A Concise Glossary on Technical Terms used in the Literature on Islāmic Business and Finance

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Editor's Note: *A comprehensive glossary of Sharī'ah related terms used in Islāmic commercial law – business, banking and finance was published in the JIBM, Vol.2 No.2, 2012. In continuation of that, JIBM is making another humble addition to the literature on Islāmic business, banking and finance by giving the, so far, most concise glossary on technical terms being used currently in the literature of Islāmic finance. Sincere effort has been made to portray the best explanation of the terms. However, mistakes or problems, if any, or any further terms needed to be added / explained, may kindly be brought into notice at editor.jibm@riphah.edu.pk so that corrections could be made, or additions given in the any future Issue of the JIBM.*

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Accessory Contracts: In the literature on Islāmic law, a number of contracts have been discussed that can be considered as accessory or sub-contracts, within the main contracts like *shirkah*, *ijārah* or *bai'*, although sometimes these are used as the main contracts. Such contracts are: *wakālah*, *amānah*, *ḥawālah* (assignment of debt), *kafālah* (guarantee), *ju'ālah* (reward payable on completion of a job), etc.

Actuary: A highly professional individual, who computes statistics relating to *takāful* /insurance, typically estimating loss reserves and developing contribution rates. The ultimate objective of an actuary is to quantify the risks and ensure fairness to all parties in the operation of *takāful*. Specifically, the roles of an actuary include: i) Calculation of mathematical reserves; ii) Determination of surplus; iii) Ensuring company's solvency; iv) Determination of appropriate re-*takāful* program; v) Asset liability management and General risk management, and vi) Development and analysis of industry and company's experience.

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Actuarial Surplus: Surplus at the end of a financial year of family *takāful* fund that is determined by actuarial valuation.

Asset-backed Security: The securities backed by an income generating asset with defined cash flow. It involves true sale securitization where the recourse is to the underlying asset and not the originator. It implies that their holder would be compensated out of the proceeds of the underlying asset or pool - their credit-risk profile is delinked from that of the originator and is, instead, determined solely by the performance of the asset. These are different from the asset based securities [see below)]. Typically, *ṣukūk* have to be asset-backed enabling their valid trade in the capital market from the Sharī'ah perspective. The structure and operation of such *ṣukūk* are closer to the principles and the spirit of the Sharī'ah. Holders of such *ṣukūk* have lien over the assets, and are therefore in a preferential position over other unsecured creditors.

Asset-based Security: The securities that are based on an undertaking by the Originator to be liable for payments to the holder. Although there might be any underlying asset to facilitate the issue or the transaction, but that is only for the purpose of Sharī'ah fulfillment legally rather than to serve as a source of profit and capital payments. Hence, here the recourse is to the originator who undertakes to repurchase the assets at maturity of the *ṣukūk*, or upon a pre-defined early termination event, for an amount equal to the principal repayment, irrespective of the market price at that time. In case the originator is unable to repurchase the assets, the security holders have no pr eferential position to any other creditors. Asset-based *ṣukūk*, having debt like structure, commonly referred to as "Islāmic bonds", are generally considered objectionable from the perspective of Islāmic law of contracts. Further, all defaults so far have pertained to the "asset-based" *ṣukūk*.

Advance against *Murābaḥah* Account: 'Advance against *murābaḥah*' is the title of Account in which the payment (advance) for the purchase of the goods is recorded by an Islāmic bank. At the culmination of *murābaḥah* i.e. at the time of sale of goods to the customers (with signing of declaration by the bank and the client), the advance against *murābaḥah* account is adjusted with the '*murābaḥah* Financing Account'.

Agent: An agent is a person (or company) employed by another person (or company) called the Principal, for the purpose of doing any jobs like selling or purchasing for the principal or arranging the contracts between the principal and the third party. An agent thus acts as an intermediary in bringing together the buyer and seller or parties to any other contracts.

Agency could be both paid (fee for the service rendered) or non-paid (without payment).

Al-*Ṣanādīq*: (Singular: *ṣandūq* which means box/coffer); in finance they refer to Islāmic Funds, investment funds, accounts or portfolio.

Annuity: A term used in insurance - a series of equal payments of fixed intervals from an original lump sum investment. In other words, a financial product sold by financial institutions that is designed to accept and grow funds from an individual and then, upon annuitization, pay out a stream of payments to the individual at a later point in time. Annuities are primarily used as a means of securing a steady cash flow for an individual during retirement years. *Takāful* annuity is a contract that provides a stream of periodic income upon retirement for a term dependent upon human life. There could be Sharī'ah compliant *takāful* annuities on the basis of cooperative fund pooling and risk sharing, of course, remaining within the principles of Islāmic law of contracts.

Arbitrage: It is the process of making money out of the price differentials in two market / products / instruments; i.e. simultaneous purchase and sale of the same commodity at price(s) which guarantee an assured profit; allowed as per Sharī'ah rules if both of the transactions are otherwise valid and involve ownership transfer and possession.

Arbitration: Arbitration is a process in which an arbitrator (neutral / third person/party) or an arbitral tribunal, is nominated / hired for the resolution of disputes outside the courts. Arbitrators review the evidence in the case and impose a decision that might be legally binding on both sides and enforceable in the courts.

Back-to-back Financing: In case the bank is in tight liquidity position, it directs financing of a specific transaction to another bank.

Balance Transfer Facility (BTF): A facility provided to a person having conventional mortgage to convert that to Islāmic basis by using the concept of '*Sale and Lease-back*'. The client sells a part of the property, say 50% ownership units, to Islāmic bank and, from the proceeds, pays the mortgage debt; Islāmic bank leases its part of the property to the client on rent payable as and when the lease agreement takes place. However, to avoid *bai' al-'īnah*, the sale of ownership units back to the client has to be after (one year) or such time that the value of the property changes, as decided by the Sharī'ah committee on merit.

Banca *Takāful*: Banca *takāful* is the distribution of *takāful* products by banking institutions. A bank and a *takāful* company enter into an arrangement in terms of which bank provides *takāful* products to its client.

In recent years, Islāmic banks have started offering banca *takāful* policies serving as agent to the *takāful* Companies. They market and sell the products via their retail branch networks to the prospective participants. It is desirable that the banks may charge lower policy distribution fee than what the *takāful* companies (TCs) with corporate structure charge from the participants as banks have not to undertake as much efforts and incur expenses as required in case of individual distribution agents hired by the TCs .

Balance Sheet Risk Management: Risk management by re-structuring the asset and liability items on the balance sheet (B/S). During last three decades, emphasis has shifted from B/S to Off B/S risk management, relying heavily on financial derivatives. For IFIs, balance sheet RM is still vital due to prohibition of financial derivatives.

Banking *Murābaḥah*: The *murābaḥah* by Islāmic banks as a mode of finance; different from the traditional *murābaḥah* as discussed in books of Islāmic *fiqh*. It comprises a number of contracts and specific processes for providing goods to the clients on credit and fulfilling their financial needs. AAOIFI has titled it as '*Murābaḥah to the Purchase Orderer'*.

Benchmark: A reference rate or standard by which something can be measured or judged. Benchmarks are needed for executing and pricing the contracts. In banking sector, all investment and financing rates are benchmarked both at the national and global levels by reference rates like Karachi Interbank Offered Rate (KIBOR), LIBOR, etc. For conventional finance, there is mainly one reference rate (interest rate), while for Islāmic finance, two reference scales are needed: Price / mark up/ rent reference scale, and the sharing ratio reference scale, through the central bank *muḍārabah* ratio or interbank *muḍārabah* ratios.

Capital Adequacy Ratio (CAR): Capital Adequacy Ratio is the ratio of a bank's capital to its risk weighted capital. National regulators track a bank's CAR to ensure that it can absorb a reasonable amount of loss and complies with statutory capital requirements.

Capital Gain: Money made by selling a fixed asset or shares, when the sale is done at the price higher than the purchase price, is called Capital Gain (opposite to capital loss.)

Capital Loss: A loss made by selling fixed assets or shares, when the sale is done at the price lower than the purchase price (opposite to capital gain)

Capital Recovery Risk: The risk of inability to keep the capital in a business intact, or to regain the invested capital from an instrument of investment like a Stock or Security maintained by financial institutions in

case of a loss.

Cash Flow Financing: Short-term financing to provide additional cash to cover cash shortfalls in anticipation of revenue, such as the receivables.

Catastrophic Risk: The risk arising from the possibility of the occurrence of a natural disaster causing loss of or damage to goods.

Cedant: A *takāful* Operator giving contributions to a *retakāful* company that agrees to indemnify the former for all or part of the loss that it might sustain, under the *takāful* contracts that it has made as manager of the *takāful* Fund – the risk fund, is known as a cedant, sometimes spelt as cedent.

***Ceteris Paribus*:** A Latin phrase meaning "keeping all other things (factors) equal or held constant".

Charity Clause: A stipulation made at the time of contract execution which requires paying a certain amount as charity, whenever a default in payment of any due amount of money by the clients of Islāmic financial institutions (IFI) will arise in future, in the contracts of *ijārah*, *murābaḥah*, etc. Such amount of charity is not treated as income of Islāmic bank or IFI.

Claims Stabilization Reserve (CSR): The reserve kept in *takāful* and re-*takāful* for ensuring and smoothing the payment of claims. Some industry practitioners suggest that the whole amount of surplus in the Risk Fund may be kept as CSR. If the CSR amounts are used only for the purpose of claims payments in future, such reserves could be allowed provided proper disclosure is made to the participants.

Collateral: Any security for keeping the assets pledged for the repayment of a debt. The collateral serves as protection for a financier / seller against the purchaser's default.

Commercial Paper: An unsecured, short-term debt instrument issued by a corporation, typically for the financing of accounts receivable, inventories and meeting short-term liabilities. Maturities on commercial paper rarely range any longer than 270 days.

Commodity: According to the IFSB (Guidance Note on commodity *murābaḥah* transactions (CMT), 2010), "commodity" means a physical product which is and can be traded on a secondary market - e.g. agricultural products, minerals (including oil) and precious metals. This includes different types of freely tradable Sharī'ah-compliant commodities (such as platinum, crude palm oil (CPO), wheat, cotton, etc. for CMT) as approved by the respective Sharī'ah Supervisory Board (SSB). Gold, silver, and currency/money are not included in commodity here.

Commodity *Murābaḥah*: Commodity *murābaḥah* also known as 'Financial *Tawarruq'*(compared with juristic tawarruq) is a money market contract, fund raising and liquidity management tool, widely used by the IFIs in the Gulf (except Oman) and the Far East. In 'Commodity *murābaḥah*' a bank purchases and takes formal title to the relevant assets from a third party / broker. The bank then sells the assets to the borrower at cost plus a specified profit. Payment of the sale price is usually deferred and may be structured in accordance with the wishes of the parties. The borrower enters into a contract to sell the assets to the broker for the cost price. The net result is to create a deferred payment obligation from the borrower to the bank. Bank and the customers usually enter into a succession of such transactions to create monthly, quarterly or semi-annual payment obligations. 'Commodity *murābaḥah*' was prohibited by the Jeddah based Islāmic *Fiqh* Council in 2009 probably for the reason that fulfillment of the requisite conditions to make it Sharī'ah compliant is not practically possible.

Commodity *Murābaḥah* Transaction (CMT): According to the IFSB (2010), CMT refers to *murābaḥah* -based purchase and sale process of Sharī'ah-compliant commodities, whether on cash or deferred payment terms. Terms and conditions of the CMT contain, inter alia: (a) the nature of the transaction; (b) the type and description of the commodities; (c) the quantity of goods, details of the time of payments and the unit price thereof; (d) the purchase price or cost, rate of profit and sale price; (e) the stipulation that delivery of the commodities is certain and unconditional; and (f) the nature of the seller's ownership of the commodity in terms of period and type of currency before selling it to the counterparties under the CMT. As pointed out by the IFSB, CMT was mainly developed for the purpose of Sharī'ah-compliant interbank transactions, but the IFIs have extended its use to other areas as well; they use it for both sides of B / Sheet (to place a short-term excess liquidity with counter parties, or to fund their own short-term liquidity shortages) causing a number of issues with regards to the IFIs operations and the supervisory matters.

Commutative Contract: A commercial contract involving an exchange from both the contracting parties. It is opposite to Gratuitous Contracts *('uqūd ghair mu'āwaḍah*) in which only one party gives/spends while the other only receives. Commutative contracts could be: i) Partnership contracts ii) Exchange Contracts; and iii) Investment contracts.

Constructive Possession: Any form of documentary evidence that proves rightful ownership of an asset thereby sanctioning the seeking of gain from it; where the one possessing the asset is in a position to use the item

for which it is intended (compare with physical possession).

Contributions: Monetary contributions provided once or periodically by a participant to a *takāful* operator for the purpose of investment and *tabarru‘*. In *retakāful*, contributions are provided by the *takāful* operators to the *retakāful* companies.

Corporate Finance: Financial matters of the joint stock companies compared with that of individuals or firms; taking care of or overseeing the financial activities of a Company. Corporate finance is different from business finance. Business finance is a broader term referring to the finance of all types of business, i.e. sole traders, partnership firms, joint-stock companies, while corporate finance means finance of joint-stock companies only. Corporate finance is primarily concerned with maximizing shareholders value through long-term and short-term financial planning and the implementation of various strategies. Everything from capital investment decisions to investment banking falls under the domain of corporate finance.

Corporate Governance: The system of rules, practices and processes by which a company is directed and controlled. Corporate governance essentially involves balancing the interests of the stakeholders in a company - these include its shareholders, management, customers, suppliers, financiers, government and the community.

Counter Indemnity (in Performance Bond): Indemnifying the bank or the principal of the contract against any claims or losses one may suffer up to the guarantee amount as a consequence of failure of the Participant (contractor) to perform in accordance with the plans, specification and conditions of the contract.

Credit Card: A card issued by a financial institution giving the holder a revolving limit to borrow funds, usually at point of sale. Credit cards charge interest and are primarily used for short-term consumer financing.

Credit Risk: The risk of non-payment of the receivable (full of partial) emerging from a client's default to repay a debt emerging from financing operations of the banks.

Current Ratio: Current assets divided by current liabilities -- a measure of liquidity to check the ability to pay short-term obligations and creditor's demands.

Debit Balance: A debit balance is a negative cash balance in a checking account with a bank, which is said to be overdrawn. Bank simply refuses to honor any checks presented against the account that would

cause it to have a debit balance, except in the case it sanctions an overdraft or financing arrangement.

Debt to equity Ratio: It is a measure to calculate company's financial leverage (debt) by dividing its total liabilities by stockholders' equity.

Deficit Financing: A type of financial planning by a sovereign in which it borrows money to cover the difference between its income and its expenditure. It is carried out by borrowing, rather than getting income through taxation.

Derivative Instruments: A derivative is a contract that derives its value from the performance of an underlying entity i.e. can be an asset, stocks, commodities, currencies, and market indexes. The value of derivative instrument is determined by fluctuations in the underlying asset. Although the world of derivatives comprises a wide variety of financial instruments, the most common derivatives fall into four categories namely Swaps, Options, Futures and Forwards. In global finance, financial derivatives are considered as a means to create and bargain in excessive risk. Genuine credit sales (*mu'ajjal-murābaḥah*) or forward sales (*salam*) fulfilling their respective conditions are not included in the 'financial' derivatives.

Displaced Commercial Risk (DCR): The DCR is the risk of loosing the depositors / investors with a bank emerging from less than the market competitive rates given to them. IFIs manage the funds of investment account holders on a profit and loss sharing basis. However, in order to maintain competitiveness with conventional banks, which offer fixed returns, or even with other Islāmic banks that may give better returns, some banks typically surrender part (or all) of their profit share in order to allow their depositors to get their expected profit. This effectively means that the risk attached to depositors' funds is partially or wholly transferred to the IFI's capital, which increases the overall risk for IFIs and is referred to as DCR.

Documentary Credit: A documentary credit, commonly known as a Letter of Credit (L/C), is a written and conditional assurance of a bank on the instructions of the applicant (importer) to the beneficiary (exporter) to pay a specific amount of agreed currency provided the beneficiary submits documents in conformity with the L/C within the prescribed deadlines.

Down Payment: An initial amount given as partial payment at the time of purchase, while the rest of amount is paid in future in lump sum or in installments.

Ethical Screening: Checking companies (for the purpose of investment) against certain moral standards, and removing those which do not conform to those standards.

Eurocredit: It is a loan whose denominated currency is not the lending bank's national currency. For example; a U.S. bank lending a corporation 10 million Russian rubles is a c ase of Eurocredit. In terms of Islāmic finance, it could be termed as *Eurofinance*.

Exchange Item (in a contract): The object on w hich any exchange takes place is an exchange item or the subject matter in any transaction. In commercial law, exchange items could be: i) General Goods / assets (*a'yān*) or the Papers representing them, tradable at market price; ii) Debts or debt instruments / receivables (*dayn*), tradable at par, with the condition of recourse to the original debtor; iii) *manfa'at* (usufruct of any assets not consumed with use), *ijārah* of which is allowed; and iv) money / monetary units (*athmān*) - exchange of currencies – Forex, under the principles of *bai' al-ṣarf*–hand to hand and equal for equal, if exchange items are of the same genus; hand to hand, if items of exchange are different .

Fiduciary: A person, in a position of trust. Islāmic banks have fiduciary responsibility to manage the investment funds of the depositors as a trustee for the best benefit of the account holders.

Financial Engineering: The designing, developing, implementing innovative financial instruments and processes, and formulating creative solutions to problems in finance. Financial engineering in Islāmic banking and finance has to be subjected to the principles of Islāmic law of contracts derived from Qur'ān and Sunnah of the Holy Prophet.

Finance Lease: A contract of lease where the lessee enjoys all financial benefits of the leased asset and bears all related financial risks (hence, it is not Sharī'ah compliant).

Force Majeure: Something happens which is out of the control of the both or any of the parties which affect the performance of the contract, e.g. a strike, war or storm.

Forex Trade: As per Islāmic law of contracts, both parties in exchange of currencies must take possession of the counter-values before dispersing, such possession being either actual or constructive. A forex contract shall not contain any conditional option or deferment clause regarding the delivery of one or both counter-values. According to AAOIFI (Standard on currency exchange), currency transactions shall not be carried out on the forward or futures market. Hence, it is not permissible to enter into a FX transaction on a particular date and stipulate a settlement date/time

later, delay the remittance/delivery of the currencies for any reason. Delay in making transfer is allowed, [on the basis of necessity due to time difference and likely closure of banks], provided the currencies which have been sold or purchased are transferred and remitted by the parties. A maximum period of the two days allowed-for actual delivery of the currencies as this is the maximum time required due to routing of the FX through New York. However, the payee is not entitled to dispose of the currency during the transfer period, unless and until the effect of the bank transfer has taken effect so that the payee is able to make an actual delivery of the currency to a third party.

Forex Spot: Forex Spot is an agreement between two parties to buy one currency against selling another currency at an agreed price for settlement on the spot date (two business days from the trade date). A notable exception is the USD/CAD currency pair, which settles at T + 1. This is to allow counterparties to arrange for currencies for delivery on the agreed T+2 date. However, for Sharī'ah compliance, Sharī'ah scholars have to ensure that the value taken is that of the transaction date [see Forex Trade].

Forex Swaps Market: The market wherein the dealers conclude two contracts - one spot and the other forward. Spot contract is reversed in the forward contract. The rate differentials in the spot and forward contracts are interest rate differentials on two currencies during the period of maturity – to hedge and to get interest. Forex swap transactions are carried out by large banks and finance houses that hold inventories of swap currencies of different maturities - one week to one year. The rate in the swap market changes as the maturity date gets nearer - the farther a maturity date, the greater is the risk, and higher the interest rate.

Forward Contract: In forward contracts, counterparties are bound by a non-standardized obligation to buy (or sell) an asset at a future date for contracts of real assets; delivery of assets generally takes place. *Salam* is a kind of Forward contract, allowed by the holy Prophet (pbuh) with certain conditions, price is paid at spot while the delivery of goods is deferred to specified future date. As per Islāmic law, forward contracts are allowed with the conditions of a valid *salam* contract.

Futures Contract: Futures are standardized contracts between two parties to buy or sell a specified asset of standardized quantity and quality for a price agreed upon today (the futures price) with delivery and payment occurring at a specified future date. In Futures market, which does not visualize physical delivery of any commodity, generally derivatives of forward market contracts are traded. Settlements are made

through clearing houses- dealers pay into or receive from the clearing house without even knowing the name of the other party - it is a zero-sum game - Losses of the one are gain for the other. It may also involve over-exposure – larger purchases than the actual number of shares / instruments. One can operate with a small margin, the subject matter being non-existent, no delivery / transfer; hence, the gearing ratio is very high. Short and Long position in futures: For each "short" hedger there is a "long' speculator and vice versa - speculators facilitate the hedgers to hedge - they assume the risk which the hedgers want to shed. Futures markets operate to the benefit of powerful "insiders" or professional speculators and not to the society at large. Real benefit is reaped by professional speculators who assume the reverse position which hedgers adopt.

Gratuitous Contract: A non-commutative contract involving an exchange from one party only, e.g. charity. In such contracts the receiver is not required to pay anything in exchange.

Gearing Ratio: It is a financial ratio that compares some form of owner's equity (or capital) to borrowed funds. Gearing is a measure of financial leverage, demonstrating the degree to which a firm's activities are funded by owner's funds versus creditor's funds. The gearing ratio is calculated by taking the gross borrowings divided by the total assets.

Hire-Purchase: A system of buying something by paying a sum regularly each month. In this contract, hiring the asset and transferring its ownership go side by side. The lease and the transfer of the ownership to the lessee have to be separate and independent of each other. This is why, AAOIFI, in its standard on *ijārah* has suggested '*ijārah muntahīyah bi al-tamlīk*' as the proper mode of leased based finance by Islāmic banks.

Holding Risk: The risk that may occur when the assets are possessed by the financial institution, before they are delivered to the buyer.

Index / Indices (Capital Market): An Index is a gauge for measuring performance of Sharī'ah compliant equity investment which provides investors with a benchmark for comparing returns on their investments in various sectors / areas. An index can be selected and expanded, the stocks in the underlying index to be constantly monitored - if they stand to become compliant due to changes in their financial ratios. Examples are: Dow Jones Islāmic Market Index (DJIM), Morgan Stanley Capital International (MSCI) Global Islāmic Index, S&P CNX 500 Sharī'ah and the S&P Nifty Sharī'ah; KSE Meezan Index (KMI-30).

Islāmic Forex Swap: Islāmic FX swaps are based on the structures of

either *tawarruq* and /or *wa'ad*. The *tawarruq* based structure normally involves two *tawarruq* transactions at the beginning and the end that allows the same effect as achieved in conventional FX swap. Problem arises when the parties involved want to exchange currency at some time in the future but fix a rate today when the contract is concluded. This contravenes the *bai' al-ṣarf* rule that it must be transacted on a spot basis. To avoid the prohibition, the concept of *wa'ad* is used along with *tawarruq*.

Islāmic Cross-Currency Swaps: It involves a series of commodity *murābaḥah* transactions, not one, as in case of FX swap, because it not only involves the principal value at the beginning and end, but also the stream of cash flow during the lifespan of the product.

Islāmic Interbank Benchmark Rate (IIBR): Thomson Reuters launched in November 2011 the world's first Islāmic Interbank Benchmark Rate which provides an indicator of the average expected cost of short term Islāmic interbank market funding at global level. IIBR is the profit rate that an individual Contributor Panel bank would **perceive to be reasonable** for Sharī'ah compliant funding were it to do so by asking for and then accepting inter-bank offers in reasonable market size, just prior to 11.00 am Makkah local time (GMT + 3). The value dates for settlement are T+0 for Overnight funds and T+2 for all other tenors. It uses the rates quoted by (18) Islāmic banks and the Islāmic windows of conventional banks on US dollar funding to provide an alternative for pricing Islāmic instruments to the interest-based benchmarks like LIBOR. IIBR reflects fixed returns on funding without any actual link to any business activityas is the case with conventional interest based benchmarks. However, neither any 'across the industry' opinion has evolved about IIBR's validity among the scholars and practitioners, nor it has been widely adopted by the IFIs around the world[1].

Informational Asymmetry: A situation where important relevant information is known by some parties or stakeholders, but not by all.

Initial Public Offering (IPO): The process of offering new shares in a corporation for sale to the public as a way of launching the corporation on the Stock Exchange.

Internal Controls: Internal controls are used to provide reasonable assurance regarding the achievement of organizational objectives and

[1] See for further details: JIBM Discussion Forum, Journal of Islāmic Business and Management Vol.4 No.1, 2014.

include financial, operational, Sharīʻah compliance and regulatory compliance controls.

Investment Account Holder (IAH): An investor who places funds with an Islāmic bank for investment purpose on a profit and loss sharing (*muḍārabah*) basis. An Islāmic investment account offers no capital guarantee and no returns distribution guarantee. Returns are given from the profit earned on the investment less management/ mudarib fees, after some reserves are kept like profit equalization reserve (PER), investment risk reserve (IRR), etc.

Investment Risk Reserve (IRR): A type of reserve kept to be utilized by Islāmic banks to subsidize the risk of capital loss to the unrestricted investment account holders arising out of ordinary commercial reasons in *muḍārabah* based profit sharing investment accounts. IRR comprises amounts appropriated out of the income of investment account holders after deduction of the *muḍārib's* share of income, to meet any future losses on investments financed by the IAHs.

Legal Risk: The potential loss that may occur to an investment as a result of insufficient, improperly applied, or simply unfavorable legal documentation and proceedings in the country in which the investment is made.

Legal Tender: Coins or notes which can be legally used to pay the price of goods/services or for settlement of debt.

Lessor: The owner of the leased asset in any lease deal. The lessee makes payment to the lessor in return for the use of the asset.

LIBOR: London Inter-Bank Offered Rate (LIBOR) is used in the global financial markets as a benchmark for interbank lending and borrowing, short term liquidity placements, pricing credit instruments and sovereign debts. LIBOR, or any other national or international finance benchmark, represents time value of money or loans and, as such, **when used for pricing money and credit**, is **prohibited** in Islāmic finance. However, as the prohibition of interest is not absolute denial of time value of money (that is accepted in terms of pricing of real goods and services), use of such benchmarks has been generally allowed by the Sharīʻah scholars as a basis of pricing goods and their usufruct in trading or leasing based Islāmic finance contracts.

Lien: The legal right to hold someone's goods, asset or a bank account until a debt has been paid.

Liquidity Management: The management of an excess or shortage of

funds by financial institutions through inter-bank treasury transactions to meet day to day business needs and liquidity reserve requirements.

Loss Reserves: That portion of a fund's earnings or permanent capital designated by the board of directors as a reserve against possible losses.

Margin Trading (stocks): Margin trading is termed as buying stocks on margin and using loans from the broker, interest is paid for this loan; so not allowed.

NOSTRO Account: A bank account held in a foreign country by a domestic bank, denominated in the currency of that country, to facilitate settlement of foreign exchange and trade transactions. The term is derived from the Latin word for "ours."

Off Balance Sheet Financing: Financing by leasing equipment instead of buying it, so that it does not appear in the balance sheet. Instead of loans, debt and equity, off-balance-sheet financing may include joint ventures, R &D partnerships, leases, etc. to keep debt to equity and leverage ratios low.

Operating Lease: A lease where an asset is leased for a period less than its 'Useful Economic Life'; all rights and responsibilities of ownership are vested in the owner (lessor). The asset is returned to the owner on expiry of the leasing period.

Operational Risk: The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events as well as non-compliance to Sharī'ah regulations or a neglect of fiduciary responsibilities.

Options Trading: Dealing in a kind of financial derivatives which implies the choice to deal or not to deal in a particular share. The person who takes the option gives option money, usually a fraction of price of each share he wants to buy or sell. The option money is known as call money if person wants to purchase the share, and put money if to sell it. A giver of call money has right to purchase shares during the call period at today's price; a giver of put money has right to sell, and giver of put and call money has choice either to buy or to sell. It involves uncertainty which is the product of call and put options - *gharar* for the buyer and the seller both; if the giver of call or put money does not perform, his advance is forfeited by the taker.

Profit: The return on i nvestment or from any business activity. The economists relate the concept of profit to six situations: i) Profit as an implicit factor return; ii) Profit as reward to enterprise and innovations; iii) Profit related to uncertainty (as Knight's theory - "all true profit is linked

with uncertainty" (1921); iv) Profit as a premium for risk bearing; v) Profit as an evil fruit of monopoly and hoarding making 'scarcity' as a major phenomenon of economics - profit in conventional economics is return to contrived or artificial scarcity caused by the monopolists; and vi) Profit as Marxian surplus value, in contrast with the capitalist pricing theory (Samuelson, 1976: 620 – 628). In Islāmic economics, profit is the reward of the entrepreneur for managing the business - indispensable for success and growth of business, but only just and reasonable profit can be allowed (Rahman, 1975: 274). Ibn Taimiyah (1263 -1328 AD) regarded profit as the creation of labour and capital jointly, hence both had right to share.

Profit and Loss Sharing (PLS): The term used to describe a mode of financing based on the principle of sharing the profits arising out of the underlying activity financed, with the condition that the business loss, if any, would be borne by the financier / investor, featuring the contracts of *muḍārabah* and *mushārakah*.

Profit Equalization Reserve (PER): A profit smoothing tool, a reserve created and utilized by banks to minimize fluctuations in the profit pay-outs and sometimes to give profits comparable to conventional deposit returns, in response to pressures to maintain a competitive rate of return to avoid DCR.

Profit Rate Swap: In profit-rate swap, cash flow from a floating rate is changed with a fixed rate. The *'Islāmic Profit Rate Swap'* seeks to achieve Sharī'ah compliance by using bilateral *wa'ad* and multiple *murābaḥah* transactions. If the company wishes to cancel the w′ad, it must pay compensation of the cost that is borne by the bank, if any. Hence, the company is again exposed to a risk for which it might not have a real need and against which it intended to hedge. No party pays the price of the commodity and only netting-off is made as happens in conventional profit rate swap. 'Actual' cost to the bank is nothing but the rate differential and the speculative gain or the loss of expectation.

Profit Sharing Ratio (PSR): PSR is the ratio, decided in the beginning of partnership, for sharing profit between the financier and the entrepreneur. Profit ratio can either be fixed or variable according to the tiers. Profit has to be allocated in percentages of earning and not in a sum of money or a percentage of the capital or investment. Profit sharing is not necessary according to proportionate capital contributions – it could be as agreed between the parties. However, a sleeping partner cannot share the profit more than the percentage of his capital. Partners may at any later stage agree to change the profit sharing ratio, and on the date of distribution, a partner can surrender a part of his / her profit to another partner. Further,

one partner can cap his share of profit – the case of 'Tiers profit'. The distribution of provisional profits is allowed, subject to final settlement after actual or constructive liquidation. The partners may also agree not to distribute a portion of profit – creation of various reserves. There is a complete consensus among the jurists that the business loss, if any, has to be borne in proportion of the capital provided.

Profit Smoothening: A practice of the Islāmic banking institutions by which they tend to minimize the variations in the profit payouts on investment accounts kept with them under the *muḍārabah* principle. Banks have been using the tool of changing the profit Sharing (b/w themself and the depositors) ratio or giving *hibah* indiscriminately that could spoil the whole spirit of the *muḍārabah* principle. Hence they are discouraged to give such *hibah* and instead maintain profit equalization reserves (PER) to be used for the purpose of smoothing.

Project Finance: Project finance is a financing structure that relies primarily on the project's cash flow for repayment, with the project's assets, rights, and interests held as secondary security or collateral and are paid back from the cash flow generated by the project.

Pure Risk: The risk that involves only two possibilities, which are loss or absence of loss [the concept used in *takāful* / insurance]. For instance, damage to property due to a fire that may or may not occur. This is different form business and speculative risk which has an extra possibility which is gain. In *takāful*, pure risk is the fear of loss with no chance to gain, such as loss of life, damage to property. In such Policies the compensation amount is equal to the loss incurred.

Rebate (pre-payment case): A reduction in the amount of money to be paid. The concept of pre-payment rebate is a crucial issue in Islāmic banking particularly in *murābaḥah* based financing. In case the cash flow of the clients allows, they would prefer to repay earlier than the due date (as normally happens in conventional trade finance) to get rebate on the price stipulated in the credit *murābaḥah* contract. It is prohibited by AAOIFI to give rebate to the client on early payment as a result of contractual arrangement. However, if customer makes early payment and there is no prior understanding or commitment from the bank in respect of any discount, the bank has the sole discretion in allowing rebate.

***Retakāful*:** *Retakāful* can be defined as *takāful* for *takāful* funds managed by the *takāful* operators. Re-*takāful* is the Islāmic alternative to the reinsurance industry.

Residual Value: A value of an asset after it has been depreciated in the company's accounts.

Restricted *Muḍārabah*: The *rabb al-māl* (capital provider) may specify a particular business for the *muḍārib*, in which case the latter has to invest the money in that particular business only.

Re-scheduling (a receivable): In case the client is not able to pay a receivable, an Islāmic bank may re-schedule the payment, the amount remaining the same, but with re-pricing of the same commodity (Roll-over) is not allowed.

***Retakāful* Leakage:** *Takāful* coverage taken by the *takāful* operators from the reinsurance companies, rather than from *Retakāful* companies. Although 22 r e-*takāful* companies were operating around the world in 2014, yet a significant portion is still being ceded to conventional reinsurance companies under the *ḍarūrah*, *ḥājjah* or *maṣlaḥah* principles.

Return on Assets (ROA): ROA is the widely used indicator of earning and is calculated as net profit as percentage of average assets. It measures the operating performance of an institution.

Return on Equity (ROE): The amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Risk: In business, risk is the probability of loss that is considered by Islām as *ḍamān* vis-à-vis profit, meaning that accepting liability of business loss justifies the profit[2]. In financial perspective, risk is an exposure to loss of value in cash as per the agreement of trade or business. Risk can be classified into: i) microeconomic (non-systematic) and macroeconomic (systematic) risks; ii) non-systematic risks within the bank like internal risk, incidental mishaps, credit risk, and liquidity risk. Systemic risk, imposed on a bank from outside by market conditions, may include changes in bench mark rates, monetary assets, commodity and stocks prices, price related changes, political, regulatory, governance, force majeure and integrity related risks. Risk or *ḍamān* in a business has to be distinguished from *gharar* (uncertainty about the subject matter and the consideration in an exchange contract). Risk in *takāful* is defined as the: i) Possibility of an unfortunate occurrence (Life *takāful*); ii) Possibility of loss (General *takāful*); and iii) Uncertainty of loss (When loss will occur, whether loss will occur, how severe the loss will be or how

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[2] The legal maxim, "*Al-Kharaj bi al-ḍaman*" links valid gains and incomes to risk taking.

many times the loss will occur in a year). While taking business risk is a requirement for valid profit, creating risk for any of the parties or dealing in risk is prohibited.

Risk Management: Risk management is the systematic process for the identification and evaluation of risk or loss exposures faced by an organization or individual and for the selection and implementation of the most appropriate techniques for treating such exposures. Main risk categories are credit risk; equity investment risk, market risk, liquidity risk, rate of return risk, operational risk and the reputational risk. Risk management serves several important functions, including implementation of strategy, development of competitive advantage; measure of capital adequacy; aid to decision making, aid to pricing decisions, reporting and control of risks, and management of portfolio of transactions. In Islāmic finance, risk can be managed / mitigated, but not shifted to others.

Risk Management Products: Islāmic finance offers a w ide range of possibilities to manage risks other than just replicating conventional complex derivatives and the hedging products. The focus has to be on choosing the truly compliant and the most adequate risk management strategies. Broadly, the risk mitigation tools include: guarantee (collateral), personal guarantee, pledge, *hamish jiddīyah*, promise, agency, *kheyyārāt* (option to rescind the contract), parallel forward bargain like in *salam*, *takāful*, *sharṭ jazā'ī* in *istiṣnā'* etc. The Non-systematic risks can be mitigated by ensuring cost effectiveness, by requisite training of the staff, by resorting to suitable *takāful* policies, by choosing good clients, by adopting suitable capital budgeting and by prudent and Sharī'ah compliant liquidity management policies. With regards to the risk management products and mechanisms, namely, those that are formally being standardized, such as the ISDA/IIFM *Tahāwwut* (Hedging) Master Agreement; or the possibility to use mechanisms to replicate conventional risk management products, Sharī'ah boards have to differentiate between the acceptable and the non-acceptable mechanisms keeping in view the principles of Islāmic law of contracts.

Risk weighted Assets: Risk-weighted assets are the bank's assets or off-balance-sheet exposures, weighted according to risk.

Roll-over: At the time of the maturity of a loan, the contracting parties agree to continue to carry over the loan for another, successive period of time with new terms and conditions, of course with the same underlying subject matter. In Islāmic banking, a *murābaḥah* contract cannot be rolled

over, in case of default, as the goods once sold by the bank are property of the client and also because debt, *per se,* cannot be sold.

Sale and Lease Back: In Islāmic finance, it's permissible to lease an asset to a party that sold the same asset to the bank, provided that the *ijārah* transaction should not be stipulated as a condition of the 'purchase contact' and the both contracts are executed separately. To avoid *bai' al-'īnah* (sale and buy-back that is prohibited), a reasonable period of time, between the purchase contract and the time of the resale of the asset to the lessee, must have expired. However, some scholars don't prefer this kind of lease and restrict its use to only those clients who intend to convert their borrowings to Islāmic modes.

Secondary Market: A market where existing securities are bought and sold again and again, as opposed to a primary market, where new issues are launched.

Securitization: The process of issuing certificates of ownership against an asset, an investment good or a business.

Security Deposit: An amount of money given to the bank by the customer, in *murābaḥah* or leasing, to confirm the latter's sincerity for taking a lease on the asset, or entering into *murābaḥah*, and the subsequent obligations. If the customer breaches promise to get lease or enter into *murābaḥah*, the actual damage/loss incurred by the bank can be recovered from the security deposit.

Sharī'ah Conversion Technology: A method devised by the financial engineers to enter into Islāmic total return swaps (TRS); to use non-compliant assets to bring returns into a so-called Sharī'ah compliant investment.

Sharī'ah Screens: The criteria developed by the Sharī'ah scholars against which Islāmicity or otherwise of a stock is decided are known as the Sharī'ah screens. For a stock to be Sharī'ah compliant, it must meet certain conditions with regard to the core business of a company and certain financial ratios. Currently, investments in Islāmic capital markets are governed by a number of screening norms and methods such as Dow Jones Islāmic Market Index criteria, FTSE criteria, Meezan's criteria for investment in stocks, AAOIFI's screening criteria and SEC Malaysia's screening criteria. The screens pertain to the major business activity of investee Company that should be *ḥalāl* and financial ratios like debt ratio, liquid assets ratio, impermissible investment ratio and the limit of allowable impermissible income.

Sight Letter of Credit (Sight L/C): A letter of credit which is paid when the necessary documents are presented. It does not involve financing by the L/C opening bank.

Smart Card: A credit card with a microchip, used for withdrawing money from ATMs, or for payment of purchases.

Sovereign Risk: A risk that a government may default on its debts.

Special Purpose Vehicle (SPV): A legal entity created solely to serve a particular function, such as the facilitation of a financial arrangement or creation of a financial instrument.

Speculation: A mental activity in which a person formulates his judgement about future trend of the market; the act of trading in an asset, or conducting a financial transaction, that has a significant risk of losing most or all of the initial outlay, in expectation of abnormal gain. Speculation by itself is not unlawful; but professional speculators are doing harm to the system and the society – entering into transactions with asymmetric information, without sufficient knowledge or undertaking an excessively risky or inherently uncertain transaction. Islām has provided anti speculation policy measures which include: i) Each transaction has to involve physical delivery – the requirement that is against temperament of the speculators; ii) Ban on interest based borrowing–*badla* based trading (COT); and iii) All loans / debts have to be repaid; unlimited liability of borrower - speculators would not be inclined to borrow for speculation, exposing their assets to all infinite risk.

Speculative Risk: A category of risk that, when undertaken, results in an uncertain degree of gain or loss - uncertainty about an event under consideration that could produce either a profit or a loss, such as a business venture or a gambling transaction. Hence, speculative risk is the possibility of loss, profit or no change in value; compared with the 'pure risk' that is only the possibility of loss or no loss. Unlike pure risks, speculative risks are usually not insurable.

Start-up Capital: A form of Capital, usually for small business that is just beginning its operations, especially a new business supported by venture capital and in a sector where new technologies are used.

Sub-lease: The lease of an asset by the lessee who has taken the asset on lease from the owner. A sub-lease may be prohibited by the original lease, or require permission from the first lessor.

Subordinated Debt (Junior Debt): It is the debt over which senior debt takes priority. In the event of bankruptcy, subordinated debt-holders receive payment only after senior debt is paid in full.

Swaps: Swaps are the smartest of the structured derivatives excessively used by the conventional institutions over the last two / three decades. A swap has been defined as a financial transaction in which two counter-parties agree to exchange streams of payments overtime according to a predetermined rule. Depending upon the structure, the two parties agree to simultaneously make periodic payments in exchange for two different streams of cash flow. This payment is determined based on hypothetical values of underlying assets called 'notionals'. There are over a dozen types of financial swaps commonly used in conventional finance. The main types based on their relative importance include: interest rate swaps, currency swaps, credit default swaps, commodity swaps and equity swaps. Swaps provide the highest degree of leverage than any other categories of derivatives and could lead to insolvency of any big financial institution and even distort the whole system[3].

SWIFT: Abbreviation for 'Society for Worldwide Interbank Financial Telecommunications'; founded in Brussels in 1973, the SWIFT is a co-operative organization dedicated to the promotion and development of standardized global interactivity for financial transactions. Its original mandate was to establish a global communications link for data processing and a common language for international financial transactions. The Society operates a service for financial messages, such as letters of credit, payments, and securities transactions, between member banks worldwide. SWIFT's essential function is to deliver these messages quickly and securely. Member organizations create formatted messages that are then forwarded to SWIFT for delivery to the recipient member organization. SWIFT operates out of its Brussels headquarters and processes data at centers in Belgium and the United States.

Syndicate: A group of people or companies working together to do business or fund a project.

***Tanāzul*:** An act to waive certain rights of claim in favour of another party in a contract; for example, giving a part of profit by a partner at the time of profit realization and distribution to other partner.

Third Party Guarantee: In Islāmic finance, none of the partners in *mushārakah* / *muḍārabah* can provide guarantee of the capital or the profit to the other partner(s). However, a third party may provide a guarantee to make up a loss of capital of some or all partners with the conditions that: i) The legal capacity and financial liability of such a third party as a guarantor are independent from the *shirkah* contract; ii) The guarantee is

3 See: Steinherr, Alfred; 2000; P. 194.

neither provided for consideration nor linked in any manner to the *shirkah* Contract; iii) The third party guarantor is not the owner of more than a half of the capital in the entity about which guarantee is being given; and iv) The guaranteed entity should not own more than a half of the capital in the entity that undertakes to provide a guarantee.

Takāful**:** The word takāful comes from the Arabic root word *kafālah*, meaning "guarantee". *Takāful* is the practice whereby individuals in the community jointly guarantee one another against loss or damage. For example, individuals can make donations to a common fund from which they may each draw in the event that they suffer loss to their houses or livelihoods. It was first established in the early Islāmic era with the purpose of promoting mutual solidarity and co-operation among the Muslim community. In *takāful* the elements of *ribā* (interest), *maīsir* (gambling), *gharar* (uncertainty) have to be removed from the operations.[4]

Takāful **Guarantee (in Performance Bond):** Indemnify the Bank or the Principal of the contract against any claims or losses they may suffer up to the guarantee amount as a consequence of failure of the Participant (Contractor) to perform in accordance with the plan, specification and conditions of the contract.

Total Return Swap (TRS): Total return swap is a financial contract that transfers both the credit risk and the market risk of an underlying asset. It allows the party receiving the total return to gain exposure and benefit from a reference asset without actually having to own it. *Waa'd*-based total return 'Islāmic' swaps, which gained popularity in global Islāmic finance since 2007, enabled the investors to benefit even from clearly non-Islāmic returns. By means of the TRS, an investor actually participates in the non-Sharī'ah-compliant investments, however indirectly, and the money paid is most certainly used to finance those other investments[5]. This is done by drawing a misleading legal analogy between the use of LIBOR as a benchmark for pricing and the use of the performance of non-Sharī'ah-compliant assets as a determinant for returns. The use of TRS may lead to highly undesirable reputations risks for Islāmic finance.

Tier I Capital: The risk based capital system divides capital into two tiers - core capital (Tier I) and the supplementary capital (Tier 2). Tier 1 capital includes fully paid up capital, balance in share premium account, and reserve for issue of bonus shares, general reserves as disclosed on the balance-sheet and un-appropriated /un-remitted profits. As per BASEL 3,

[4] http://www.secp.gov.pk/ID/pub_id/Pdf/Takaful.pdf accessed on October 20, 2014.
[5] Michael Mahlknecht; Report on Islāmic banking, April 2009

the predominant form of Tier 1 capital must be common shares and retained earnings.

Tier II Capital: Tier 2, also called Supplementary Capital, includes general provisions or general reserves for loan losses, revaluation reserves, exchange translation reserves, undisclosed reserves and subordinated debt. Tier 2 is limited to 100% of Tier I capital.

Tier III Capital: It consists of short-term subordinated debt and is solely held for the purpose of meeting a proportion of the capital requirements for market risks. To qualify as tier 3 capital, assets must be limited to 250% of a bank's tier 1 capital, be unsecured, subordinated and have a minimum maturity of two years. AS per BASEL III, Tier 3 has to be be abolished to ensure that market risks are met with the same quality of capital as credit and operational risks.

Toxic Assets: Financial assets whose value has fallen significantly and for which there is no longer a functioning market.

Trust Participation Certificate: A negotiable document conveying beneficial ownership in a property held in a trust to an investor in a manner consistent with contemporary securitization process.

Unconditional Agency Agreement: An agency agreement where the agent is allowed to exercise his own discretion with reference to the assigned task, taking into consideration the market norms.

Usufruct: The benefit that can be received from an asset in a contract of *ijārah*/lease.

Venture Capital: Money provided by investors to startup firms and small businesses with perceived long-term growth potential. This is a very important source of funding for startups that do not have access to capital markets. It typically entails high risk for the investor, but it has the potential for above-average returns.

VOSTRO Account: An account held by the domestic bank in its home country for a foreign bank is called vostro account, derived from the Latin word for "yours."

***Wa'ad* based Islāmic Swap:** *Wa'ad* based Islāmic swap is an agreement between the bank and the investor to swap the returns from two baskets of performing assets (one *ḥaram* and the other Sharī'ah compliant), which are kept separate. When the assets are deposited with the bank, bank agrees with the investor to hand over the return from the basket of *ḥaram* assets at the due date, in return for the return from the basket of Sharī'ah compliant assets. The investors receive a profit or loss on their investment in the Securities based on the performance of the specified underlying

reference asset or index (the “Reference Asset” or “Index”) rather than the performance of the Shares in the Islāmic Account. As indicated in the Deutsche Bank’s *White Paper* on use of *wa‘ad* (January, 2007), “The Investors will receive a profit or loss on their investment in the Securities based on the performance of the specified underlying reference asset or index (the “Reference Asset” or “Index”) rather than the performance of the Shares in the Islāmic Account”. Two promises are signed to ensure that both sides carry out their obligations on the due date. Following receipt of the relevant notice to perform the obligations of either Promise 1 or Promise 2, the transactions are **deemed to take place** as per promise to sell or purchase for the purpose of netting off. It implies that systemically transaction do not actually take place as required under Sharī‘ah law.

Weightages: Weightages are ratios assigned to various investments for the purpose of profit allocation. These are subject to change with changes in market trend. Weightages are assigned to investment deposits of Islāmic banks on the basis of tenor and or the size of the accounts. The rationale behind different weightages is that Sharī‘ah does not mandate an equal return to all partners, and instead allows a “just” and “equitable” measure of distribution of profit. The longer the tenor of deposits, greater would be the weightage to be assigned to them. According to the framework introduced by the State Bank of Pakistan in 2012, the maximum weightage to the *muḍārabah* based deposit of any nature, tenor and amount shall not exceed 3 times of the weightage assigned to saving deposits (general deposits with checking facility at discretion of the depositor). Seemingly, it may be to encourage the longer term deposits. So long as the weightages do not differ with regard to size of deposits of a particular tenure, this treatment has been accepted by all Sharī‘ah bodies.

Working Capital: Working capital refers to the funds needed by a business to conduct its daily operations, such as payment of wages, purchase of raw material, covering overhead costs and offering credit services. Working capital can be subdivided into two areas: regular working capital that provides a steady base for overall business objectives, and short-term working capital used to facilitate the day-to-day business operations.

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