

Istisna' Product Guide

Policy	Person / Function
Accountable Executive	Islamic Banking Division
Policy owner	Head of Islamic Banking Division

Approved by DAB Shariah Supervisory Board :	Date:
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1 INTRODUCTION

1.1 PURPOSE

This Istisna' Product Guide ("the Guide") is an integral part of the overall Shariah Governance Framework ("SGF") developed by the Islamic Banking Division ("the IBD") of Da Afghanistan Bank ("DAB"), the Central Bank of the Islamic Republic of Afghanistan and sets out guidance for the application of Istisna' contract to various products and services for use by any Islamic Finance Institution ("IFI"), Islamic Window Operation or an Islamic Unit operating in Islamic Republic of Afghanistan (collectively referred to as "the Bank") in developing products and services using the Istisna' contract.

The Guide shall, however, be read in conjunction with other related internal and external policies, manuals and guidelines and specific/general transaction documentation issued by DAB from time to time.

All relevant staff in the Bank are expected to be familiar with the policy and understand their roles and responsibilities with respect to application of the Istisna' contract to various products and services.

1.2 REVIEW AND UPDATE OF POLICY

- 1.2.1 This Guide shall be reviewed periodically by the Head of the IBD of DAB to ensure that it is in line with the leading industry practices and caters to the customer requirements as well as ensure that the Guide is in line with other applicable changes introduced by DAB and other regulatory authorities.

1.2.2 Amendments to the Guide may be required as a result of one or more of the following reasons (not exhaustive):

- i. Changes in laws and regulations;
- ii. Changes in functions and activities of the Banks in the Islamic Republic of Afghanistan;
- iii. Changes in business processes;
- iv. Changes in the organizational structure of the Bank;
- v. Changes in job roles, duties, and descriptions;
- vi. Any other change, where the management deems necessary to update the Bank's policies and procedures;
- vii. Any significant modifications arising out of the review shall be recommended by the Head of IBD reviewed by the Supreme Council of DAB and presented to the DAB Shariah Supervisory Board (the "SSB") for their approval.

2 OBJECTIVES AND SCOPE OF APPLICATION

2.1 OBJECTIVES

2.1.1 The objective of this Guide is to describe the features and the characteristics of the Shariah contract of *Istisna'* to be referred to by DAB to assist Banks in developing and offering Shariah compliant products which adopt the underlying Islamic contract of *Istisna'*.

2.1.2 The Guide is a framework which shall ensure that the process of product development and product offerings adopting the *Istisna'* contract at the Bank is governed by a set of clear guidelines to be adopted by the Bank staff.

2.1.3 The Guide shall outline and communicate the key guidelines for the application of *Istisna'* contracts to various products and services. More specifically, the primary objectives of the Guide is to:

- i. Provide concept and legitimacy of the *Istisna'* contract under Shariah;
- ii. Provide features of the *Istisna'* contract; and
- iii. Provide guidelines on the application of the *Istisna'* contract.

2.2 SCOPE OF POLICY

The Guide applies to the Bank, its subsidiaries and branches.

3 GOVERNANCE AND OVERSIGHT

3.1 SHARIAH SUPERVISORY BOARD OF DAB

3.1.1 The Shariah Supervisory Board ("SSB") is the authority for approval of the Guide.

3.2 HEAD OF IBD

3.2.1 The Head of IBD is the Guide owner providing, in consultation with the SSB, the necessary oversight which shall consider the following:

- i. ensuring the Guide is in line with the current business strategy, governance framework and business structures;
- ii. ensuring that detailed procedures are in place across the Bank to ensure compliance with the Guide;
- iii. assisting in providing subject matter expertise, support and technical guidance to the business in accordance with the Service Level Agreements (SLAs) signed with various departments; and
- iv. Communicating the Guide to the business units and concerned functions and ensuring it is understood.

3.2.2 The Governor of DAB is consulted on dealing with executive decisions and/or actionable issues arising from the *Istisna'* product offerings process and any deficiencies.

3.3 ISLAMIC BANKING DIVISION

3.3.1 The IBD is the Accountable Executive (AE) for the Guide with the head of IBD shall be the Policy Owner.

3.3.2 The IBD assumes oversight and supervisory responsibilities for the framework used in the *Istisna'* product development, offerings process and ultimate

responsibility for the ongoing review and for recommending alterations to the Guide.

3.3.3 Any deviations or exceptions to the Guide must be based on a proposal by the IBD and/or other relevant authorised senior management person to the SSB, who shall approve or deliberate on such exceptions periodically. Any material deviation or exception shall be referred to the SSB for guidance or approval.

3.3.4 The IBD shall review the Guide's validity, relevance and accuracy as and when needed.

4 DEFINITION

The word *Istisna'* means request to construct.

Technically, *Istisna'* refers to an agreement to sell to or buy from a customer a non-existent asset which is to be manufactured or built according to the ultimate purchaser's specifications and is to be delivered on a specified future date at a pre-determined selling price.

For the purpose of this Guide, the technical definition is adopted in the financial sector when the customer would essentially request the Bank to finance the manufacturing of specified assets. The Bank as the seller has the option to manufacture or build the asset on its own or engages the services of a party other than the *Istisna'* ultimate purchaser as supplier or subcontractor, by entering into a parallel *Istisna'* contract.

5 LEGITIMACY OF *ISTISNA'* CONTRACT

5.1 The legitimacy of *Istisna'* contract is founded on the basis of the Sunnah of the Prophet Muhammad, Peace Be Upon Him (PBUH), the consent of Muslim Jurists (*Ijma'*) and the decision of establish Shariah caucuses.

5.2 THE SUNNAH OF THE PROPHET MUHAMMAD (PBUH)

5.2.1 The Narration of Nafi'

Nafi' reported that Abdullah ibn 'Umar has reported to him that the Prophet Muhammad (PBUH) has requested the manufacturing of a golden ring. (Bukhari, Sahih Bukhari, 5/6160)

5.3 THE IJMA' OF THE MUSLIM JURISTS

Ijma' constitutes a juristic basis for the legality of *Istisna'*. In addition, legality of *Istisna'* is also recognized by contemporary established Shariah bodies such as the Council of the Islamic Fiqh Academy (*Majma' al-Fiqh al-Islamiy*) which passed a resolution on *Istisna'* in its 7th meeting held in Jeddah, Kingdom of Saudi Arabia from 9th to 7th May 1992.

6 FEATURES OF THE *ISTISNA'* CONTRACT

The principal features of *Istisna'* are:-

- i) Binding contract;
- iii) Price of *Istisna'*;
- iv) Delivery and disposal of asset;
- v) Guarantee/ Collateral/ Warranty; and
- V) Asset.

6.1 Binding Nature of *Istisna'* Contract

6.1.1 The purchaser executes an *Istisna'* contract with the seller requesting the latter to construct or manufacture a specified type of goods. The contract must specify:

- i. Type of goods to be manufactured/constructed by the Seller;
- ii. Price;
- iii. Specification of asset;
- iv. Mode of payment.

6.1.2 It is permissible, after the conclusion of an *Istisna'* contract, for the seller and the purchaser to agree on amending the manufacturing or construction specifications previously agreed upon or introducing additional specification requirements, on condition that the price is

adjusted accordingly and a reasonable period for the execution of the new requirements is granted.

6.1.3 A contract of *Istisna'* is binding on the contracting parties. If the subject matter does not conform to the specification agreed upon, the purchaser has the option to accept or refuse the subject matter.

6.1.4 Both parties may agree to be binding under the *Istisna'* contract for manufacturing customised assets i.e the asset that shall be manufactured or produced by a specific manufacturer (if parallel *Istisna'*), or manufactured from a specific material that has yet to be manufactured by the Seller.

6.1.5 The Seller may secure *urboun* (earnest money) in advance prior to commencing the work. The *urboun* can be deducted from the selling price if the contract is fulfilled or forfeited if the contract is rescinded.

6.1.6 It is permissible, after the conclusion of an *Istisna'* contract, the Seller and the Purchaser to agree on amending the manufacturing specifications or introducing additional specification requirements.

6.1.7 It is permissible that an *Istisna'* contract includes a clause to the effect that if any additional conditions are inserted into the contract at a later date as a result of directives of the relevant authorities, and these additional conditions lead to extra expenses it will be borne by the Purchaser.

6.2 Price

6.2.1 Price for a subject-matter under an *Istisna'* contract must be known at the conclusion of the contract, and it may be in the form of cash, tangible goods or the usufruct of an asset for a particular duration,

whether such usufruct is related to an asset other than the subject-matter or to the subject-matter itself.

- 6.2.2 The time and mode of payment may be in any manner as agreed by the parties. The payment may also be in instalments.
- 6.2.3 The cost for providing warranty and after sales services may be considered when determining the *Istisna'* price.
- 6.2.4 The disclosure on the production cost by the seller is not mandatory. Unlike *Murabahah*, the selling price may be determined based on the direct and/or indirect costs of the *Istisna'*.
- 6.2.5 It is not permissible for a contract of *Istisna'* to be drawn up on the basis of a *Murabahah* sale.
- 6.2.6 It is permissible to request the purchaser to undertake to take up any escalation cost incurred during the construction of the asset. The undertaking by the customer must be separated and independent from the *Istisna'* Agreement.
- 6.2.7 The Purchaser shall not be entitled to claim from the Seller any reduction of *Istisna'* sale price due to reduction of construction cost. However, the Seller may decide to waive (*ibra'*) part of the selling price based on its discretion.
- 6.2.8 A third party may be appointed to provide additional professional services related to the project. The engagement of the additional services and fees are to be specified and mutually agreed in a separate contract.
- 6.2.9 It is not permissible that an additional sum will be paid in consideration for an extension of the period of payment.

6.2.10 However, a rebate for pre-payment is permissible provided it is not stipulated at the conclusion of the contract.

6.3 Delivery and Disposal of Subject-matter

6.3.1 It is permissible that the delivery of the subject matter takes place before due date, on condition that the subject matter meets the specifications agreed upon, in which the purchaser is obliged to accept the subject matter.

6.3.2 The delivery of the subject-matter may take place through constructive possession, by enabling the purchaser to take control over the subject-matter after the production process is completed. At this point, the liability of the manufacturer in respect of the subject-matter comes to an end and the liability of the customer begins.

6.3.3 It is permissible to state in a contract of *Istisna'* that the Seller will act as the agent of the Purchaser to sell the subject-matter if there is a delay on the part of the Purchaser in taking delivery of the subject-matter within a particular period of time. In this case, the Seller will sell the subject-matter on behalf of the Purchaser, and after deducting the agreed contract price, the balance, if any, will be returned to the Purchaser. If the price obtained is less than the contract price, the Seller shall have a right of recourse to the Purchaser for the recovery of the remaining balance. The Purchaser will bear the expenses incurred in selling the subject-matter.

6.3.4 It is permissible for the Seller acting in the capacity of the Purchaser to appoint, after taking possession of the subject-matter, the manufacturer as an agent to sell the subject-matter to the latter's customers on behalf of the Seller. The agency may be carried out free of charge or for consideration either in the form of a fixed fee or a particular percentage of the sale price. The contract of agency and the contract of *Istisna'* must be separate from each other.

- 6.3.5 It is permissible for the contract of *Istisna'* to include a fair penalty clause stipulating an agreed amount of money for compensating the Purchaser adequately if the Seller delayed in delivering the subject matter. Such compensation is only permissible if the delay is not caused by intervening contingencies.
- 6.3.6 It is not permissible to stipulate penalty clause against the Purchaser for default in payment. However, the Purchaser may pay to the Seller, by way of *ta'widh* (compensation) for any delay in any instalment or bill as guided by DAB's Guideline on Late Payment Charges.
- 6.3.7 The Seller is discharged from any liability associated with losses suffered arising from the failure of the purchaser to accept any delivery of the completed asset.

6.4 Guarantee/ Collateral/ Warranty

- 6.4.1 It is permissible for the Bank, acting either in the capacity of the manufacturer or of the customer/purchaser, to demand or give accordingly *urboun* as guarantee, which will either be part of the price if the contract is fulfilled, or forfeited if the contract is rescinded.
- 6.4.2 Warranty terms may be included in the *Istisna'* agreement to safeguard the interest of the customer (either the Bank or the ultimate buyer in the case of parallel *istisna'*) against defects and to ensure necessary maintenance work is carried out after the asset is delivered.

6.5 Assets

- 6.5.1 In the event asset delivered is not following the specifications, the Purchaser can reject or accept it as it is, with or without a price discount.
- 6.5.2 It is **not permitted** for the Bank and the contractor (in the case of parallel *istisna'*) to stipulate in the contract of *Istisna'* that it is not liable for defects.

- 6.5.3 If the asset is completed and ready to be delivered but the Purchaser delays in taking delivery, the asset in the possession of the Seller will be on a trust basis and the Seller is not liable for any loss or damage unless at the negligence and misconduct of the Seller.
- 6.5.4 The Seller is permitted to appoint representative or specialist (including the Purchaser) to supervise the manufacturing process in order to ensure that the asset is manufactured in conformity with the specifications.

7 Early Termination

Unilateral early termination of *Istisna'* contract is allowed provided that the Seller (the Bank or contractor) has not commenced work. Once the work has started, the contract cannot be terminated unilaterally.

8 Default

- 8.1 In case the customer/Purchaser defaults, the Bank/Seller can either:
- i. Institute claims against the customer/Purchaser for the completed portion of asset (net of *urboun*);
 - ii. Recover from pledged assets (if any); or
 - iii. Claim against the guarantor.
- 8.2 If the Seller is unable to discharge his obligation due to his misconduct, the Purchaser is liable to pay only for the value of the completed structure and the contractor is liable to compensate the Bank (buyer under the parallel *Istisna'*) for any actual damage and loss suffered.
- 8.3 If the failure to perform is due to the misconduct of the Purchaser, the Seller is entitled to the value of the work he has completed and compensation for any damage or loss.

- 8.4 The Seller assumes the completion risk that is associated with the failure to complete the project at all, delay in completion, cost overruns, occurrence of a *force majeure* event and unavailability of qualified personnel and reliable Seller(s) or subcontractors in parallel *Istisna'*.

9 Shariah Compliance

The asset and the purpose of manufacturing and construction must be Shariah compliant.

10 Discharge of Liability

The Seller's liability is discharged if;

- i. The subject matter is completed and delivered to either the Purchaser or to a person appointed by the Purchaser; or
- ii. The Purchaser is given full control over the subject matter.

11 Parallel *Istisna'*

- 11.1 In order to enable the Bank to deliver the asset ordered by the customer, it is permissible for the Bank to enter into a contract with another contractor in which the contractor is to construct/ manufacture the asset based on the given specifications for delivery on a specified future date at a pre-determined Bank's purchase price. This is called parallel *Istisna'* (*Istisna' al-muwazi*).
- 11.2 The second *Istisna'* contract must be independent of the first *Istisna'* contract.
- 11.3 The Bank assumes the liability of ownership risk including maintenance and takaful/insurance expenses prior to delivering the subject matter to the ultimate buyer (the customer). The Bank is not permitted, in the parallel

Istisna' contract to transfer to the manufacturer the risk arising from its obligations towards the customer.

- 11.4 It is not permissible for a party to the *Istisna*' contract to withdraw his contractual obligations or intentionally delay the delivery of the subject matter of the contract due to the second *Istisna*' being immaterialised.
- 11.5 It is also not permissible for a party to the first *Istisna*' contract to increase the price of the assets because of increase in the cost involving the second *Istisna*' unless the ultimate buyer/ customer agrees.
- 11.6 If the contractor is unable to complete the assets under the second *Istisna*', the Bank is still responsible to deliver the assets sold under the first *Istisna*' via the followings;
- i. Appointing another contractor to complete the asset, or;
 - ii. Purchasing asset of similar specification from a third party,
or;
 - iii. Paying compensation to the customer subject to mutual agreement or in the event of disagreement, the compensation amount is to be decided by the court.
- 11.7 Any variation of contract performance due to *force majeure* may be made through an agreement between the contracting parties. This may result in loss sharing, partial cancellation of contracts, deferment of performance and reduction of obligation to the affecting party.
- 11.8 In the event the contractor is unable to complete the asset as per the specification, the Bank can institute claims against the contractor.

12 ACCOUNTING TREATMENT

Financial reporting of the Seller

- 12.1 Istisna' costs comprise of the following:
- a) Direct cost
 - b) Indirect cost relating to the contract on an objective basis (excluding general and administrative, selling and R&D expenses)
- 12.2 Identified product costs incurred during the financial period, as well as, pre-contract costs, shall be recognized in an Istisna' work in progress account and reported as assets in the statement of financial position. In Parallel Istisna', this treatment is classified in Istisna' cost accounts in the books of the seller.
- 12.3 Progress billing to the buyer by the seller shall be recorded as Istisna' billings and Istisna' account receivables. The istisna' billing account (revenue) is then offset against cost as recorded in either the Istisna' work in progress account or the Istisna' costs account. In the case of the seller's istisna' costs, the price agreed with the producer is offset with the price agreed with the buyer.
- 12.4 The Istisna' revenue of the seller is the total price agreed between both seller and buyer. The price of the first istisna' contract is also classified as parallel istisna'. It includes the profit margin, which is determined by the difference between the istisna' billing and the istisna' cost accounts.
- 12.5 The istisna' revenue and the associated profit margin are measured and recognized according to the completion or the completed method as follows:
- a) Completion method: involves different stages or phases of the contract period, with revenue and profits recognized proportionately.

Parallel istisna' revenue and profit adopts the percentage of completion method since the selling and cost prices are both known with reasonable certainty. The recognized portion of profits shall be added to the istisna' cost account. Hence, the balance of the account equals the cumulative cost of the istisna' contract and istisna' profits are recognized up to the reporting date.
 - b) Completed method: No contract revenue shall be recognized until the contract is fully completed. Contract costs are carried forward in istisna' work in progress account.

Financial reporting of the buyer

- 12.6 Upon receiving bills from the seller, the buyer account for the istisna' is payable to the seller accompanied by corresponding istisna' cost account.
- 12.7 Upon completion of the product/ subject matter of istisna' according to specifications, the assets are reported at historical costs. If the originally agreed specifications are not met, the buyer can do the following with respective accounting treatment:
- a) Revoke the contract resulting in the entire payment to the seller and that which is due from the seller becoming receivables; or
 - b) Accept the product with uncompensated loss.

13 CUSTODIAN OF THE DOCUMENT

This Product Guide shall be under the safe custody of the Islamic Banking Division ("IBD") of DAB. Any changes to this Guide shall be made by the IBD with prior consultation with the SSB, as reviewed by the DAB Executive Board and upon approval by DAB Supreme Council. A copy of the amended Guide shall be made available to all stakeholders and SSB members for reference and implementation.

14. EFFECTIVE DATE OF THE DOCUMENT

The Effective date of this Guide is the _____ day of _____ 20__