

CIFE13, 14, 15: UNDERSTANDING SALAM AND ISTISNA – FORWARD SALE AND MANUFACTURING CONTRACTS

What makes a forward contract Islamic? Learn here. In this module on Salam, the Islamic forward sale, and Istisna, the Islamic manufacturing contract, we begin with Salam. We look at the goods for which a Salam may be executed, the prerequisites, and the use of a Parallel Salam. We discuss security, replacement, and default before explaining how its pricing is calculated. We then look at Istisna and discuss the major differences between it and the Salam. We also discuss delivery, default, and termination in an Istisna. We conclude the 3 module series with a practical product structuring exercise where you get to choose the appropriate financing tools in a given scenario.



Salam is a sale where the price of the subject matter is paid in full at the time of the contract's execution while the delivery of the subject matter is deferred to a future date. It is not necessary that the subject matter exist, and be owned and possessed by the seller at the time of the Salam's execution as is the customary requirement of a standard sale, provided it meets the other criteria specific to it. Salam is a mode of finance that helps the seller generate and utilize liquidity and at the same time allows the buyer to purchase commodities for a price lower than the spot market price.

A Salam may be executed for homogeneous commodities but not for specific commodities and mediums of exchange.

Homogeneous commodities, also termed fungible, are similar to one another and are sold as units. The difference between them is negligible. Since they are homogeneous, in case of loss, one unit may be replaced by another.

Salam Prerequisites

1. The quantity and quality of Salam goods must be specified in order to avoid any ambiguity that may lead to dispute between contracting parties. Salam goods must be readily available in the market so that at the time of delivery if they do not meet specifications the seller can procure them easily and supply them to the buyer.
2. Salam price must be paid at spot. The price is fixed and cannot be increased due to an increase in the price of Salam goods in the market during the contract's term. The seller must deliver the goods without demanding any excess money as the Salam goods become the property of the purchaser once the contract is signed.
3. The place of delivery of Salam goods must be specified and they must be delivered in their entirety on a fixed future date or in installments on predetermined dates.
4. Salam goods cannot be sold to a third party before receiving possession however a parallel Salam may be executed for them.

Parallel Salam

A Parallel Salam is a transaction executed simultaneously with the original Salam. The buyer of goods in the first Salam is the seller of goods in the second or Parallel Salam.

For instance, a buyer makes a payment for the subject matter to be delivered at a date, three months in the future.

At the same time, as a seller, he executes another Salam for a higher price with a third party for the same goods to be received by him in the future. This way the money disbursed to purchase goods in the first Salam is retrieved as price payment and profit from the parallel Salam. Once the goods of the original transaction are delivered they are transferred to the buyer in the Parallel Salam.

A Parallel Salam is permitted with a third party only.

Salam Essentials

Price

Most things established as the price for an ordinary sale may also be established as Salam price (i.e. cash, goods and usufruct).

It is important to remember that goods may serve as the Salam price provided they do not fall into the Amwaal e Ribawiya category.

Usufruct refers to the benefits received from a particular asset. The buyer in a Salam may offer the seller an asset's usufruct for a specific time period as the Salam price.

The Salam price is determined based on the number of days the bank's funds remain invested in the Salam transaction.

Subject Matter

1. The subject matter must fall into the category of homogeneous goods and be easily available in the market throughout the contract's term or at the time of delivery.
2. The subject matter must be clearly specified in terms of quantity and quality.
3. The subject matter must not be a commodity for which value cannot be established. For instance precious stones.
4. The Khayar al Aib (option of defect) may be exercised for Salam subject matter, however, not the Khayar al Rooyat (option of refusal).

The *Khayaar al Aib* is an option that a buyer may exercise to return goods to the seller if they are found to be defective according to the specifications at the time of delivery.

The *Khayaar al Rooyat* is an option of refusal based on which the buyer may decline from accepting the goods as a result of non-conformity to specifications.

Delivery of Salam goods

1. The date of delivery of the subject matter must be clearly established at the time of the contract's execution.
2. The place of delivery of the Salam goods must also be clearly specified.
3. The delivery of the subject matter implies the complete transfer of its ownership.

Salam Termination

Once executed, a Salam may not be revoked unilaterally by either party. It is a sale contract binding on both parties and may be terminated completely or partially by mutual consent by returning the actual or proportionate amount of the price paid.

Salam Term

A Salam may be executed for any length of time mutually agreed upon between the buyer and the seller.

Security in a Salam

Since Salam is based on advance payment, the buyer is within his rights to obtain a form of security from the seller. In case of default, the buyer liquidates the security and makes up for the actual price paid for the subject matter.

Alternatively at the time of contract execution, the buyer may establish that in case of default, he will sell the security in the market and purchase the goods that the seller was supposed to provide at their going rate. The seller will then make up for the price difference if any.

Replacement of Salam Subject Matter

Salam subject matter cannot be replaced before the delivery date however it may substituted for another commodity based on mutual consent and the observance of some conditions.

Delay in Delivery of Salam Subject Matter

In case the seller is unable to deliver the subject matter on time, the buyer may not charge a penalty, however, a charity clause established at the time of contract execution serves as a deterrent against a delay in delivery.

Default in Salam

Default in a Salam may be intentional or unintentional.

Unintentional

If the seller is unable to meet delivery due to unavailability of goods or a price rise:

- The buyer may wait for the commodity to return to the market or
- Both parties can mutually agree to terminate the contract and the buyer may be reimbursed the entire payment or
- Both parties may mutually agree to replace the original subject matter with another commodity

Intentional Default

In the case where the seller deliberately does not purchase the commodity from the market to avoid a personal loss, he must be compelled to follow through with the original commitment or else the buyer may liquidate the security to make up for loss.

Salam: Practical Application

The price of goods in a Salam may be fixed at a lower rate than the price of goods delivered at spot. The difference between the two prices earns the financial institution a legitimate profit.

The Islamic bank after purchasing the commodity may sell it through a parallel Salam contract for the same delivery date.

If a parallel Salam is not feasible, the Islamic bank may obtain a promise to purchase from a third party.

Istisna

An Istisna is a transaction used to acquire an asset manufactured on order. It may be executed directly with the supplier or any other party that undertakes to have the asset manufactured.

There are usually two parties involved in an Istisna contract; the Istisna requestor, or orderer, and the manufacturer.

An Istisna takes place when one party agrees to manufacture a product for another party at a specific price. This agreement involves an exchange of an offer and an acceptance which completes the contract.

Subject Matter in an Istisna

1. The subject matter of an Istisna need not exist, be owned or possessed by the manufacturer at the time of contract execution.
2. It must be an item that is manufactured as customary market practice and undergoes processing to convert from one form to another.
3. The manufacturer cannot execute a pre-agreed Istisna for goods that he already possesses.
4. The Istisna subject matter must be clearly specified.
5. The manufacturer and not the Istisna requestor must procure the subject matter.
6. Unless the requestor stipulates otherwise, the manufacturer may also have the goods produced from another source.
7. The quantity or quality of Istisna subject matter can be changed by mutual consent of the contracting parties.
8. The Istisna requestor reserves the right to exercise the Khayar al Aib after receiving the delivery of Istisna goods within a certain time limit the manufacturer specifies.

Istisna Essentials

1. Cash, goods and usufruct may serve as the Istisna price.

Goods may be established as the Istisna price provided they do not fall into the category of Amwaal al Ribawiya.

2. Istisna price may be paid at the time of contract execution, in fixed installments over the contract's term or as a lump sum at the end of the contract's term.
3. The Istisna price is mutually agreed upon between the Istisna requestor and manufacturer at the time of contract execution.
4. The Istisna price may not be established on a cost plus profit basis like a Murabaha but as a lump sum.

The manufacturer need not pass on the benefit of a lower manufacturing cost to the requestor and conversely if the manufacturing cost turns out to be greater than the estimate, he must bear it.

Istisna Term

An Istisna may be executed for a time period mutually agreed between the Istisna requestor and Istisna manufacturer. In case a time period is not agreed upon, the goods may be manufactured and delivered within a reasonable period of time as is the market norm for those goods.

Parallel Istisna

A parallel Istisna is a second Istisna contract executed alongside the first Istisna. The manufacturer in the original contract serves as the Istisna requestor in the parallel contract and profits from a difference in price. The parallel Istisna is completely separate and independent of the original Istisna contract.

For instance a client places an order for the manufacture of goods with an Islamic bank, the bank enters into an Istisna with the manufacturer.

Once the bank receives the goods, it transfers them to the client.

As the client is the ultimate buyer, the bank may appoint him as an agent to supervise the production of the Istisna goods.

It is important to remember that the bank may not enter into an existing Istisna contract between two parties.

Default in Istisna

The Islamic bank may demand security in its capacity as requestor or manufacturer. Such a security is called Arbun. Arbun is a non-refundable down payment that the seller/manufacturer receives from the buyer/requestor, in order to secure the purchase of goods.

Delivery of Istisna Goods

1. The buyer may not consume Istisna goods before they are delivered. The buyer must first assume physical or constructive possession of the goods.
2. If Istisna goods do not meet specifications and are of an inferior quality, the buyer can reject them however if they are of superior quality he must accept them unless he requires them as raw material.
3. The buyer may accept Istisna goods of an inferior quality if the manufacturer agrees to reduce their price.
4. In case of early delivery, the buyer may accept it provided it does not adversely affect his prior arrangements.

5. If the buyer delays accepting goods delivered on time, the manufacturer may charge him for the expense for holding them on his behalf.
6. If the buyer refuses to accept goods, the manufacturer may sell the goods as agent on the buyer's behalf. Any amount above the original price is returned to the buyer and if goods sell for a lower price, the buyer is expected to pay the difference.

Shart al Jazai

A penalty established at the time of contract execution that allows for a reduction in the price of manufactured goods in case of a delay in their delivery. Such a penalty is only permitted in manufacturing contracts as the buyer requires the goods at a fixed time and in the absence of a deterrent, a delay in delivery could have serious consequences with respect to follow-on commitments.

Rebate in an Istisna

The manufacturer is permitted to grant the Istisna requestor a rebate in the price at his own discretion. A rebate may not be stipulated at contract execution.

Prohibition of Buy-Back

The Istisna must not involve a buy-back at any stage. Before the Istisna is executed it is important to ensure that the contracting parties are separate and independent legal entities.

Istisna Termination

Either of the two contracting parties may terminate the Istisna unilaterally provided the manufacturing process has not commenced. If manufacturing has begun then the contract is binding on both parties and can only be terminated by mutual consent.

Istisna: Practical Applications

An Istisna can be used to finance construction, export and infrastructure development.