

## PROPOSING SUITABLE SHARĪ'AH COMPLIANT FINANCING SOLUTION TO THE BUSINESSES – INDUSTRY INSIGHT

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### ABSTRACT

*This paper highlights the importance of understanding (i) the features, risks and practical implications of modes of financing used by Islamic banks and, (ii) the business model of the customer in order to propose suitable and suitable Shari'ah compliant financing solution to the businesses. Lack of understanding in this regard may cripple the provision of ensuring strict Shari'ah compliance guidelines in true letter and spirit. The paper also emphasis the need of rigorous capacity building of Islamic banking staff, awareness Shari'ah sessions for customers and other related parties so that everyone know the role and responsibility expected from them while dealing in Islamic banking products and services.*

**KEYWORDS:** Islamic Banking, Shari'ah compliance, Business model, sustainable growth

**Introduction:** Ensuring Shari'ah compliance is the basic fiduciary responsibility of the Islamic banking institutions (IBIs). Faith-driven customers invest in Islamic banks due to reason that these are Shari'a-compliant (Shome, et al., 2018). Perception of Shari'ah non-compliance may negatively affect the reputation of the Islamic banks (Azrak, et al., 2016) It will also affect sustainability of these banks in the long-run (Rosman, et al., 2017). Since, Islamic banks are traders, business partners and lease the assets they provide the structured business solutions to the customers. Therefore, employees of Islamic banks must understand the features of the modes of financing as well as the practical implications of these structures. If they not understand this necessary knowledge, it will affect the Shari'a compliance level in the banks.

This paper calls the attention of all the stakeholders to take further measures to enhance the knowledge-level of their Islamic banking staff members and the related parties. Because developing Islamic banking and finance on the concrete foundations, which shall not only ensure better Shari'a compliance in the institutions today, but also give the opportunity to ripe the benefits of real business-based model of banking tagged with long-term and sustainable growth of the industry.

**How Islamic Banking involve in Businesses?** Islamic banks enter to different contracts like contract of sale, contract of lease, contract of partnership etc to do business. In trading, Islamic banks buy assets i.e. the subject matter of the contract from vendors and sell it to customers. Similarly, Islamic banks buy assets like cars and give it to customers on rent. They invest in businesses and share the profit. They provide services and get service charges. Whatever the case may be, they are actively doing trading and become part of the production process of businesses.

When Islamic banks involve in businesses as a trader or manufacturer or partner, the important point in it is to understand different businesses and how they are carrying out their operations. As trader they must know the rules of selling and buying, as a manufacturing concern they must know the manufacturing process and as a partner they need to know the profit-sharing rules, rules loss sharing, how the management of partnership can be done and how these partnerships be terminated.

Similarly, they must know the market norms, the terms and conditions, the industry and products related risks e.g. risk of Murabaha, Salam and Istisna, the pricing methodology, the payment mechanisms, the inventory management, transportation and delivery of goods, method of separation of goods, nature of purchase and sale evidences of every business sector which differs from industry to industry and product to product. To satisfy the customers' needs which ranges from purchasing raw material to project financing, Islamic banks have developed different financial products and services in order to deal with various industries and businesses. They have number of trade-based modes like Mūrabaha and Mūsawamah for purchasing of raw material, Istisnā and Salam for managing liquidity needs, Bai' Salam linked currency Salam for currency trading and finished goods for financing of finished goods financing. They also offer participating modes e.g. Musharakah, Mudarabah Muzara'a and Musaqat for business needs. They have Ijarah for renting vehicles, motorbikes and generators etc. Therefore, rather than lending money to the customers as conventional banks do in majority of the cases, Islamic banks are using different business structures, modes and different relationships for satisfying the business needs of their customers.

Moreover, Islamic banks present different variants to best suit the customer financing needs. For example, they have different financing method of Mūrabaha based on the needs of different customers, different products and different industries. Thus, process-flow of Mūrabaha, for iron is different from sugar-cane and floor mills. This is because sugar-case has different risk structure and different business technique. Similarly, the business methodology of cement industry is quite different from coal and steel industry. Risks in export Mūrabaha transactions are different from Mūrabaha in import Mūrabaha transactions. The method of segregation of subject matter varies for medicines products and agricultural products. The method of payment to the supplier and the customer is also different in different industries. Sometimes amount is paid in cash, sometimes in bank draft and sometime it is paid through customer itself and sometimes directly to the vendors. Still the list is not complete, only for one mode i.e. Mūrabaha, because the way of doing business is different for different products and industries. One of the important points drawn from the above discussion is that each financial contract and business transaction in Islamic law has its own essence and sanctity. Without going deep into the philosophy of why Islam permits these so many contracts, every contract is allowed for facilitating the specific human business need. Mūrabaha is allowed along-with Mūsawamah. What we are experiencing in contemporary Islamic banking, in certain cases where Mūrabaha cannot be used, Islamic banks have the liberty to use Mūsawamah. Same is the case with Istisnā and Salam and so on and so forth. Based on the background discussed so forth, it is easy to apprehend the theme of the paper, 'Proposing Suitable Shari'ah Compliant Financing Solution to the Businesses'. Hence, it is pertinent that Islamic bankers involved in financing activity, in one way or the other<sup>1</sup>, need to understand which mode is exactly suitable for satisfying customer financial needs. At first instance, it looks simple, but practically it is not easy. What it

requires from the Islamic banking staff, the customers and the other stakeholders like suppliers, vendors and even Muqaddam is outlined in the section below.

**The required skills and knowledge** First step in proposing the correct Shari'ah-compliant financing alternative is the deep understanding of the features and practical implications of each available financing alternative in the Islamic bank's portfolio. For example, Mūrabaha is a 'trust sale' which implies that if the bank receives any discount from the supplier, the same shall be transferred to the customer. On the other hand, Istisnā may be used in cases for providing liquidity to the customers, since the Islamic banks are concerned with 'manufactured goods' at maturity. Similarly, Istisnā means manufacturing a thing from raw material involving labour, therefore, for selling finished goods already available in stock, Istisnā is not suitable but certainly Tijarah is. Second step in this way is correctly identifying the customer business need to ascertain the purpose for which customer requires the funds. It is done through a detail discussion with the customer; whether he requires the funds for buying raw material like cotton or sugar-cane or paying wages and salaries or for medium to long-term project financing needs like buying building as well as machinery or any other equipment. Once the need is correctly identified, it is the time to align the customers' financing requirement with financing alternatives with the bank by choosing the best, the one which satisfy the financing need without disturbing the Shari'ah rules and principles deduced from Islamic commercial law.

Once these basic steps are completed, the credit proposal is reviewed and approved if the credit and risk related requirements are met. It is important for Risk Management Group (RMG) at this stage to consider the Shari'ah compliance risk at par with other business risks<sup>2</sup>. Third step in this regard is drafting a process-flow of the business transaction. This is the most critical step whereby the step by step way of doing business is elaborated. It also defines the responsibilities of relationship manager, branch manager, credit administration and risk department, the business team and staff of Shari'ah department.

This is the stage where relationship managers, branch managers and staff of the Shari'a department are expected to be more vigilant. They are required to understand that how the customer is doing business? The customer, in all such cases may be a corporate client, SME, a firm or a sole-proprietor with different risk profile and industry dynamics. Why it is important that all the bank staff involved must understand the business cycle of the customer? Here are some of the reasons:

- ❑ Shari'ah team normally review credit application of the customer,
- ❑ Business team deal actively with the customer and prepare the process-flow of the transaction which is then approved by the staff of the Shari'ah department.
- ❑ Understanding different inherent risks, control risk and detection risk and applying proper internal controls in each step of the process-flow,
- ❑ Understanding the Shari'ah-compliance risk, its dimensions in product to product and industry to industry,

- ❑ Ensuring that the steps and documentation of each transaction are executed in true letter and spirit,
- ❑ Conducting effective client visits.

To understand customer business cycle, Islamic banks usually use a Customer Information Sheet (CIS) to collect the business related information of the customers that helps in drafting the transactional process-flow. For example, a customer requires the credit to purchase raw material. A suitable mode in this regard is Mūrabaha. The business and Shari'ah staff needs to understand the following dimensions:

Point to understand	Description	Example
<i>What is the nature of the business of the customer?</i>	Whether the customer is involved in trading activity or manufacturing or distribution or using a mix of these activities.	Textile industry is a manufacturing concern
<i>What kind of raw material is used by the customer?</i>	Name of the assets, goods or commodities purchased by the customer as a raw material.	Cotton, Polyester etc.
<i>Who are the providers of this raw material?</i>	The list of suppliers or vendors or contractor is asked from the customer.	Textile industry purchases cotton from farmers.
<i>How the suppliers pack the raw material?</i>	Type of packing includes bags, sacks, drums, cartons and the raw material is sold without any packaging i.e. Open	Sacks
<i>Is there any prior relationship of customer &amp; supplier?</i>	It is necessary to confirm if there is any blood relation or prior contractual relationship between customer and supplier to avoid Bai' Enah or fictitious transaction etc.	Normally textile industry has long contractual relationship with suppliers. They purchase cotton other than bank finance.
<i>What is the mode of payment to the supplier?</i>	Either the bank pay directly to the supplier or vendor or credit the customer account for pay-order, demand draft, online slips etc. In some cases, physical cash is also paid.	Usually indirect payment is made to the suppliers. Where farmers do not have bank account, physical cash is paid. Extra controls are applied to ensure that the cash is not used for other purposes by the customer.

Some of the sample questions mentioned in the chart shows that nature of each business need to be evaluated to prepare a customer specific transaction process-flow. The list is not exhaustive. It only covers some of the areas of supplier-side. The customer-side is separately understood. For example, how customer manages the inventory? Following questions may help in this regard:

Point to understand	Description	Example
<i>How customers ensure the separation of banks goods from own his goods?</i>	Whether they use separate go-downs? Or if same go-down is used the separate by Tagging/ Bin-cards. In case of liquid like oil they inventory is managed on Musha.	Bin Cards

<i>What is the inventory holding period?</i>	To ensure that the offer & acceptance is done before inventory is sent for work in process.	It differs from season to season. Normally, textile industry holds inventory for 60 – 90 days.
<i>What is the inventory usage method?</i>	Whether it is FIFO or AVCO.	FIFO

Hence, for drafting a customized alternative for businesses, all the variables that affect the way of doing business need to be understood in order to ensure Sharī'ah compliance in true letter and spirit.

A step forward, understanding of customer matters is important. In Mūrabaha transaction, for example, customer must understand the importance of the fact that the goods purchased under Mūrabaha are owned by the bank and cannot be used by him before declaration and offer and acceptance stage (it is called Mūrabaha contract in Islamic banking). If customer has taken more than one product-lines like for example Mūrabaha and Istisnā, customer (even Muqaddam) should know the difference and purpose of different documents used in different products. For example, customer and Muqaddam sometimes may not distinguish between Mūrabaha Declaration and Murabaha contract with the 'Goods Receiving Note (GRN)' of Istisnā transaction.

Therefore, since Islamic banks are practically involved in business and production process by offering trade-based modes, lease-based modes and participation-based modes they must have deep understanding of features and risks of Islamic modes of financing as well as the business model of the customers. This shall lead to:

- ❑ Understand the nature of business.
- ❑ Understand the customer and customer-related Inherent risks including Sharī'ah compliance risk.
- ❑ Apply requisite Sharī'ah controls.
- ❑ Prepare process-flow according to customer needs in light of Sharī'ah principles.
- ❑ Each party understands the roles and responsibility at each step of the transaction.
- ❑ Avoid fictitious transactions e.g. offering Mūrabaha for paying electricity bills.
- ❑ Avoid fake invoicing and other purchase and sale evidences for covering up the transaction.
- ❑ Avoid loss of income (If any anomalies are detected at later stages in Sharī'ah audit and Sharī'ah compliance reviews).
- ❑ Help in conducting an effective and informed customer visits.

On the other hand, any negligence in this regard leads to cripple the provision of Sharī'ah compliance in Islamic banks, which is mainly and the only reason for their existence. The Product Development staff is expected to involve actively with business team and customer to understand and facilitate the transaction.

**The Way Forward** Although at this stage, Islamic banks use certain arrangements to avoid excessive involvement in trading and production process like making agency agreement, however, to ensure Sharī'ah-compliance in true letter and spirit and for the long and sustainable growth of Islamic banking, it is need of the hour to equip the Islamic banking staff with:

- ❑ Deep understanding of Islamic modes of financing, the features, risks and practical implications and sanctity of documents used in each transaction.
- ❑ Ability to identify the correct financing need of the customer.
- ❑ Understand business model of the customer in order to propose suitable Shari'ah-compliant solution.

Following steps may be taken in this regard,

❑ **Enhanced Training & Capacity Building Measure of Islamic Banking Staff**

Extensive training of all the related staff including credit, risk, credit, risk management, audit, compliance, business teams and Shari'a staff on business-models and Shari'a is required. State Bank of Pakistan (SBP) has taken an initiative encouraged Islamic banks to train their staff and create a culture of continuous learning for development of knowledge and capacity in Islamic banking industry (SBP, 2018).

❑ **Awareness Sessions for the General Public & Customers**

Training & awareness sessions for customers should be arranged so that the customer should be capable to understand their role and responsibilities.

❑ **Strong Industry-Academia Collaboration**

For long-term sustainable growth, there is a need to teach applied knowledge of Islamic banking & finance to under-grad and grad students. The dilemma with the academics is that their sole focus is teaching the theory. The more specific application of Islamic modes is required. The academic institutions should engage industry practitioners having hands-on knowledge of the practices.

*This is a preliminary article to start the discussion that why it is important to understand the nature of Islamic financial contracts and their practical application in Islamic banking and finance. Islamic banking & finance professionals and industry practitioners are encouraged to share their practical experiences while offering Islamic financial modes so that the industry insights may help all stakeholders to understand the industry and product related risks. Suggestions and comments are welcome [zahoor.ahmed.79@gmail.com](mailto:zahoor.ahmed.79@gmail.com)*

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<sup>1</sup> This includes business team (corporate/ commercial or SME), credit administration department, risk management group, product and Shari'a team.

<sup>2</sup> Discussing the credit approval process and explaining each step in detail is out of the scope of this paper.