

Hamish Jiddiyyah and Arboun - Shariah, Regulatory, Accounting & Risk Management Perspective

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Abstract

Hamish Jiddiyyah and Arboun have evoked a number of issues that are of interest not only to the industry practitioners but also other stakeholders like regulators and academia. Most of these issues need to be subjected to Shariah scrutiny for effective application. This paper is an attempt to identify contemporary Shariah rulings, regulatory perspective and risk management relating to Hamish Jiddiyyah and Arboun. It, inter alia, includes definition, permissibility or otherwise and practical modalities related to these two types of deposits or advance payments that the Islamic banks can demand from customers. This paper also highlights accounting treatment recommended by AAOIFI and brief commentary on current practice followed by IBIs in Pakistan. Further, Market and Credit Risk modalities emanating from Arboun and Hamish Jiddiyyah have also been discussed as applicable to contemporary Banking Murabaha, Operating Ijarah and Ijarah Mutahia Bittamleek. Last but not the least, this paper also identifies changes notified by State Bank of Pakistan while adopting Shariah Standard in 2010 viz., Murabaha to the Purchase Orderer with respect to Arboun.

Key Words

Hamish Jiddiyyah, Arboun, Credit Risk, Market Risk and Capital Charge.

A. Shariah Perspective

I. Hamish Jiddiyyah (security deposit)

Hamish Jiddiyyah (Hamish: علامت; Jiddiyyah: سنجیدگی) is the security deposit paid by the customer (i.e., purchase orderer) upon request of the bank (i.e., purchaser) to ensure his seriousness. If Customer refuses to purchase the asset, bank can recover the actual loss in case of binding promise¹.

This concept can be further elaborated as follows:

- **Binding promise** - If the customer does not execute Murabaha, Islamic Banks can recover its loss by holding the asset and subsequently disposing it, to the extent of loss only.
- **Non-binding promise** - If the customer does not execute Murabaha, the Islamic Banks will return the entire amount of Hamish Jiddiyyah, even if the Islamic bank incurs a loss due to the non-fulfilment of promise.

Hamish Jiddiyyah can be demanded from customer by Islamic banks and is taken **before sale** while Arboun is taken **after sale**.

If Islamic Banks incur expenses in purchasing asset and promisee does not honour “promise to purchase”, bank can recover actual loss (i.e., selling price minus cost incurred by the Islamic Bank but does not include cost of funds i.e., its opportunity loss).

II. Arboun (Earnest Money)

Arboun (بيعانه) in case of Banking Murabaha, is the security deposit paid by customer (i.e., purchase orderer) to Islamic bank (i.e., purchaser) after murabaha sale subject to the condition that if sale is executed during a prescribed period, arboun is considered as part of the price. If the customer does not conclude sale, bank may fully retain it².

This concept can be elaborated as follows:

- **If customer proceeds with the Sale:** Arboun will be treated as part of sale proceeds
- **If customer does not proceed with the Sale:** Bank will retain Arboun irrespective of any occurrence of loss due to non-fulfilment of promise by Purchase Orderer

Agreement to sell is not a contract and any money paid with the promise is not considered as Arboun³.

Bai Al Arboun is not a valid contract according to the three schools of Islamic law i.e., Shafii, Hanafi and Maliki School. Only Hanbali School uphold it provided time should be stipulated for the option⁴.

Resolution No. 72 (3/8) of the Islamic Fiqh Academy also allows Arboun sales subject to same conditions as stipulated by AAOIFI.

Mode of Arboun payment can be cash, in kind or with a usufruct⁵.

Since Khiyar al-Shart is a constituent of Arboun, it is considered as impermissible in sarf contracts. In Salam, Salam Capital shall be paid in advance which means that the transaction is not considered to be Salam unless advance payment is made.

Option period need to be specified (either express or “Urf”) so as to avoid Gharar. Article 44 and 45 of the Majelle state that Urf amongst merchants is regarded as if agreed upon between them. Urf, therefore, is the basis of shariah rulings in contemporary Islamic finance such as permissibility of arboun, penalty clause in istisna, etc.

Buyer's right to rescind is lapsed if he confirms contract or disposes the subject-matter (i.e., Mabee). If the remaining price is not paid within the option period nor seller granted extension to the effect, the contract is considered revoked⁶.

Seller is liable for any loss before delivery. If so, contract is not legally enforceable and earnest money will be refunded.

Buyer is liable after delivery. If so, buyer's option is cancelled and he has to return the balance. (Clause 6, Shariah Standard No. 53 viz., Arboun).

Sellers' and buyers' liability before and after delivery respectively is based on Shariah maxim that ownership is established upon the conclusion of the contract while liability is subject to delivery⁷.

Delivery of mabee during the option period may be taken by buyer. However, this does not indicate confirmation of contract by itself unless the buyer's behaviour indicates that he has accepted the subject matter i.e., mabee⁸.

Growth physically attached to the original is considered as part of the original⁹ owing to the fact that it represents an integral part of it¹⁰. In principle, any growth in mabee during option period (either with or without delivery) is considered part of the mabee. However, seller may require that any growth not physically attached should belong to him despite the fact that ownership of mabee does not rest with him¹¹.

In case of identified sold item, seller cannot dispose it off. If seller does so by any mean such as sale or lease etc., rules relating to Fodooli disposals are applied¹². In case of ratification, buyer loses his option and is liable for remaining price to the first seller. Disposal by first seller is legally enforceable and he is entitled to receive sale price. If seller's action is not ratified by first buyer, the second disposal is void.

In case of identified mabee, seller need to deliver the same item and it cannot be a different mabee even with same specs, except with buyer's consent.

If it is stipulated that buyer will offer the mabee during option period duly accepted by seller, buyer's right to rescind contract remains effective even after offering mabee to his clients. Sale to his clients is considered as confirmation of contract¹³.

Options arising from payments of Arboun cannot be traded¹⁴.

Buyer may stipulate a condition for refund of arboun if conditions warrant it such as licenses from relevant authorities is not obtained¹⁵.

III. Application of Arboun & Hamish Jiddiyyah

Obtaining guarantees for tenders are allowed including bid and performance guarantee. These amounts are held on trust by the offeror of the bid on behalf of the successful bidder and are not viewed as Arboun. Moreover, this cannot be confiscated except in compensation for actual damage¹⁶.

For a unilateral binding promise, banks may obtain Hamish Jiddiyyah. Since no contract has been established and is taken before sale, this is held on trust and not as Arboun. If customer does not fulfil his binding promise, Institution's rights are limited to actual loss i.e., Selling Price minus Cost of the item to the Institution¹⁷.

Arboun is allowed from a buyer or lessee upon conclusion of sale or lease provided certain conditions are met as mentioned above. If buyer or lessee does not fulfil contract within specified period, seller or lessor can retain it. Institution should preferably refund balance after deducting from the Arboun the amount of actual damage¹⁸. As per SBP, the institution must return Arboun after deducting the actual damages¹⁹. Fatwa with respect to Hamish Jiddiyyah in Banking Murabahah issued by the Shariah Supervisory Board of Al Baraka²⁰ is also applicable to Ijarah.

Employees, either private or shared, can obtain Arboun while signing the contract. If hired, Arboun becomes prepaid salary, otherwise it goes to employee. However, if not hired, employee may take actual loss caused to him²¹.

B. Regulatory Perspective in Pakistan

To align Shariah practices as per internationally recognized AAOIFI Shariah Standard, SBP adopted SS No.8 in 2010 wherein it was made mandatory to return Arboun after mitigating the actual loss (IBD Circular I of 2021) as opposed to AAOIFI that treats it as preferable if customer rescinds the contract (Clause 2/5/6, SS No. 8, Murabaha to the Purchase Orderer).

This regulatory instruction will result in removing varying practices adopted by Islamic Banks. Further, this would increase customer trust in Islamic banking once the amount in excess of actual loss is returned to the customer despite the fact that the bank might have retained it.

C. Accounting Treatment

Islamic Financial Accounting Standard (IFAS) No. 1 on Murabaha issued by Institute of Chartered Accountants of Pakistan was implemented via Statutory Regulatory Order No. 865(I)/2005 in August 2005. This standard is silent on accounting treatment of Hamish Jiddiyyah and Arboun. However, AAOIFI FAS No. 2 deals with Hamish Jiddiyyah and Arboun.

I. Hamish Jiddiyyah

AAOIFI FAS No. 2 states that Hamish Jiddiyyah is considered an obligation on the Islamic Banks and is treated as a liability lest the Sharia Supervisory Board decides otherwise. Normally, when the customer purchases the asset as per the promise, Hamish Jiddiyyah is accounted for with sale price of asset.

Following are the journal entries in respect of Hamish Jiddiyyah.

Executed Transaction

1. Receipt of Hamish Jiddiyah

Debit: Cash/Customer Bank Account	xxx	
Credit: Security Deposit - Hamish Jiddiyah		xxx

2. Purchase of asset by the Islamic Bank

Debit: Inventory - Murabaha	xxx	
Credit: Payable to Supplier		xxx

3. Sale of the asset/Inventory

Debit: Murabaha Receivable	xxx	
Credit: Murabaha Sale*		xxx

4. Cost of sale

Debit: Murabaha Cost of Sale*	xxx	
Credit: Inventory - Murabaha		xxx

5. Recording adjustment of the Hamish Jiddiyah after the sale of asset to customer

Debit: Security Deposit - Hamish Jiddiyah	xxx	
Credit: Murabaha Receivable		xxx

*This is preferred method as per AAOIFI. As per industry practice in Pakistan, sale and cost of sale is not recorded.

On the other hand, if the customer fails to fulfill his promise in case it was non-binding, IFI has no right over the advance and a reversal entry will be made to record the

repayment of the same to the customer. Continuing on the above example, if the customer defaults on a binding promise, the treatment is shown below.

Unexecuted, Binding Promise, Loss is less than Hamish Jiddiyah

1. Disposal of Murabaha Inventory/asset at loss with adjustment to Hamish Jiddiyah

Debit: Cash	xxx	
Debit: Security Deposit - Hamish Jiddiyah (To the extent of loss)		xxx
Credit: Murabaha Inventory	xxx	

2. Return of balance Hamish Jiddiyah (if any)

Debit: Security Deposit - Hamish Jiddiyah	xxx	
Credit: Customer Bank Account		xxx

The remaining amount of Hamish Jiddiyah shall be returned to the customer. Where the value of the loss is higher than Hamish Jiddiyah a receivable is booked from the customer (or customer account is debited) if there is evidence of customer's failure to fulfill the promise.

Unexecuted, Binding Promise, Loss higher or equal to Hamish Jiddiyah

Disposal of Murabaha asset at loss with Hamish Jiddiyah fully adjusted

Debit: Cash	xxx	
Debit: Security Deposit - Hamish Jiddiyah		xxx
Debit: Receivable from Customer	xxx	

Credit: Murabaha Inventory	xxx
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II. Arboun

The treatment of Arboun is irrespective of the legality of the promise (whether binding or non-binding).

Entries Recording Arboun and its adjustments

1. Receipt of Arboun

Debit: Customer Bank Account	xxx	
Credit: Security Deposit - Arboun		xxx

2. Subsequent entry for adjusting Murabaha receivable with Arboun when Murabaha is executed

Debit: Security Deposit - Arboun	xxx	
Credit: Murabaha Receivable		xxx

3. Subsequent entry where Murabaha is not executed and asset is sold at loss lower than the amount of Arboun

Debit: Cash	xxx	
Debit: Security Deposit - Arboun (Full Amount)		xxx
Credit: *Other Income (Above the loss amount/Balancing Figure)	xxx	
Credit: Murabaha Inventory (At cost)		xxx

*As per regulatory requirement in Pakistan as mentioned in “Part B” above, this cannot be taken to income. Rather it will be returned to customer. Accordingly, instead of crediting other income, Islamic bank will credit customer’s bank account with the balancing figure.

D. Risk Management

Risk Management Guidelines for Islamic Banks were implemented in 2008 through IBD Circular No. 1 of 2008. The outline of SBP regulatory instructions was based on IFSB²² guiding principles on Risk Management.

Besides fifteen principles of risk management, these instructions cover six categories of risks. Among these six risk categories, risks pertaining to both Arboun and Hamish Jiddiyah are Market and Credit Risk which are briefly discussed below:

Market risk, being the risk of losses in “on and off-balance sheet” exposures emanating owing to fluctuations in market prices, exposes Islamic Banks to price risk. If customer defaults, Islamic Banks will have two options i.e., either re-rent or dispose of the asset at the market price.

Lessor, under operating Ijarah, is open to market risk on residual value of leased asset or if lease is terminated earlier by lessee’s default.

Lessor, under Ijarah Muntahia Bittamleek, is open to market risk on carrying value of leased asset in case of default.

This risk exists if customer, under Ijarah Muntahia Bittamleek, does not continue with contract or not to take the ownership of the asset at the end of contract and the book value of the asset exceeds the market price. Risk, in both cases, is partially diminished by the value of the asset and the Hamish Jiddiyah paid by the customer.

Credit risk is the one where counterparty, debtor or obligor, defaults or does not fulfil agreed terms.

CRM techniques²³ that are commonly employed by the Islamic Banks are Hamish Jiddiyah and Arboun.

Capital Adequacy Requirements for Islamic Financing**Assets with respect to Hamish Jiddiyah and Arboun**

Islamic Financial Services Board (IFSB 15) provides capital adequacy standards for Institutions offering Islamic Financial Services (IIFS). SBP, however, had not implemented IFSB standard and implemented Basel III in 2013 for full implementation by December 31, 2019 including Islamic Banks.

Among nine classes of Islamic financing assets as per IFSB 15 for minimum capital requirements which considers both credit and market risk, two classes which deal with Hamish Jiddiyah and Arboun are Murabaha To Purchase Orderer²⁴ and Ijarah Mutahia Bittamleek.

A. Murabaha & Non-Binding Murabahah To the Purchase Orderer

- **Credit Risk** - Once title is transferred, price risk is substituted with credit risk and this exposure is accounted for based on accounts receivable. The accounts receivable recorded at cash equivalent value is assigned a risk weight based on the credit standing to obligor as rated by an External Credit Assessment Institution (ECAI). If obligor is not rated, 100% risk weight is assigned.
- **Market Risk** – Asset is treated as inventory and 15% capital charge (187.5% RW) is applied.

B. Binding Murabahah To the Purchase Orderer

- **Credit Risk** - Recourse to Hamish Jiddiyah will be available to IIFS in case of default and will dispose it off to third party. If IIFS has the legal right to recover from the orderer any loss on disposing of asset, after accounting for Hamish

Jiddiyah, then claim receivable will be subject to Credit Risk which is calculated as asset acquisition cost minus market value of asset after any haircut minus Hamish Jiddiyah multiplied by 100% Risk Weight.

- **Market Risk** – If the IIFS does not have such right, the cost of the asset constitutes a market risk and this market risk is mitigated by HJ. Thus, market risk does not attract any capital charge.

C. Ijarah and Ijarah Muntahia Bittamleek

- **Credit Risk - Both Operating Ijārah & Ijarah Muntahia Bittamleek**

Credit risk weight, where asset is available before signing a lease contract, is equal to acquisition cost minus market value of asset after any haircuts minus Hamish Jiddiyah multiplied by the customer's rating or 100% Risk Weight for unrated customer.

Credit risk weight, upon signing and lease rentals are due, is equal to total lease receivable risk-weighted according to lessee's rating. 100% risk weight for an unrated lessee less recovery value of leased asset is applied.

- **Market Risk**

Capital Charge, where asset is available before signing a lease both for Ijarah & Ijarah Muntahia Bittamleek, is equal to 15% (187.5% Risk Weight equivalent) until lessee takes possession.

Capital Charge for operating Ijarah, upon signing and rentals are due, is equal to residual value risk weighted at 100%.

Capital Charge for operating ijarah, at maturity and asset is returned, is equal to 15% of carrying value of asset.

Conclusion

This paper provides the key rulings on Hamish Jiddiyah and Arboun applicable to Islamic Banks in Pakistan except minimum Capital Adequacy Requirements issued by Islamic Financial Services Board. SBP has not yet implemented separate capital standards for the Islamic banks. It is suggested that SBP should adopt IFSB guidelines for Islamic Banks. In case there is any practical modality such as for comparison purposes or any other global reporting requirements, this may be adopted as a parallel run with Basel Accord.

Further, SBP instruction to return the amount of Arboun in excess of actual loss to the customer despite the fact that the bank might have retained it, is a good step to bring uniformity in practices adopted by Islamic Banks. This would increase customer confidence in Islamic banking. AAOIFI allows arboun subject to certain conditions as mentioned above in the article. Options (Put or Call) as a derivative are not allowed in Islamic finance.

References

1. Financial Accounting Standard (FAS) No. 2: Murabaha and Murabaha to the Purchase Orderer
2. Shariah Standard No. 8 viz., Murabahah
3. Clause 2/2 of Shariah Standard No. 53 viz., Arboun
4. Al Fiqh al-Islami wa-Adilatuhu by Wahbah Zuhayli, Publisher Darul Ishaat, Karachi
5. Clause 2/3 of Shariah Standard No. 53 viz., Arboun
6. Clause 5/1 and Clause 5/2 of Shariah Standard No. 53 viz., Arboun
7. As per Article 293 of Al-Majalla al-Ahkam al Adaliyyah, if mabee is destroyed in vendor's possession, purchaser is not liable and loss rests with vendor. Further, as per Article 294, if mabee is destroyed after delivery, vendor is not liable and loss rests with purchaser.
8. Clause 7 of Shariah Standard No. 53 viz., Arboun
9. Clause 8/1 of Shariah Standard No. 53 viz., Arboun.
10. Article 85 of Majelle states that entitlement to profit depends upon liability for loss (Al-Kharaj Bi al-Daman).
11. Clause 8/2 of Shariah Standard No. 53 viz., Arboun.
12. A Fodooli is one who concludes a contract on behalf of another person in good faith without proper authority. Both AAOIFI and the Contract Act, 1872 applicable in Pakistan recognize the subsequent ratification by the principal of an earlier unauthorized transaction entered by an agent. Such ratification makes the transaction effective retrospectively. This may happen when a person who does not actually have authority as an agent negotiates with a third party, representing him as an agent of a named principal. However, the named principal might then choose to accept the contract with the third party. This gives retrospective validity to the actions of fodooli and an agency is created by ratification [Section 196]. As per

Sections 198 to 200 of the Contract Act, 1872, requisites for a valid ratification include i) an act to get ratified should be done on behalf of the person who wants to ratify it, ii) ratifier must be in existence at the time when the contract is entered into and also at the time of ratification, iii) ratifier must be competent to contract at the time when the contract is entered into and also at the time of ratification, iv) only lawful acts can be ratified, v) there cannot be ratification of partial transaction, vi) the person ratifying the transaction must have complete knowledge of the transaction in question else ratification will not be valid, vii) any act resulting in third party damages cannot be ratified and viii) ratification is made within a reasonable time which is a question of facts.

13. Clause 9/1 to 9/3 of Shariah Standard No. 53 viz., Arboun
14. Clause 9/4 of Shariah Standard No. 53 viz., Arboun.
15. Clause 10 of Shariah Standard No. 53 viz., Arboun
16. Clause 6/8 of Shariah Standard No. 5 viz., Guarantees
17. Loc. Cit.
18. Loc. Cit.
19. SBP IBD Circular No. 1 of 2010.
20. Resolution No. 110 (4/12) of International Islamic Fiqh Academy
21. Clause 4/11 of Shariah S Standard No. 34 viz., Hiring of Persons
22. Islamic Financial Services Board is an international standard setting organisation, inaugurated in November 2002, issues global standards and guiding principles for the Islamic financial industry including banking, capital markets and insurance sectors.
23. Clause 172 of IFSB-15 issued in December 2013) – Revised Capital Adequacy Standard For Institutions Offering Islamic Financial Services. IFSB also covers two other techniques (beyond the scope of this paper) which are With or Without recourse Guarantee and Pledge.
24. Murabaha to Purchase Orderer is also known as Banking Murabaha which means a sale contract whereby Islamic Bank sells commodity to a purchase orderer (a

specified commodity purchased by Islamic Bank based on promise to purchase, binding or nonbinding, from the customer) at cost with agreed profit margin.

25. gift.