

Bail Financial Sharing (BFS)

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Abstract

To cover producers and consumers against future prices fluctuation risk, depositors can forward-purchase raw materials or products to be delivered at specified time in future through Bail Financial Sharing (BFS). Bail Financial Sharing is a subsystem of Rastin Profit and Loss Sharing (PLS) banking system and in this regard, instructions, organization and application methods and electronic devices and contracts are similar to the context defined in the Base System of Rastin PLS banking system.

Bail Financial Sharing (BFS) enjoys from Bail Certificate innovation, which can play an important role in stabilizing and increasing efficiency of money and financial markets. Depositor (financer) receives digital Bail Certificate for this kind of participation, which is negotiable in the secondary Rastin Certificate market. Regarding the characteristics of this certificate and its clear substantial differences with futures derivative, it prevents unreal paper markets formation. The latest owner of the certificate is owner of the commodity. Moreover, depositor can ask bank that the entrepreneur sells the commodity and pays the money –instead of commodity- to him at the end of contract.

Keywords: Forward-Selling, Forward-Purchasing, *Salaf, Salam*, Rastin Profit and Loss Sharing, PLS, Bail Certificate, Islamic Banking, Rastin Certificate.

Introduction and Objective

When future price fluctuation is expected, producers and consumers need risk coverage for buying future raw materials and commodities to prevent price effect on their future operational plan or consumption pattern. To design a solution for this, Bail Financial Sharing (BFS) is introduced as a financial subsystem of Rastin Profit and Loss Sharing (PLS) Banking system. Bail Financial Sharing (BFS) might also be helpful for those who do not want to hoard cash money and desire to hold their assets as commodities for a period and meanwhile do not want to deliver the commodity or keep it in their own warehouse and just want to save the purchasing power of their money funds. Moreover, BFS finance is also used for financing firms that need working capital or fund to produce or buy commodities for future sale.

This approach can stabilize the economy in price fluctuations in financial and political crises. This is because during rapid price fluctuations or future expected price fluctuations the yield and productivity of various capital markets start to change and in order to keep their purchasing power, or obtaining more yields, the owners of financial resources try to move their funds from a market to another market. This action itself will exacerbate the market fluctuations.

Some new Islamic papers have been defined in Islamic countries. Some kinds of *Sukuk* papers have some similarity to Bail Certificate in Bail Financial Sharing but are completely different from supervision and structure viewpoints of Rastin PLS banking.²

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² See:

- Zubair Hasan, Credit creation and control: an unresolved issue in Islamic banking, International Journal of Islamic and Middle Eastern Finance and Management, Vol. 1 No. 1, 2008, pp. 69-81.
- M. Kabir Hassan and Mervyn K. Lewis (Editors). Handbook of Islamic Banking. Edward Elgar Publishing

Methodology and Scope

The BFS subsystem creates the background of risk fluctuation coverage for producers and consumers in buying commodities and raw materials and venturing in economic activities and investment project³ in various fields. In this way, depositor⁴ will buy firms products in advance (via PLS bank⁵) and in return for his funds, the entrepreneur⁶ promises to deliver the commodity or its value to depositor at maturity. The bank's trustee unit⁷ will supervise the obligations carry out of entrepreneur on behalf of depositor and bank receives commission for his financial intermediation.

BFS is a financial subsystem⁸ of Rastin PLS banking⁹ and in this regard, instructions, organization and application methods and electronic frameworks and contracts are very similar to the context defined in the Base Rastin PLS banking system and therefore, many of the necessities of this subsystem can be accessed in detailed instructions of Rastin PLS banking¹⁰.

In BFS financing, like other subsystems of Rastin PLS banking, bank can be private or public. Bank as financial intermediate works as the attorney or agent of depositor and in addition to providing capital management, provides the necessary conditions for sharing his funds in investment activities and receives commission.

Rastin Certificates¹¹ financial innovations are used in Rastin PLS banking and by issuing these certificates, bank activates secondary markets and efficiency of money and financial markets increases. BFS is applicable by using Rastin PLS infrastructure and issuance of Bail Certificate as a type of Rastin Certificates provides new conditions for participation of depositors in economic project of entrepreneur.

Salaf and Salam Transactions

Terminologically, *Salaf* means advance payment, acceptance and obey¹². *Salam*

Company, UK and USA, April 2007: 443 Pages.

³ Project is a collection of economic activities with specified and concrete plan with defined cost and term for making profit through Rastin PLS banking offered to PLS bank.

⁴ Depositor is a real or legal person who asks PLS bank to participate his certain amount of fund (cash) in Rastin PLS banking products through direct contact or internet and buys Rastin Certificate of one of the PLS banking products.

⁵ In Rastin PLS banking, bank is a unit which allocates resources from depositors to entrepreneur and according to specific contracts the obtained profit or loss is divided between depositor, entrepreneur. By receiving commission (*Joalah* fee), bank provides capital management services to depositor, and invest his resources according to his choice and in return, delivers Rastin Certificate to him. Bank has to protect depositors' rights by using all his specialized potentialities.

⁶ Entrepreneur is a real or legal entity who proposes a project to PLS bank for financing through PLS banking system and executes the project until the end. In addition to have legal, financial, technical and performance capabilities, the entrepreneur should have the other capabilities and facilities/possibilities to carry out the job.

⁷ The trustee unit is a unit in Rastin PLS bank for supervision and control of Rastin PLS proposed projects on behalf of bank and regarding good performance of projects in comparison to initial proposal through key indicators and financial reports till final delivery of project.

⁸ Financial subsystems of Rastin PLS banking refer to different defined financing methods and services. These subsystems are governed by Rastin PLS Base System regulations.

⁹ Rastin Profit and Loss Sharing (PLS) is an activity in Rastin Banking based on participation of depositors in investment and economic activities of entrepreneur based on real yield of projects in order to establish interest-free banking according to Islamic criteria and ethics.

¹⁰ For more information and full-text documents of Rastin PLS banking see: <http://www.bidabad.com>

¹¹ Rastin Certificates are a collection of certificates designed and issued in the base system and subsystems of Rastin PLS banking. Regarding the supervisory feature of the trustee unit of the bank on these certificates, they are distinguished from other financial papers and have prefix of "certificate". Being nameless, negotiable in secondary virtual Rastin Certificates Market, having market price based on supply and demand of certificates, settlement at the end of participation period by the latest certificate holder are some characteristics of these certificates. Settlement and replacement of these certificates are carried out under the supervision of trustee unit of the PLS bank.

¹² Ansari, Masood, Taheri, Mohammad, Private Law Encyclopedia, Mehrab Fekr publication, Tehran, 2005, 1st ed., 2nd Vol., P. 1091.

transaction is synonymous to *Salaf* transaction¹³ in which the price of the transacted is paid at time of making contract, but the commodity (or service) is delivered (rendered) in future and is regarded as debt of seller to buyer. In other words, *Salaf* or *Salam* contract is a forward-purchase or forward-sell¹⁴ considering buyer's or seller's viewpoints¹⁵. In this contract, the commodity is delivered at the end of contract (not at the time of signing contract). In contrast to credit transaction, in *Salam* or *Salaf* contracts, delivery of commodity is done at maturity, but the price is paid in advance. In other words, they are future commodity term-transaction with cash payment.

Religious jurists consider this contract as an allowable contract. The price of what is sold in forward deal could be cash money or commodity. There is consensus that forward deals with cash payment are allowable. But the term payment of price of a commodity is a credit deal. Forward deal of similar commodities is critical from *Reba* viewpoint. The same is the case of transaction of term money with cash; this is because if their value are equal at the time of signing contract and the delivery time, it will not be considered as a transaction (*Baie*) contract, but it is considered as a loan and if it has different values at the signing of contract and delivery times, it becomes discounting and transaction enters into *Reba* realm.

The two parties of the contract (seller and the buyer) and their agreement and subject of transaction which should be typical and not specific are the three main pillars of *Salam/Salaf* contract. The substance, kind, quality, amount, price, time and place of delivery should be determined in advance and at the time of signing contract.¹⁶ In addition, the subject of contract must not cause *Reba*. In *Salam* contract, the price could be defined as a substance, or a general commodity¹⁷. If only a part of the price is paid, the *Salam* contract is correct for just the corresponding part. If the seller delays to deliver the commodity, the buyer has the right of cancellation (right of excuse).

If the price at *Salam* contract is a previous debt of buyer to seller, the contract will be correct and then seller will have no debts to him any longer. Therefore, credit payment of the price can be correct and buyer can consider his claims from seller as the price of purchased commodity. The prompt payment of price at beginning of *Salam* contract is not mentioned in Civil Law of Iran; therefore, the prompt payment of price at the time of signing contract is not the necessary condition of deal. The Civil Law¹⁸ permits the two parts of the contract to define a date for payment of price and delivery of commodity.

Some jurists critic that selling the subject of contract (commodity) before maturity (end of contract period); while others consider it acceptable. Selling the subject of contract to the seller before delivery of it and after the end of contract period is correct, but there is no consensus about selling it to other person before delivery. Some consider this action detestable (*Makrouh*) but not against law, and some others consider it detestable only if the subject of contract is edible, and some others consider it detestable only if the subject of contract is measurable or weighable (*Makil* or *Mozoun*).

Rules of the second chapter of Usury-free Banking Law describe *Salaf* contracts¹⁹ as: Forward-purchase of produced commodities at defined price (by considering *Shariah* principles).

¹³ Jafari Langeroudi, Mohammad Jafar, Detailed Law Terminology, Tehran, Ganj-e-Danesh Publication, 1999, 1st ed., Vol.2, P. 978.

¹⁴ Taheri Habib Allah, Civil Law (6 and 7), Islamic Publication, Qom, Vol. 4, P. 42.

¹⁵ Katouzian Naser, Specified Contracts, Publication Co. LTD, 2008, 10th ed. Vol. 1, P. 174.

¹⁶ Jafari Langeroudi, Mohammad Jafar, *elementology Dictionary*, Tehran, Ganj-e-Danesh Publication, 2003, 1st ed., P. 367.

¹⁷ Imami Hassan, *Civil Law*, Islamieh Publication, 1961, 3rd ed., Vol. 1, P. 455.

¹⁸ Article 341 of Civil Law.

¹⁹ Regulations of the Second Chapter of Usury-free Banking Law, approved by Council of Ministers, No. 81962, 1983.

BFS Subsystem

In BFS, the entrepreneur can be a producer with real or legal entity. The entrepreneur submits his proposal²⁰ to PLS bank to finance the necessary resources to purchase or import raw or auxiliary materials for his firm working capital for production or commodities for transaction under the regulations of PLS banking base system²¹.

The proposal contains the present price of commodity, the amount and duration of needed finance and technical, executive, economic and financial information of the project. The entrepreneur should prepare his proposal according to the necessary standards and submit it to the PLS bank. After approval of proposal by assessment unit²² of the bank, its items can be used against the entrepreneur formally. The entrepreneur should approve his capability for implementing the project by offering necessary documents.

In case of approval of the competence and technical capability of the entrepreneur by the bank, assessment unit will assess the proposal and accepts it on behalf of depositor. After approval, bank will introduce the proposal to depositors and by selling Bail Certificates to depositors, will provide the necessary resources for implementation of the entrepreneur's project under supervision of trustee unit of the bank. In this method bank is financial intermediate.

Entrepreneur is responsible for provision of preliminaries, raw, auxiliary and construction materials and other necessary requisites of the project. All usages of resources should be mentioned in the proposal and assessment unit should have approved its technical, financial and economic justification. The entrepreneur can spend the received funds according to the approved proposal for items such as fixed and variable costs, working capital, wages and salaries of his firm, raw material, auxiliary and necessary spare parts or import of necessary items. He can buy and sell the necessary items for several times, but he has to settle the contract according to the approved proposal at maturity.

In BFS, bank enters into contract with entrepreneur through *Joalah* or *Salaf/Salam* contracts. The maximum duration of BFS is restricted to one year. The contract parties are obliged to pay commission to bank according to the Rastin PLS banking instructions and bank receives its commission before final settlement of the contract.

The entrepreneur is obliged to provide necessary guarantees and collaterals according to the related instruction at the time of signing contract with bank. Also in special cases, according to the decision of assessment unit of the bank the entrepreneur has to provide relevant insurance coverage. According to the production cycle, the entrepreneur has to provide the commodity of the contract in his warehouse as inventory.

Entrepreneur is also obliged to present periodic financial reports to trustee unit of the bank according to the standard accounting principles confirmed by auditing authorities and bank instructions and cooperate with trustee unit or supervisory companies specified by the bank. All activity should be carried out by entrepreneur according to the contract and under the supervision of trustee unit of PLS department of the bank. Supervisory obligations and standards for BFS projects are according to the instructions and standards of Rastin PLS banking.

The entrepreneur has to deliver the commodity or its price to the depositor at maturity through the bank and bank will render it to depositor after deduction of his commission.

Depositor can transact his Bail Certificate in Rastin Certificate Market.²³ The commodity

²⁰ Proposal is a written document covering a collection of necessary information about the proposed project of entrepreneur and describes analytical justification of the project from economic, technical and financial points of view, with enclosed necessary legal licenses and documents which is submitted to Rastin PLS bank by entrepreneur. After evaluation of bank if be approved, the proposal will be a reference document and can be used against entrepreneur executive operations.

²¹ Base System of PLS banking includes the main general rules and terms of Rastin PLS banking.

²² Assessment unit is a unit in PLS department of PLS bank which assesses the competence and capabilities of entrepreneur and his proposal.

²³ Rastin Certificate Market is a web-based settlement system for transaction and transfer of Rastin Certificates and

will be delivered at the place of production to the latest owner of certificate. Two weeks before the end of contract, the symbol of transaction of this contract will be closed at market website and the owner of that certificate will not be able to transfer it to other. The owner of the certificate has the grace period to apply to producer and receive the product during these two weeks and in case of finding anything in contrast to the contract, he can apply to defined authority as cited in related instruction within one week.

The latest owner of the certificate can ask the bank that entrepreneur sells the commodity of the contract under supervision of trustee unit of bank and after deducting commission, passes the remainder to him.

The contract duration is defined according to relevant conditions and production process based on the contract and approved proposal. Contract duration of BFS cannot be extended and entrepreneur's request for extra fund is not acceptable. New financing is possible through a new contract with new depositor and issuance of new Rastin Certificates. Extension of contract duration is possible only by confirmation of trustee unit of the bank according to Rastin PLS banking instructions and related considerations.

Any delay in carrying out the contract should be in accordance to related Rastin PLS banking instructions. The entrepreneur has to use the allocated funds according to the defined tasks in project proposal. He is not allowed to use the fund in other fields without obtaining bank's acceptance.

In case of not fulfilling the obligations at the end of the contract, bank can compensate losses through selling guarantees and collaterals received. The entrepreneur has to report all his physical and financial activities to trustee unit of the bank personally and if trustee unit approve these activities, he can continue the job. In case of any delay, violation, incapability of entrepreneur or any other difficulties, the trustee unit will scrutinize the case and will observe entrepreneur's activities and if needed will do necessary actions to protect the rights of depositor. Considering the nature of BFS activity, in case of halt of activity or bankruptcy or death of entrepreneur, the state of capital will be reported to bank and the case will be followed up until settlement. Bank will settle with depositors according to his share from the sold collaterals and guarantees and under the supervision of bank's trustee unit. The entrepreneur undertakes not to withdraw from the contract before complete settlement and through a will, advocates the bank to settle the contract after his death by selling guarantees and drawing from his bank accounts.

Regarding the concepts applied in Rastin PLS banking and its processes and instructions for implementing BFS and the functions defined in this regard for bank, depositor and entrepreneur, structure and organization are according to what defined by Rastin PLS banking.

Derivatives

Derivatives are a kind of financial contracts that explain a kind of value derived from a commodity or asset, which is considered as base asset and can be share, commodity, interest rates, foreign exchange or other assets. Derivative today are defined in the framework of Futures, Forwards, Options, and Swaps with particular characteristics.

Future contract: is an agreement for buying or selling a specified asset at a specified price at a specific time in future. Parties in future contract commit to transact a commodity with defined qualities at specific price and time. Both sides commit to transact according to the contract and thereof, the buyer is not worried about the future price increase, and the seller is not concerned about the future price decrease. Future contracts are made in official markets or bourses and they somehow prevent future price fluctuations. The price of base asset is not paid until the maturity of contract, but the both sides deposit certain amounts at clearing house as a guarantee for goodness of promises. Those who buy future contracts commit to deliver the asset at delivery date or final settlement date, and take a long (selling) position; and the position of deliverer of the asset to the

buyer is (called) short (buying) position. Some of future contracts are negotiable in secondary market.

Forward contract: is similar to future contract with the exception that the future contract can be transacted in bourse, but forward contracts are transacted in over-the-counter (OTC) markets. Over-the-counter market is formed on the neighborhood of bourse markets, and has no specific location and is formed by cable or internet connections of dealers. Because of the credibility of the contract parties, total amount of transaction is paid at the time of delivering goods.

Option: generally, options contracts are divided in two groups: “call option” and “put option”. In this contract, option holder or option issuer or option writer has the right to transact (sell or buy) a base asset. The call option holder has the right to buy the subject of contract at a certain price up to a certain time, but is not obliged to do so. In addition, a put option holder has the right to sell the subject of contract at a certain price up to a certain time, but is not obliged to do so. The written price in the contract is called “strike price” or “exercise price”. The written date in the contract is called “expiration date” or “exercise date” or “maturity”. The “European (call/put) options” permit the action only at maturity, while “American (call/put) options” allows the transaction from the beginning to maturity period. Another kind of option is called “Bermudan option” which can be carried out a few days before expiration date of contract. Asian options, which are also called “Average options”, are settled at the average price of asset in the option period. Option certificate is negotiable at secondary market.

In call option, after paying some specified amount of money to the seller of option, the buyer will have the right to buy the specified asset with specified quality before expiration date, but is not obliged to buy. The seller is also obliged to sell and deliver it to him if the buyer applies before contract time is expired. If option holder does not apply his right within the agreed period, his right will be taken away. In put option contract, the buyer of put option will have the right to sell the specified asset with the specified price within the specified time to the seller of put option holder after paying him a defined amount of money. This is just a right or privilege to sell and not obligation to sell. When the buyer of put option uses his right at maturity, the seller of put option is obliged to carry out his commitment according to context of contract.

Options are applicable in any kind of contract. For example, it is possible to give the right of extending rental period to one who has leased; or an issuer of a valuable paper can give the put option of the papers at special price to the buyer for a period of, say, 3 years. In addition, a person can for example buy an option by the condition to sell his own one hundred shares within future six months at a certain price.

Forward transaction (*Salaf*): is a contract in which both parties commit to transact a commodity with specific specifications and with special price at specific future time. Total amount of transaction money is given to seller at the beginning; and at the end, the commodity is transferred to buyer. Forward transactions are a kind of future contracts and even though they are often signed out of bourse, but have not much difference with futures and their most important difference is the higher amount of down payment.

***Istisna*:** is a kind of future contract in which parties commit to transact a commodity with specific specifications and with specific price at specific future time but the payment is by installments along the contract period.

Swap contract: is a kind of contract in which, parties commit to interchange two specified assets or their yields for a certain period.

Bail Certificate in BFS

Bail Certificate is an anonymous paper with a defined face value and duration issued by Rastin PLS bank branch. The owner of this certificate will receive the commodity or its price (at market price) from the entrepreneur who is obliged for this certificate.

Bail Certificate, like other Rastin certificates is issued digitally and is negotiable at bank’s web-based Rastin Certificate Market. The price of certificate is determined through supply and

demand mechanism and bank receives a specified transaction fee. Settlement is carried out with the latest owner of the certificate at maturity.

The financial instrument of "Bail Certificate" is quite different from prevailing derivatives in global bourse markets. Standard future contracts are issued in bourse transaction markets for selling a certain amount of goods with specific characteristics in future time, in which the buyer deposits a percent of total price with a third party (usually bourse organization) and the seller commits to render the good to him at a certain time, otherwise, the deposit is given to the buyer. These contracts are negotiable in bourse market and can be changed by an offsetting contract or cancelled by their agreement. This is called the "scalability" of future/forward contracts. In this contract, buyer and seller agree on the future price of the commodity. Arbitrage operation on buying and selling future contract will change the transaction value of the contracts and future price and spot price of the commodity tend to each other. Usually, close out of the contract or offsetting contract in a clearing house can put an end to the contract. Commodity future contracts are different from interest rates future contracts on bonds, and to some extent, on foreign exchanges in which interest rate is involved in discount calculation of spot price by considering margin money and good-faith deposited or earnest money for which may include *Reba*. This is because; some of these future contracts have specific yield and time and increase of duration of contract will change the discounted spot value equal to the interest of margin money. In other words, it involves *Reba* at least equal to the amount of interest of the deposited money. The more is the deposited money, the more *Reba* is involved. Future contracts with different subjects such as grains, meat, metals, edibles and fibers, energy and wood are prevailing in nowadays bourses.

Margin money kept for future contracts does not create any ownership right on the subject of contract and it just a guarantee for undertaking the committed contract. Future contracts are negotiable in bourse halls and people willing to enter these contracts can announce their wishes. Future contracts can be carried out on real and absent commodities. Since future contracts are exchangeable, we can see many contracts in bourses without exchanging any commodity and they just indicate some obligations between buyer and seller. This will increase the financial papers in circulation in the economy, and involves them in the broad definition of money and has similar effects on quasi money and therefore, affects the economy that weakens monetary policy effectiveness in these countries, because monetary authorities do not supervise these transactions; moreover, no physical commodity is exchanged in real sector economy. This is one of the defects of these transactions that can create economic crisis in countries.

The same problems exist for "forward transaction (*Salaf*)" derivatives, because as it was mentioned forward transactions are a kind of future contracts but with higher amount of down payment.

Differences between Bail Certificate (in BFS) and future contracts of nowadays bourses can be put forward as:

1. In Bail Certificate, 100% of the present price should be paid to seller at the beginning.
2. Each issued Bail Certificate is assigned to a specific real good and cannot be changed with a compensatory or offsetting contract.
3. Bail Certificate is based on *Salaf* transaction.
4. In BFS, Bank works as financial intermediate by absorbing funds and allocating them to seller.
5. Good-faith deposit is only taken from the seller (producer) as bank guarantee or other collaterals.
6. The trustee unit of the bank is in charge of supervision of allocated funds to the producer.
7. After the end of the contract, the subjected commodity will be delivered to buyer according to the contract and under the supervision of bank and the contract will be terminated.
8. Bail Certificate can be transacted in secondary market but has not exchangeable or

offsetting properties and therefore, the latest holder of Bail Certificate will be the owner of the subjected commodity of the contract at maturity. This characteristic prevents formation of paper markets and financial instability of economy.

9. Nominal value of Bail Certificate is equal to the price of real commodity. This price should not be discounted by interest rate.
10. Nominal price of Bail Certificate is predetermined by bank with respect to the customary size and packing of the subjected commodity.
11. Bank supervises entrepreneur's operations and deliverance of commodity and in the case of non-fulfillment of obligation will receive depositor's claims through entrepreneur's collaterals and guarantees according to compiled instructions and regulations.
12. Bail Certificate is issued at the time of contracting and is credible till maturity and deliverance of commodity or receiving market price of the commodity.
13. Maturity of Bail Certificate is the end of contract. In the case of non-fulfillment of obligation at maturity, the delay of entrepreneur will be quantified and measured in dollars and will be levied on entrepreneur according to Rastin PLS banking instructions.

Conclusion

Paper markets have high debt leverage effect on the economy and are cause of economic fluctuations and crises. Bail Financial Sharing (BFS) introduces an efficient substitute based on Islamic interest-free thoughts. Bail Certificate is a good substitute for future markets papers and contracts without their deficiencies. This new financial innovation works under defined structure of Rastin PLS banking. This method has just been designed and started to be executed in Bank Mellī Iran.

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