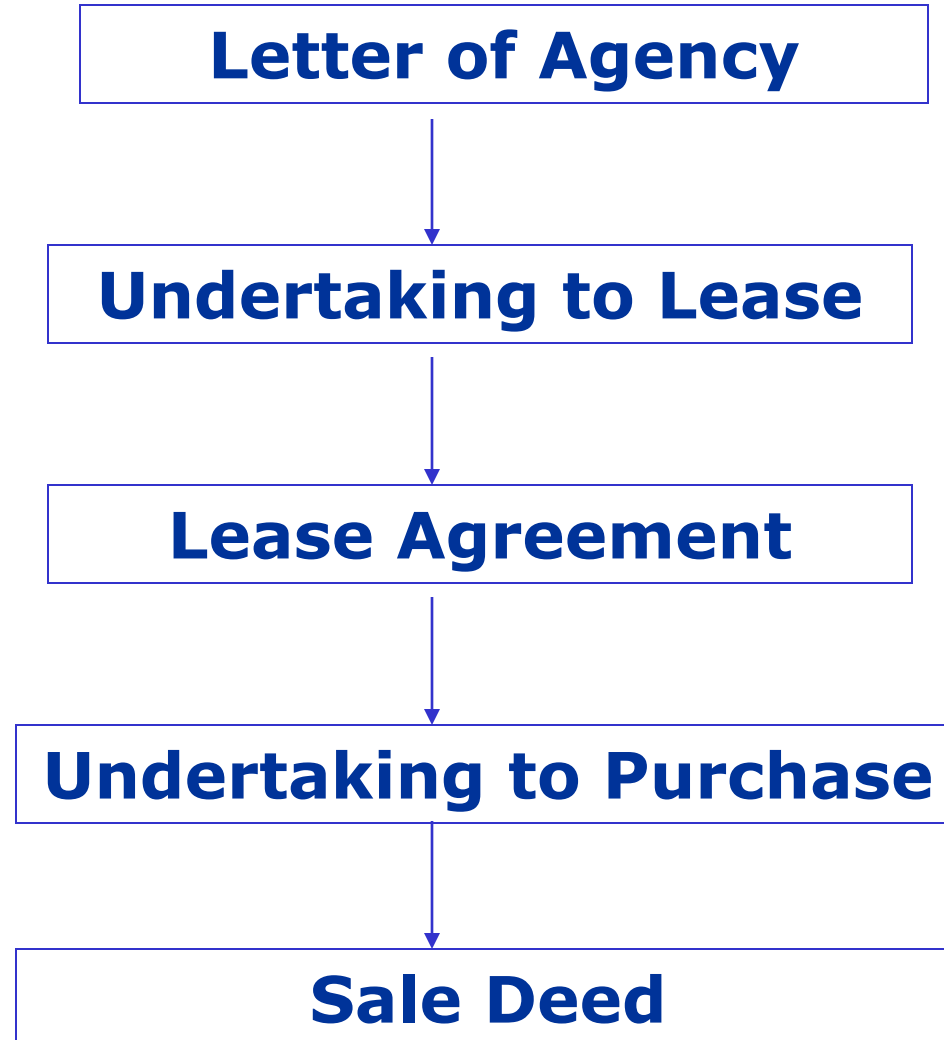
# Ijarah Documentation

- ☐ Undertaking to Ijarah
- ☐ Ijarah Agreement
  - Description of the Ijarah Asset
  - Schedule of of Ijarah Rentals
  - Receipt of Asset
  - Demand Promissory Note
- ☐ Undertaking to Purchase Ijarah Asset
- ☐ Sale Deed



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# Ijarah Documentation





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# Diminishing Musharakah-Introduction





## Diminishing Musharakah-

- In Diminishing Musharakah the financier and the client participate either in joint ownership of
  - a property or an equipment, or in a joint commercial enterprise
- The share of the financier will be divided into a number of units
- The client will purchase these units one by one periodically until he is the sole owner of the property



## Diminishing Musharakah-

- However generally Diminishing Musharakah is used in cases of Shirkat-ul-Milk
- It involves taking share in the ownership of a specific asset and then gradually transferring complete ownership to the other partner.
- This concept is based on Declining ownership of the financier
- 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



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# Diminishing Musharakah-

## Concept of Musha

- Musha means undivided ownership of the asset
- Lease of Musha
- It is allowed to lease Musha to other joint owner.



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# Basic Structure



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- **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.**
- **Customer pays rent for the use of banks share in the property**



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- **The customer approaches the Bank with the request for Project/Machinery 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.**
- **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. (with the help of a Sale transaction between bank & customer at the end of each period)**



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# Shariah Principles



## Shariah Principles

- To create joint ownership in property is called is Shirkat-ul-Milk and is expressly allowed by all schools of Islamic Jurisprudence.
- All Muslim Jurists agree on the permissibility of the Financier leasing his share in property to client and charging him rent i.e. the permissibility of leasing one's share to his partner.
- There is difference of opinion among leasing one's share to a third part But there is no difference on permissibility on leasing to a partner.





# Shariah Principles

- Promise of client to purchase units of share of financier is also allowed.
- The Transactions cannot be combined in a single arrangements and they have to be executed independently.
- This is because it is a well settled rule of Islamic Jurisprudence that one transaction cannot be made a condition for another.
- Instead of making the transactions a pre-condition for one another there can be one-sided promises from one party to another



# Shariah Principles

## Argument:

In the case of promise to sell units of share by financier one might argue that if the promise to sale has been done before entering into actual sale This is practically putting a condition on the sale itself

## Answer:

There is a difference between: Putting a condition on a sale and making a separate promise , without making it a condition.

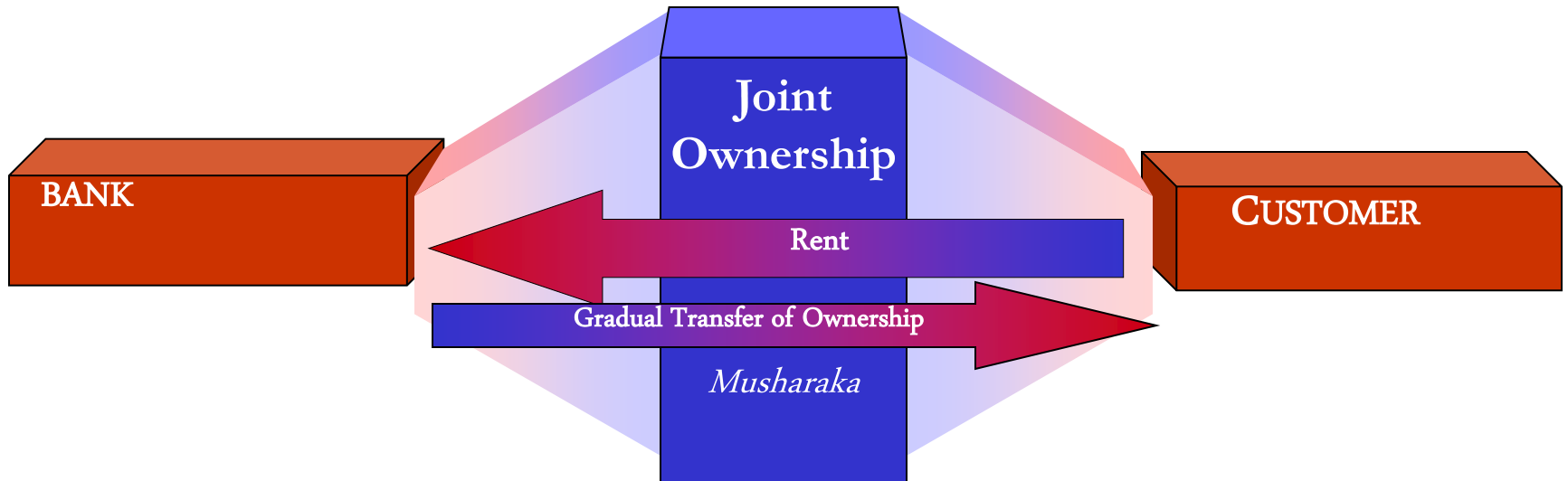
In case of condition, the sale will be valid only if the condition is fulfilled.



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# Diminishing Musharakah

<b>Tenure</b>	<b>Long Term</b>
<b>Rate</b>	<b>Fixed / Variable</b>
<b>Early Termination</b>	<b>Yes</b>
<b>Uses</b>	<b>Fixed Assets Financing</b>



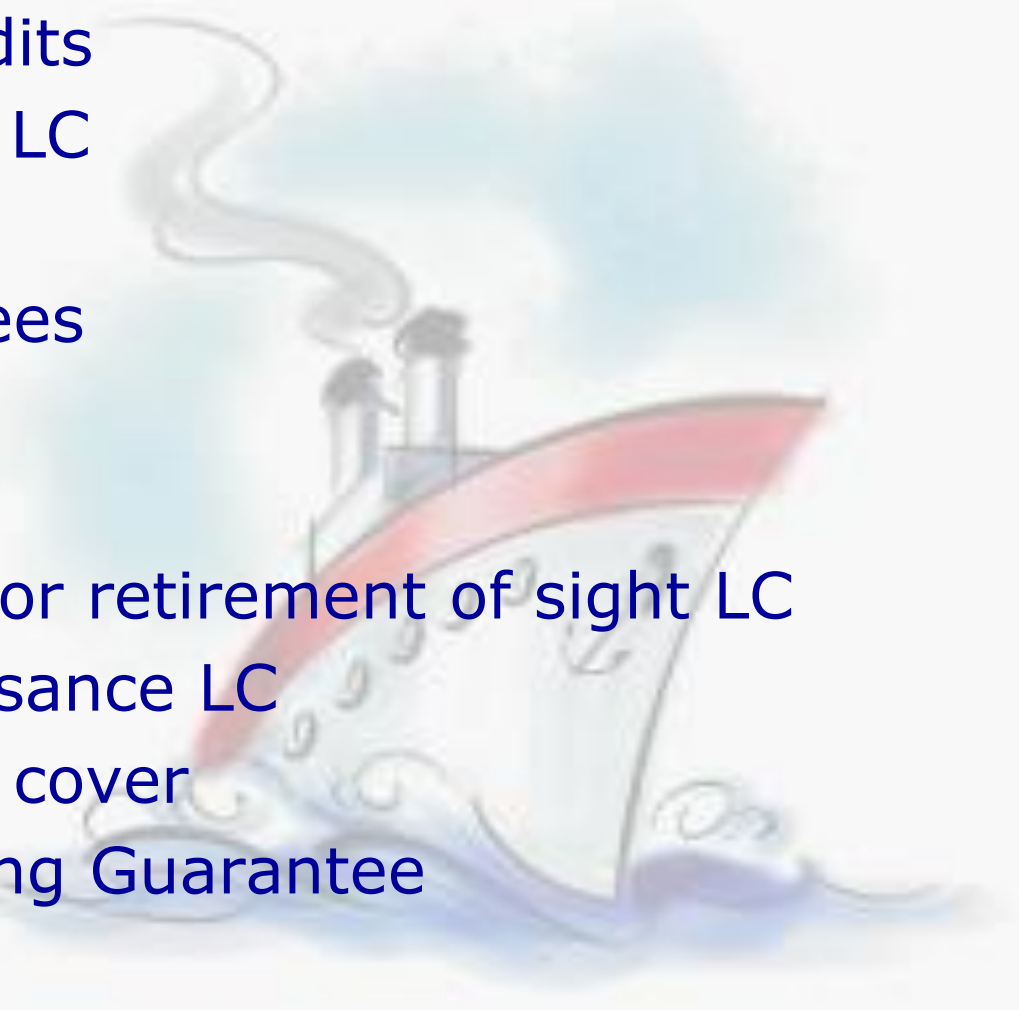


# Trade Finance Needs - Import

1. Documentary Credits
  - a. Sight LC / Usance LC
2. Forward Cover
3. Shipping Guarantees

## Possible Solutions

- Murabaha/Ijarah for retirement of sight LC
- Musawamah for Usance LC
- Wa'ad for forward cover
- Kafalah for Shipping Guarantee





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# Trade Finance Needs - Export

1. Alternative to Export Bill Discounting
2. Islamic Export Refinance Scheme

## Possible Solutions

- Murabaha/Istisna Islamic Export Refinance
- Murabaha/Tijara for Alternate to Export Bill Discounting





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## **SME focused banking**

- Fast track services & Special service counters
- Score card & program based approach for fast approval of financing
- Cash Collection service from customers' locations
- Extended online services. e.g, issuance of PO from online services
- Dedicated Shariah Advisory Desks at Islamic Banks
- Key challenges (documentation, security)



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Thank you