

“SALAM AND ISTISNA”

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SALAM AND ISTISNA'

It is one of the basic conditions for the validity of a sale in Shari'ah that the commodity (intended to be sold) must be in the physical or constructive possession of the seller.

This condition has three ingredients:

Firstly, the commodity must be existing; therefore, a commodity which does not exist at the time of sale cannot be sold.

Secondly, the seller should have acquired the ownership of that commodity. Therefore, if the commodity is existing, but the seller does not own it, he cannot sell it to anybody.

Thirdly, mere ownership is not enough. It should have come in to the possession of the seller, either physically or constructively. If the seller owns a commodity, but he has not taken its delivery himself or through an agent, he cannot sell it.

There are only two exceptions to this general principle in Shari'ah. One is *Salam* and the other is *Istisna'*. Both are sales of a special nature, and in the present chapter the concept of these two kinds of sale and the extent to which they can be used for the purpose of financing will be explained.

Meaning of Salam:

Salam is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot.

Here the price is cash, but the supply of the purchased goods is deferred. The buyer is called "*rabb-us-salam*", the seller "*muslam ilaih*", the cash price is "*ra's-ul-mal*" and the purchased commodity is termed as "*muslam fih*", but for the purpose of simplicity, I shall use the English synonyms of these terms.

Salam was allowed by the Holy Prophet (SW) subject to certain conditions. The basic purpose of this sale was to meet the needs of small farmers who needed money to grow their crops and to feed their families upto the time of harvest. After the prohibition of *riba*, they could not take usurious loans. Therefore, it was allowed for them to sell the agricultural products in advance.

Similarly, the traders of Arabia used to export goods to other places and to import some other goods to their homeland. They needed money to undertake this type of business. They could not borrow from the users after the prohibition of *riba*. It was, therefore, allowed for them that they sell the goods in advance. After receiving their cash price, they could easily undertake the aforesaid business.

Salam was beneficial to the seller, because he received the price in advance, and it was beneficial to the buyer also, because normally, the price in *salam* used to be lower than the price in spot sales.

The permissibility of *salam* was an exception to the general rule that prohibits the forward sales, and therefore, it was subjected to some strict conditions.

These conditions are summarized below:

Conditions of *Salam*:

1. First of all, it is necessary for the validity of *salam* that the buyer pays the price in full to the seller at the time of effecting the sale. It is necessary because in the absence of full payment by the buyer, it will be tantamount to sale of a debt against a debt, which is expressly prohibited by the Holy Prophet (SW).

Moreover, the basic wisdom behind the permissibility of *salam* is to fulfill the instant needs of the seller. If the price is not paid to him in full, the basic purpose of the transaction will be defeated.

Therefore, all the Muslim jurists are unanimous on the point that full payment of the price is necessary in *Salam*. However, Imam Malik is of the view that the seller may give a concession of two or three days to the buyers, but this concession should not form part of the agreement.

2. *Salam* can be affected in those commodities only the quality and quantity of which can be specified exactly. The things whose quality or quantity is not determined by specification cannot be sold through the contract of *salam*. For example, precious stones cannot be sold on the basis of *salam*, because every piece of precious stones is normally different from the other either in its quality or in its size or weight and their exact specification is not generally possible.

3. *Salam* cannot be affected on a particular commodity or on a product of a particular field or farm. For example, if the seller undertakes to supply the wheat of a particular field, or the fruit of a particular tree, the *salam* will not be valid, because there is a possibility that the crop of that particular field or the fruit of that tree is destroyed before delivery, and, given such possibility, the delivery remains uncertain. The same rule is applicable to every commodity the supply of which is not certain.

4. It is necessary that the quality of the commodity (intended to be purchased through *salam*) is fully specified leaving no ambiguity which may lead to a dispute. All the possible details in this respect must be expressly mentioned.

5. It is also necessary that the quantity of the commodity is agreed upon in unequivocal terms. If the commodity is quantified in weights according to the usage of its traders, its weight must be determined, and if it is quantified through measures, its exact measure should be known. What is normally weighed cannot be quantified in measures and vice versa.

6. The exact date and place of delivery must be specified in the contract.

7. *Salam* cannot be affected in respect of things which must be delivered at spot. For example, if gold is purchased in exchange of silver, it is necessary, according to Shari'ah, that the delivery of both be simultaneous.

Here, *salam* cannot work. Similarly, if wheat is bartered for barley, the simultaneous delivery of both is necessary for the validity of sale. Therefore the contract of *salam* in this case is not allowed.

All the Muslim jurists are unanimous on the principle that *salam* will not be valid unless all these conditions are fully observed, because they are based on the express *ahadith* of the Holy Prophet (SW). The most famous *hadith* in this context is the one which the Holy Prophet (SW) has said:

“Whoever wishes to enter into a contract of salam, he must effect the Salam according to the specified measure and the specified weight and the specified date of delivery.”

However, there are certain other conditions which have been a point of difference between the different schools of the Islamic jurisprudence.

Some of these conditions are discussed below:

1. It is necessary, according to the Hanafi school, that the commodity (for which *salam* is effected) remains available in the market right from the day of contract upto the date of delivery. Therefore, if a commodity is not available in the market at the time of the contract, *salam* cannot be affected in respect of that commodity, even though it is expected that it will be available in the markets at the date of the delivery.

However, the other three schools of *Fiqh* (i.e. Shafi', Maliki, and Hanbali) are of the view that the availability of the commodity at the time of the contract is not a condition for the validity of *salam*. What is necessary, according to them, is that it should be available at the time of delivery.

This view can be adopted in the present circumstances.

2. It is necessary, according to the Hanafi and Hanbali schools that the time of delivery is, at least, one month from the date of agreement. If the time of delivery is fixed earlier than one month, *salam* is not valid. Their argument is that *salam* has been allowed for the needs of small farmers and traders and therefore, they should be given enough opportunity to acquire the commodity. They may not be able to supply the commodity before one month. Moreover, the price in *salam* is normally lower than the price in spot sales. This concession in the price may be justified only when the commodities are delivered after a period which has a reasonable bearing on the prices. A period of less than one month does not normally affect the prices. Therefore, the minimum time of delivery should not be less than one month.

Imam Malik supports the view that there should be a minimum period for the contract of *salam*. However, he is of the opinion that it should not be less than fifteen days, because the rates of the market may change within a fortnight.

This view is, however, opposed by some other jurists, like Imam Shafi' and some Hanafi jurists also. They say that the Holy Prophet (SW) has not specified a minimum period for the validity of *salam*. The only condition, according to the *Hadith*, is that the time of delivery must be clearly defined. Therefore, no minimum period can be prescribed. The parties may fix any date for delivery with mutual consent.

This view seems to be preferable in the present circumstances, because the Holy Prophet (SW) has not prescribed a minimum period. The jurists have prescribed different periods which range between one day to one month. It is obvious that they have done so on the basis of expedience and keeping in view the interest of the poor sellers. But the expediency may differ from time to time and from place to place. Likewise, sometimes it is more in the interest of the seller to fix an earlier date. As far as the price is concerned, it is not a necessary ingredient of *salam* that the price is always lower than the market price on that day. The seller himself is the best judge of his interest, and if he accepts an earlier date of delivery with his free will and consent, there is no reason why he should be forbidden from doing so.

Certain contemporary jurists have adopted this view being more suitable for the modern transactions.

Salam as a Mode of Financing:

It is evident from the foregoing discussion that *salam* was allowed by Shari'ah to fulfill the needs of farmers and traders. Therefore, it is basically a mode of financing for small farmers and traders. This mode of financing can be used by the modern banks and financial institutions, especially to finance the agricultural sector. As pointed out earlier, the price in *salam* may be fixed at a lower rate than the price of those commodities delivered at spot. In this way, the difference between the two prices may be a valid profit for the banks or financial institutions. In order to ensure that the seller shall deliver the commodity on the agreed date, they can also ask him to furnish a security, which may be in the form of a guarantee or in the form of a mortgage or hypothecation. In the case of default in delivery, the guarantor may be asked to deliver the same commodity, and if there is a mortgage, the buyer / financier can sell the mortgaged property and the sale proceeds can be used either to realize the required commodity by purchasing it from the market or to recover the price advanced by him.

The only problem in *salam* which may agitate the modern banks and financial institutions is that they will receive certain commodities from their clients, and will not receive money. Being conversant with dealing in money only, it seems to be cumbersome for them to receive different commodities from different clients and to sell them in the market. They cannot sell these commodities before they are actually delivered to them, because it is prohibited in Shari'ah.

But whenever we talk about the Islamic modes of financing, one basic point should never be ignored. The point is that the concept of the financial institutions dealing in money only is foreign to Islamic Shari'ah. If these institutions want to earn a *halal* profit, they shall have to deal in commodities in one way or the other, because no profit is allowed in Shari'ah on advancing loans only. Therefore, the establishment of an Islamic economy requires a basic change in the approach and in the outlook of the financial institutions. They shall have to establish a special cell for dealing in commodities. If such a special cell is established, it should not be difficult to purchase commodities through *salam* and to sell them in the spot markets.

However, there are two other ways of benefitting from the contract of *Salam*.

Firstly, after purchasing a commodity by way of *salam*, the financial institutions may sell it through a parallel contract of *salam* for the same date of delivery. The period of *salam* in the second (parallel) transaction being shorter, the price may be a little higher than the price of the first transaction, and the difference between the two prices shall be the profit earned by the institution. The shorter the period of *salam*, the higher the price and the greater the profit. In this way the institutions may manage their short term financing portfolios.

Secondly, if a parallel contract of *salam* is not feasible for one reason or another, they can obtain a promise to purchase from a third party. This promise should be unilateral from the expected buyer. Being merely a promise, and not the actual sale, their buyers will not have to pay the price in advance. Therefore, a higher price may be fixed and as soon as the commodity is received by the institution, it will be sold to the third party at a pre-agreed price, according to the terms of the promise.

A third option is sometimes proposed that, at the date of delivery, the commodity is sold back to the seller at a higher price. But this suggestion is not in line with the dictates of Shari'ah. It is never permitted by the Shari'ah that the purchased commodity is sold back to the seller before the buyer takes its delivery, and if it is done at a higher price it will be tantamount to *riba* which is totally prohibited. Even if it is sold back to the seller after taking delivery from him, it cannot be prearranged at the time of original sale. Therefore, this proposal is not acceptable at all.

Some Rules of Parallel Salam:

Since the modern Islamic Banks and Financial Institutions are using the instrument of parallel Salam, some rules for the validity of this arrangement are necessary to observe:

1. In an arrangement of parallel *salam*, the bank enters two different contracts. In one of them, the bank is the buyer and in the second one the bank is the seller. Each one of these contracts must be independent of the other. They cannot be tied up in a manner that the rights and obligations of one contract are dependent on the rights and obligations of the parallel contract. Each contract should have its own force and its performance should not be contingent on the other.

For Example, if A has purchased from B 1000 bags of wheat by way of Salam to be delivered on 31 December, A can contract a parallel Salam with C to deliver to him 1000 bags of wheat on 31 December. But while contracting Parallel Salam with C, the delivery of wheat to C cannot be conditioned with taking delivery from B. Therefore, even if B did not deliver wheat on 31 December, A is duty bound to deliver 1000 bags of wheat to C. He can seek whatever recourse he has against B, but he cannot rid himself from his liability to deliver wheat to C.

Similarly, if B has delivered defective goods which do not conform with the agreed specifications, A is still obligated to deliver the goods to C according to the specifications agreed with him.

2. Parallel Salam is allowed with a third party only. The seller in the first contract cannot be made purchaser in the parallel contract of salam, because it will be a buy-back contract, which is not permissible in Shari'ah.

Even if the purchaser in the second contract is a separate legal entity, but it is fully owned by the seller in the first contract the arrangement will not be allowed, because in practical terms it will amount to 'buy-back' arrangement. For example A has purchased 1000 bags of wheat by way of Salam from B, a joint stock company. B has a subsidiary C, which is a separate legal entity but is fully owned by B. A cannot contract the parallel salam with C. However, if C is not wholly owned by B, A can contract parallel salam with it, even if some shareholders are common between B and C.

ISTISNA'

'*Istisna*' is the second kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacturer undertakes to manufacture the goods for him with material from the manufacturer, the transaction of *istisna*' comes into existence. But it is necessary for the validity of *istisna*' that the price is fixed with the consent of the parties and that necessary specification of the commodity (intended to be manufactured) is fully settled between them.

The contract of *istisna*' creates a moral obligation on the manufacturer to manufacture the goods, but before he starts the work, any one of the parties may cancel the contract after giving a notice to the other. However after the manufacturer has started the work, the contract cannot be cancelled unilaterally.

Difference between *Istisna'* and *Salam*:

Keeping in view this nature of *istisna*' there are several points of difference between *istisna*' and *salam* which are summarized below:

i. The subject of *istisna*' is always a thing which needs manufacturing, while *salam* can be affected on any thing, no matter whether it needs manufacturing or not.

ii. It is necessary for *salam* that the price is paid in full in advance, while it is not necessary in *istisna'*.

iii. The contract of *salam*, once affected, cannot be cancelled unilaterally, while the contract of *istisna'* can be cancelled before the manufacturer starts the work.

iv. The time of delivery is an essential part of the sale in *salam* while it is not necessary in *istisna'* that the time of delivery is fixed.

Difference between *Istisna'* and *Ijarah*:

It should also be kept in mind that the manufacturer, in *istisna'* undertakes to make the required goods with his own material. Therefore, this transaction implies that the manufacturer shall obtain the material, if it is not already with him, and shall undertake the work required for making the ordered goods with it. If the material is provided by the customer, and the manufacturer is required to use his labour and skill only, the transaction is not *istisna'*. In this case it will be a transaction of *ijarah* whereby the services of a person are hired for a specific fee paid to him.

When the required goods have been manufactured by the seller, he should present them to the purchaser. But there is a difference of opinion among the Muslim jurists whether or not the purchaser has a right to reject the goods at this stage. Imam Abu Hanifah is of the view that he can exercise his 'option of seeing' (*khiyar-ur-ru'yah*) after seeing the goods, because *istisna'* is a sale and if somebody purchases a thing which is not seen by him, he has the option to cancel the sale after seeing it. The same principle is also applicable to *istisna'*.

However, Imam Abu Yousuf says that if the commodity conforms to the specifications agreed upon between the parties at the time of the contract, the purchaser is bound to accept the goods and he cannot exercise the option of seeing.

This view has been preferred by the jurists of the Ottoman Empire, and the Hanafi law has been codified according to this view, because it is damaging in the context of modern trade and industry that after the manufacturer has used all his resources to prepare the required goods, the purchaser cancels the sale without assigning any reason, even though the goods are in full conformity with the required specifications.

Time of Delivery:

As pointed out earlier, it is not necessary in *istisna'* that the time of delivery is fixed. However, the purchaser may fix a maximum time for delivery which means that if the manufacturer delays the delivery after the appointed time, he will not be bound to accept the goods and pay the price.

In order to ensure that the goods will be delivered within the specified period, some modern agreements of this nature contain a penal clause to the effect that in case the manufacturer delays the delivery after the appointed time, he shall be liable to a penalty which shall be calculated on a daily basis. Can such a penal clause be inserted in a

contract of *istisna'* according to Shari'ah? Although the classical jurists seem to be silent about this question while they discuss the contract of *istisna'*, yet they have allowed a similar condition in the case of *ijarah*. They say that if a person hires the services of a person to tailor his clothes, the fee may be variable according to the time of delivery.

The hirer may say that he will pay Rs.100/- in case the tailor prepares the clothes within one day and Rs. 80/- in case he prepares them after two days.

On the same analogy, the price in *istisna'* may be tied up with the time of delivery, and it will be permissible if it is agreed between the parties that in the case of delay in delivery, the price shall be reduced by a specified amount per day.

***Istisna'* as a Mode of Financing:**

Istisna' can be used for providing the facility of financing in certain transaction, especially in the house finance sector.

If the client has his own land and he seeks financing for the construction of a house, the financier may undertake to construct the house at that open land, on the basis of *istisna'*, and if the client has no land and he wants to purchase the land also, the financier may undertake to provide him a constructed house in a specified piece of land.

Since it is not necessary in *istisna'* that the price is paid in advance, nor is it necessary that it is paid at the time of delivery, (it may be deferred at any time according to the agreement of the parties), therefore, the time of payment may be fixed in whatever manner they wish. The payment may also be in installments.

On the other hand, it is not necessary that the financier himself constructs the house. He can enter into a parallel contract of *istisna'* with a third party, or may hire the services of a contractor (other than the client). In both cases, he can calculate his cost and fix the price of *istisna'* with his client in a manner which may give him a reasonable profit over his cost. The payment of installments by the client may start, in this case, right from the day when the contract of *istisna'* is signed by the parties, and may continue during the construction of the house and after it is handed over to the client. In order to secure the payment of the installments, the title deeds of the house or land, or any other property of the client may be kept by the financier as a security, until the last installment is paid by the client.

The financier, in this case, will be responsible for the construction of the house in full conformity with the specifications detailed in the agreement. In the case of any discrepancy, the financier will undertake such alteration at his own cost as may be necessary for bringing it in harmony with the terms of the contract.

The instrument of *istisna'* may also be used for project financing on similar lines. If a client wants to install an air conditioning plant in his factory, and the plant needs to be manufactured, the financier may undertake to prepare the plant the contract of *istisna'* according to the aforesaid procedure. Similarly, the contract of *istisna'* can be used for building a bridge or a highway.

The modern BOT (Buy, Operate and Transfer) agreements may also be formalized on the basis of *istisna*'. If a government wants to construct a highway, it may enter into a contract of *istisna*' with a builder. The price of *istisna*', in this case, may be the right of the builder to operate the highway and collect tolls for a specified period.