

Islamic Modes of Finance

Theory and Key
Shariah
Principles

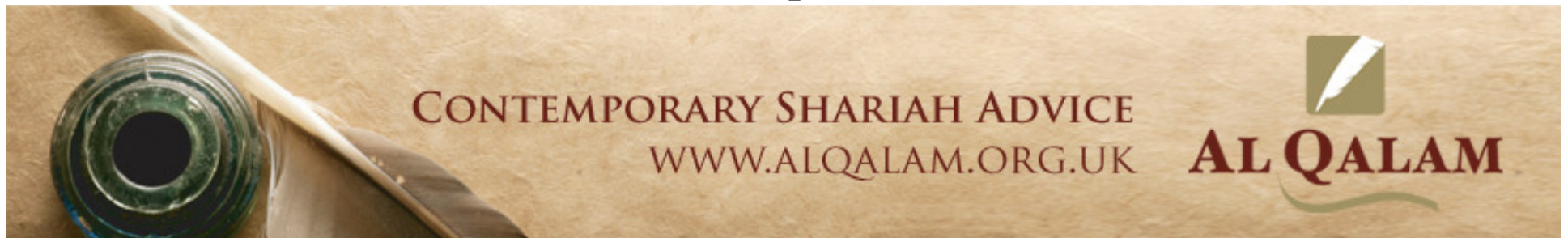
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Modes Of Finance

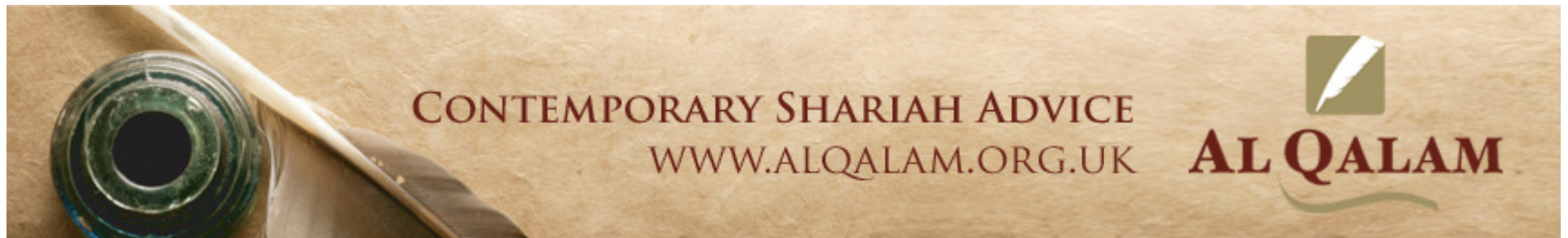
- Two are ideal modes which provide an alternative to interest banking and if implemented on a national level will result in much fairer distribution of wealth in society
 1. Musharakah – مشاركة (equity finance)
 2. Mudhaarabah - مضاربة (equity finance - sleeping partner)
- Two are not ideal **as they replicate the effects of conventional banking** but nevertheless are tolerated in Shariah
 3. Ijaarah - إجارة (leasing)
 4. Muraabahah - مرابحة (cost plus pricing)

We will also briefly analyse Salam - سلم, Istisnaa' – استصناع and Tawarruq – تورق

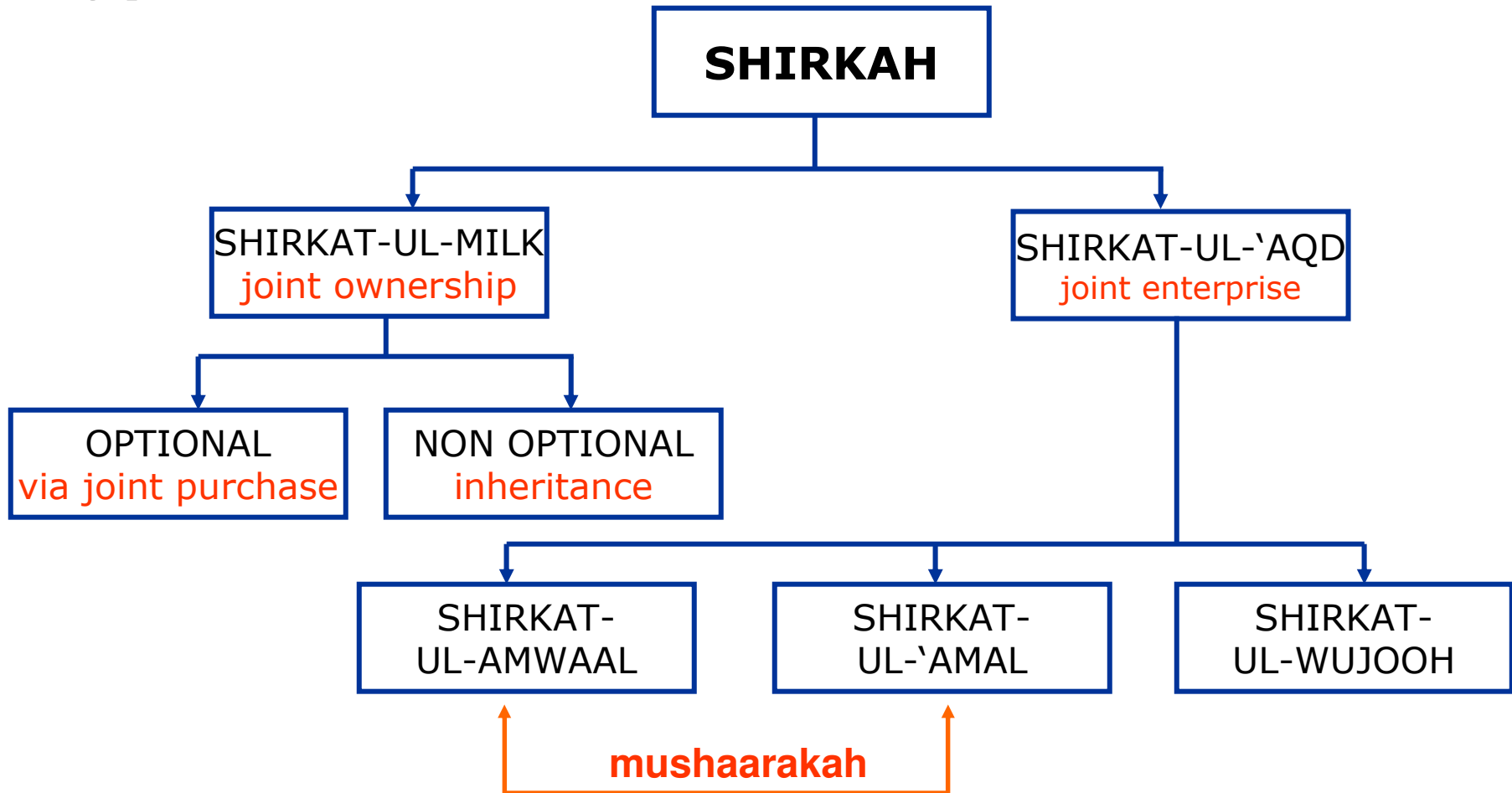


1 Mushaarakah

- “Mushaarakah” literally means **sharing**
- “Mushaarakah” is derived from “shirkah” which means “being a partner”.
- **Mushaarakah** is “a joint enterprises formed for conducting business in which all partners share the profit according to an agreed ratio while the loss is shared according to the ratio of investment”
- It is an ideal alternative for interest based financing with far reaching effects on the economy.



Types of Shirkah



Mushaarakah

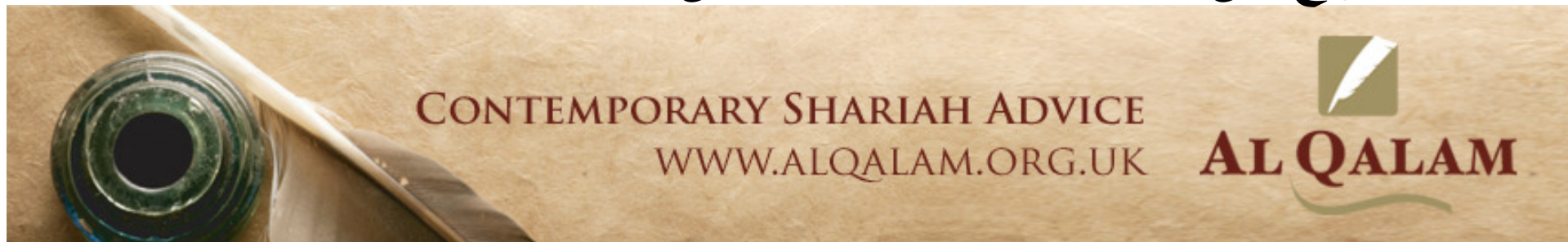
- The term Mushaarakah has been introduced recently by those who have written on the subject of Islamic modes of financing
- It is normally restricted to a particular type of “Shirkah”, i.e. **Shirkat-ul-amwaal**, where two or more persons invest some of their capital in a joint commercial venture.
- However, sometimes it includes **Shirkat-ul-’amal** also where partnership takes place in the business of services.



Rules of Musharakah

- Assets of Musharakah are jointly owned in proportion to the capital of each partner.
- Ratio of profit distribution must be agreed at the time of the execution of the contract.
 - As a proportion of the actual profit earned by the enterprise,
 - Not as percentage of partner's investment, and
 - Not in lump sum amount, otherwise, for the latter two, it can only be considered to be an on account payment subject to final settlement.
- Ratio of profit:
 - Must be equal to ratio of investment - Imam Malik & Imam Shaafi'ee
 - Does not have to be equal – Imam Ahmad
 - May differ, except that a sleeping partner cannot share the profit more than the percentage of his capital – Imam Abu Hanifah
- Profit is based on the agreement of the parties, but loss [by **general consensus**] is always subject to the ratio of investment.

الربح على ما اصطلاحا عليه والوضيعة على المال [كذا في المبسوط عن الشعبي]



Rules of Mushaarakah

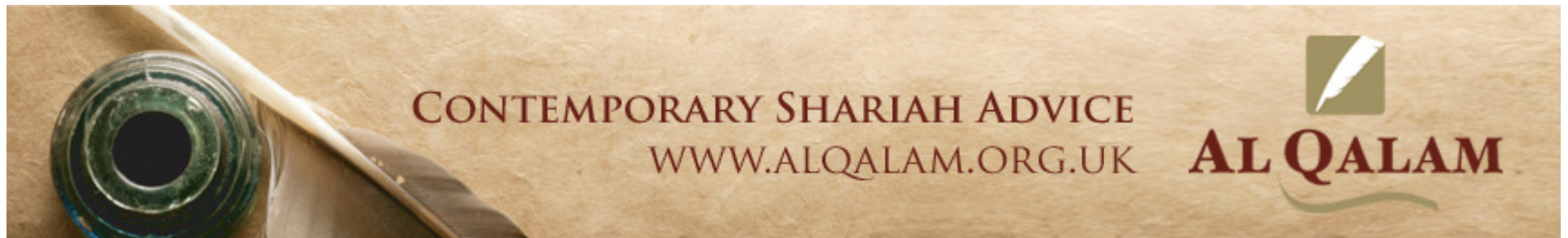
Management of Mushaarakah

- Each partner has a right to take part in Mushaarakah management.
- The partners may appoint a managing partner by mutual consent.
- One or more of the partners may decide not to work for the Mushaarakah and work as a sleeping partner.
- If one or more partners choose to become non-working or sleeping partners, the ratio of their profit cannot exceed the ratio of their capital investment.



Application of Mushaarakah

- Investment accounts – depositors are sleeping partners, bank also invests its own funds
- Stock companies
- Mutual funds
- Project financing
- Import/export finance – bank invests its funds with an importer/exporter
- etc...



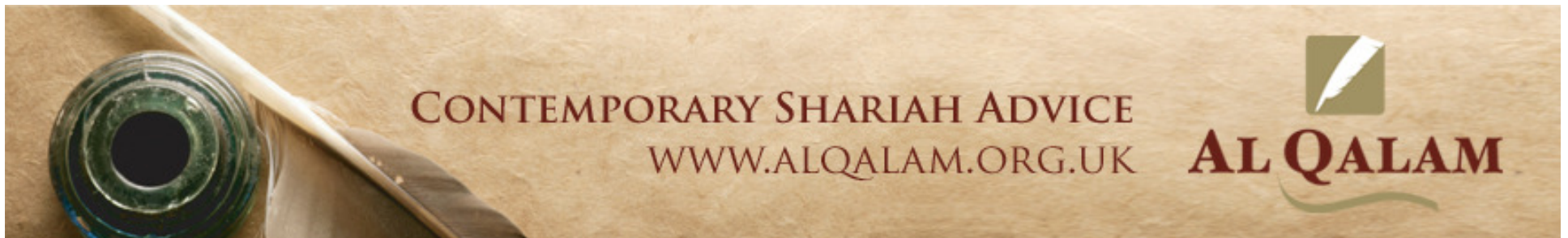
الشركة المتناقصة Diminishing Musharakah -

- A contract wherein a financier, after participation in ownership of a property/business/project, can liquidate his investment from the asset or the ongoing business.
- DM in House Financing:
 1. Joint ownership – *shirkat-ul-milk* is created in the desired property: usually c. 70% financier - 30% client [allowed by consensus]
 2. Financier's share is leased to the client by a separate contract [allowed by consensus]
 3. Separate unilateral promise from client to purchase financier's undivided share (حصة مشاعة) in units. Some Maliki and Hanbali agree to the enforceability of promise. Hanafi have allowed it in the case of *bai' bil-wafaa*.
 4. Actual periodic purchase of units of the financier's undivided share by exchange of offer and acceptance – preferably at market price, but can also be at the price promised by the client.
 5. Adjustment of the rental to reflect the decreased ownership of the financier.
- Used to finance purchase of fixed assets – house and commercial buildings, automobiles, plant and machinery, etc



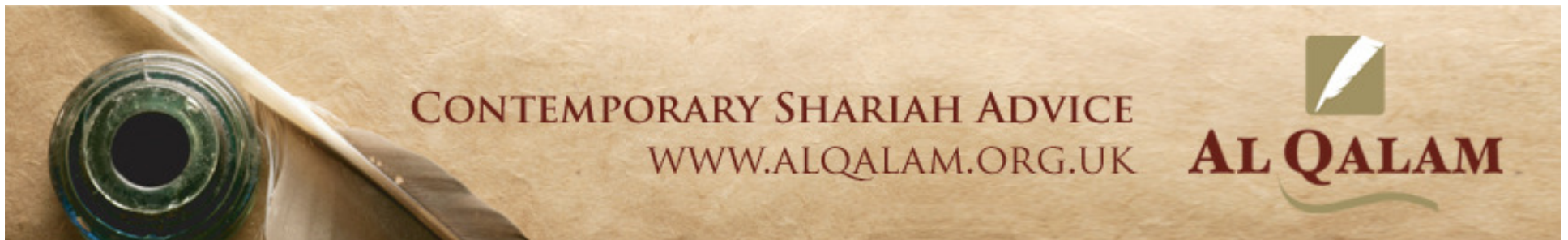
2 Mudhaarabah

- Partnership wherein one partner provides the funds for another to invest in a commercial enterprise.
- The investment comes from the "**Rabb-ul-Maal**" (Investor).
- The management and work is an exclusive responsibility of the "**Mudhaarib**" (Working Partner).
- The capital may be either **cash** or in **kind** and in the latter case must be valued.
- Profit is shared as per agreed ratio of actual profit.
- Loss of capital is borne by Rabb-ul-Maal [unless Mudhaarib is negligent], Mudhaarib loses his efforts.



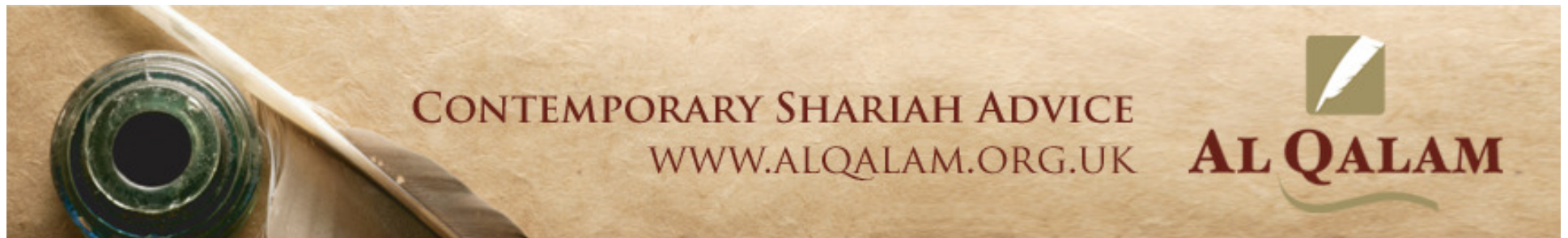
Capacities of Mudhaarib

- 1. Ameen (Trustee):** The money given by Rabb-ul-maal (investor) and the assets acquired therewith are held by him in trust.
- 2. Wakeel (Agent):** In purchasing goods for trade, he is an agent of Rabb-ul-maal.
- 3. Shareek (Partner):** If the enterprise earns a profit, he is a partner of Rabb-ul-maal and shares the profit in agreed ratio.
- 4. Dhaamin (Liable):** If the enterprise suffers a loss due to his negligence or misconduct, he is liable to compensate for the loss.
- 5. Ajeer (Employee):** If the enterprise becomes void due to any reason, the Mudhaarib is entitled to get a fee for his services.



Profit & Loss

- Parties must agree, right at the beginning, on a definite proportion of the actual profit to which each one of them is entitled, otherwise it will be presumed that they will share the profit in equal ratios.
- The Mudhaarib cannot [**by consensus**] claim any periodical salary, fee or remuneration. Imam Ahmad allows food expenses only, while Hanafis allow personal expenses, accommodation, food etc if outside his own city.
- The Mudhaarib & Rabb-ul-Maal cannot allocate a lump sum amount of profit for any party, nor can they determine the share of any party at a specific rate tied up with the capital.



Collective Mudaarabah

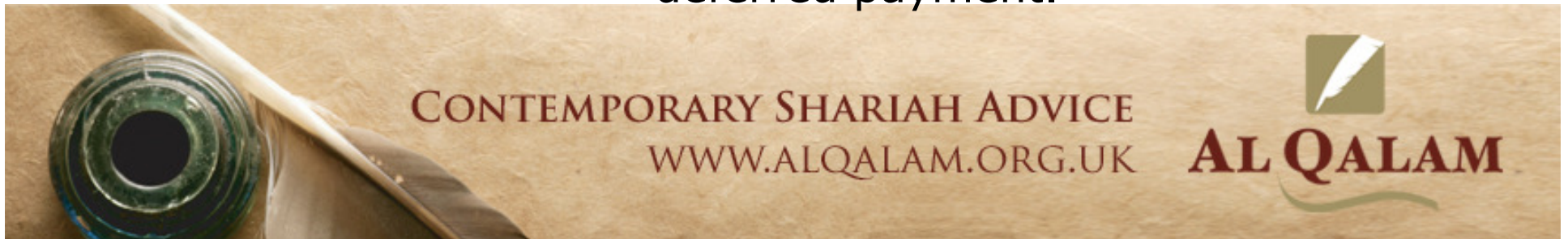
- “**Collective Mudhaarabah**” means a joint pool created by many investors and handled over to a single Mudhaarib who is normally a juristic person (شخص قانونی).
- Collective Mudhaarabah creates two different relationships:
 - ✓ Relationship between investors inter se, which is **Shirkah** or Partnership.
 - ✓ Relationship of all the investors with Mudhaarib, which is Mudhaarabah.



3 Muraabahah

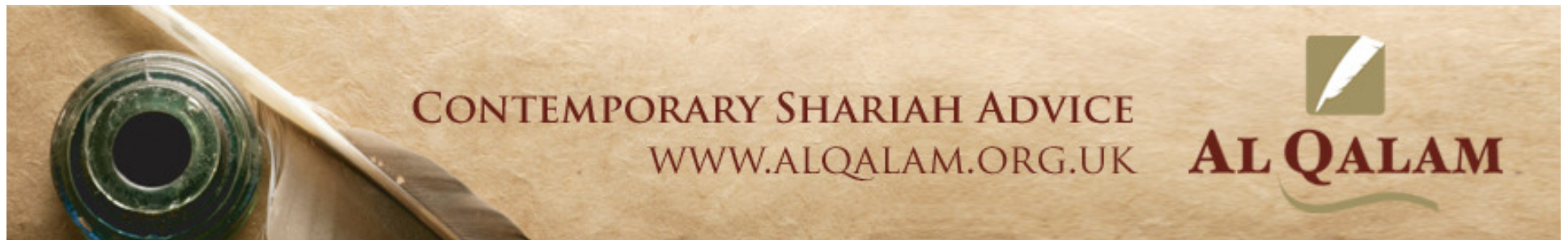
- **Muraabahah** is a particular kind of sale and not a mode of financing in its origin.
- Where the transaction is done on a “cost plus profit” basis i.e. the seller discloses the cost to the buyer and adds a certain profit to it to arrive at the final selling price.
- The distinguishing feature of Muraabahah from ordinary sale (**Musaawamah** - مساومة) is:
 - The seller discloses the cost to the buyer.
 - And a known profit is added.
- Sale at cost price is **Tawliyah** (تولية) and sale at a loss is **Wadhee'ah** (وضيعة).
- Payment of Muraabahah price may be
 1. At spot,
 2. In installments
 3. In lump sum after a certain time.

Hence, Muraabahah does not necessarily imply the concept of deferred payment.



Banking Muraabaha

- It is a contract wherein the institution, upon request by the customer, purchases an asset from a third party (a supplier) and resells the same to the customer either against immediate payment or on a deferred payment basis.
- It is a **bunch of contracts** completed in steps and ultimately suffices the financial needs of the client.
[تسمية الكل باسم الجزء]
- The **sequence** of their **execution** is extremely important to make the transaction Shariah compliant.



Steps in Muraabahah financing

1. Client and bank sign an agreement to enter into Muraabahah (MMFA).



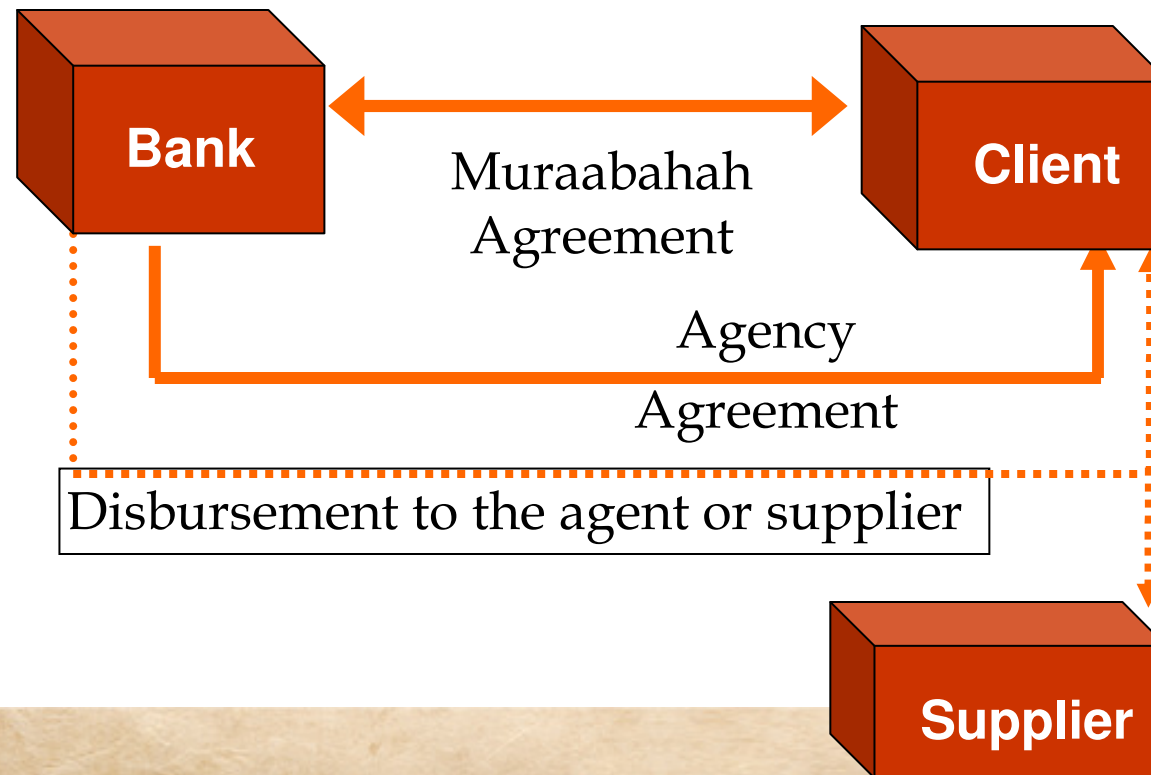
Steps in Muraabahah financing

2. Client appointed as agent to purchase the required goods on bank's behalf



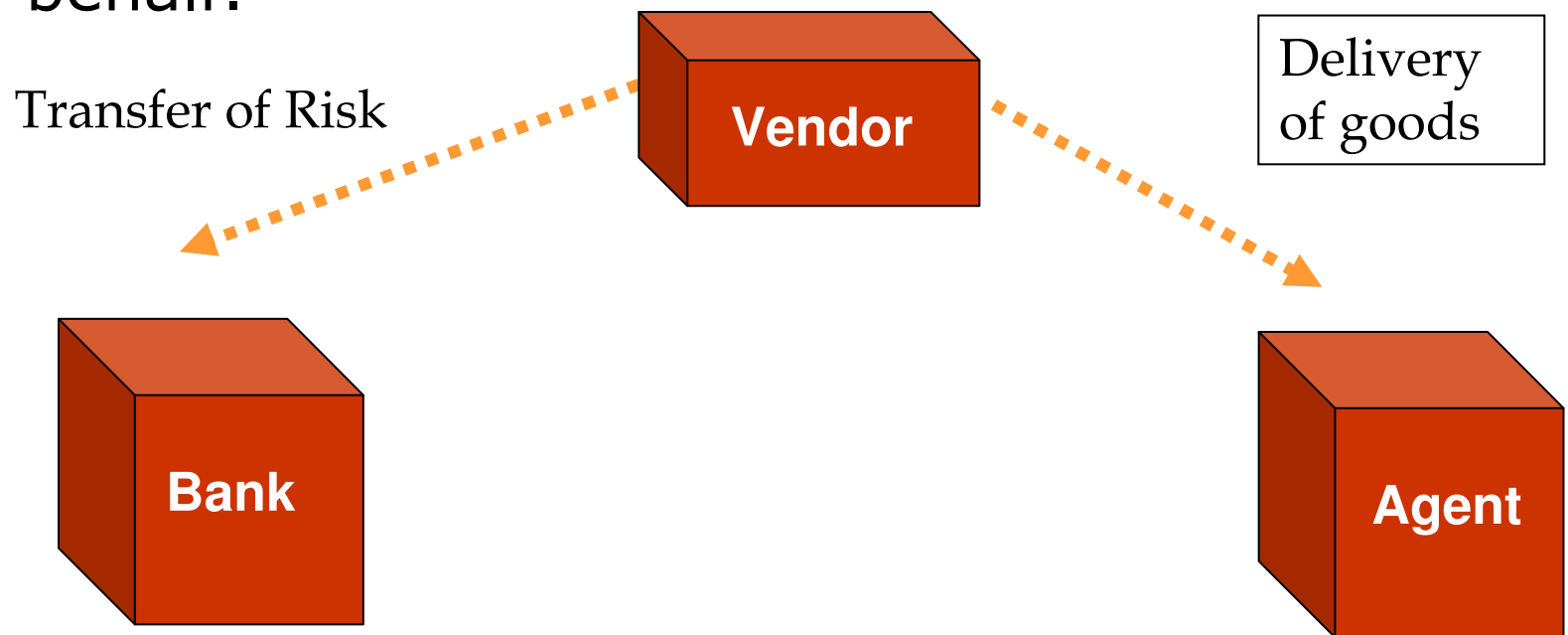
Steps in Muraabahah financing

3. Bank gives money to agent/supplier for the purchase of the goods.



Steps in Muraabahah financing

4. The agent takes possession of goods on bank's behalf.



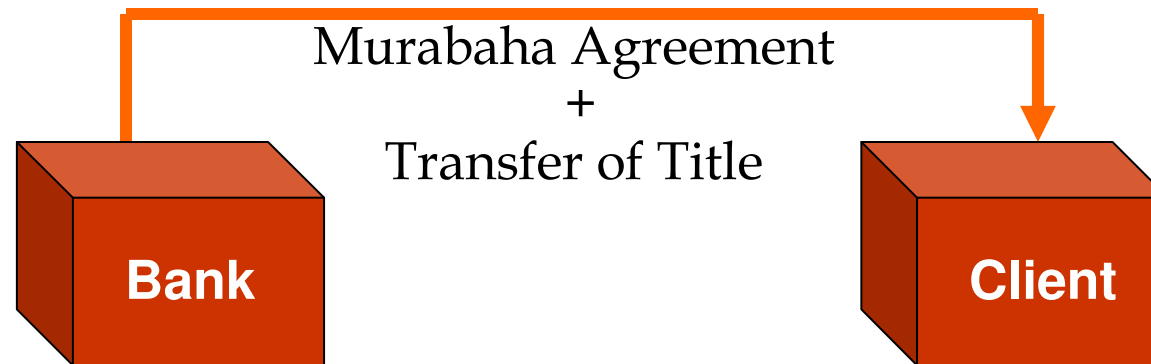
Steps in Muraabahah financing

5(a). Client makes an offer to purchase the goods from bank through a declaration.



Steps in Muraabahah financing

5(b). Bank accepts the offer and sale is concluded.



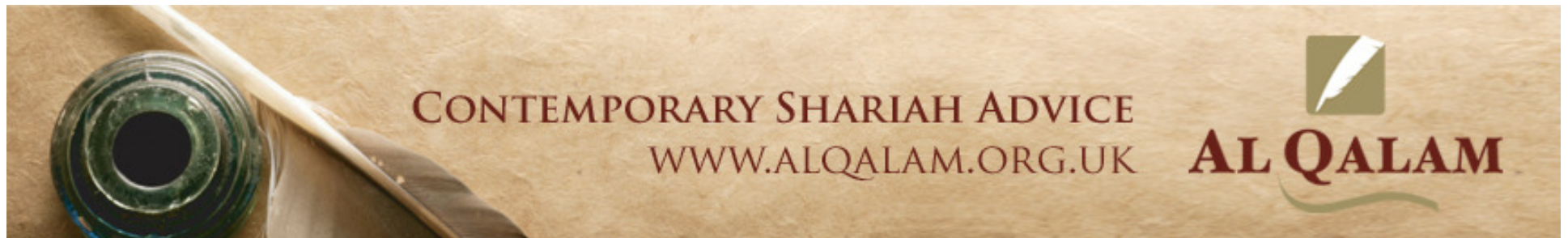
Steps in Muraabahah financing

6. Client pays agreed price to bank according to an agreed schedule. Usually on a deferred payment basis (Bai Mu'ajjal)



Steps in Muraabahah

1. MMFA – a mutual understanding to conduct business at a later stage
2. Client specifies a property belonging to a third party – bank can accept or refuse as there is no contractual agreement as yet.
3. Promise stage - Bank takes undertaking from client to purchase the property subsequent to the banks purchase of the property.
4. Agency agreement (optional) – Client becomes the agent of the bank to purchase a property on behalf of the bank.
5. **Property is purchased by the bank either directly or via it's agent (client) and liability is assumed by the bank.**
6. Client purchases the property from the bank. **This is the Muraabahah bit.**



Issues in Muraabahah

- Price differentiation in spot and credit sales
 - Money has no intrinsic utility and must be exchanged at par in both spot and credit sales – any excess is against time and is riba
 - Normal commodities have intrinsic utility and can be sold at a variance to the market rate in consideration of various ancillary factors (location/customer service/shopping experience/payment option) in both spot and credit sales – any excess above market price is always against the commodity
- The use of LIBOR as a benchmark
 - Questionable association, but not haram. Akin to a halal and haram butcher selling at the same price.
 - Does not advance Islamic philosophy of distributive justice.
- Promise to purchase
 - Some Maliki and Hanbali agree to the enforceability of promise. Hanafi have allowed it in the case of *bai' bil-wafaa*.
- Penalty clause
 - Self imposed remedial measure for dishonest clients after an initial grace period. Based on the opinion of some Maliki jurists.



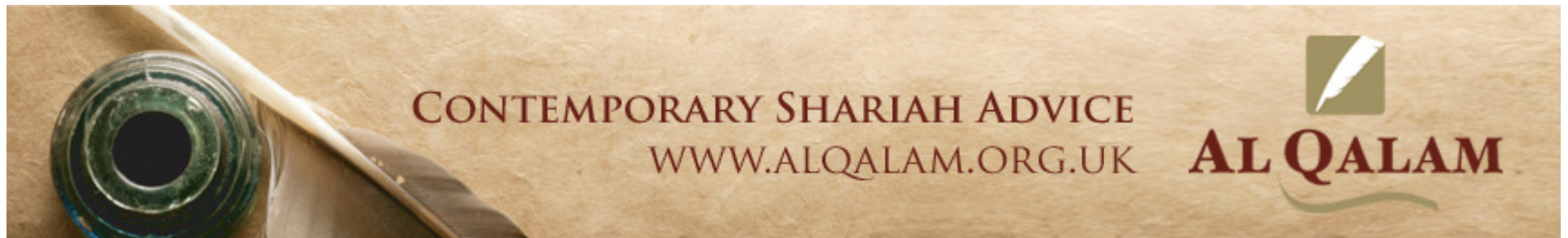
4 Ijaarah

- Literally, “To give something on rent”
- The term “Ijaarah” is used in two situations:
 1. “To employ the services of a person on wages”
e.g. “A” hires a porter at the airport to carry his luggage.
 2. Another type of Ijaarah relates to paying rent for use of an asset or property defined as “LAND” in Islamic Economics

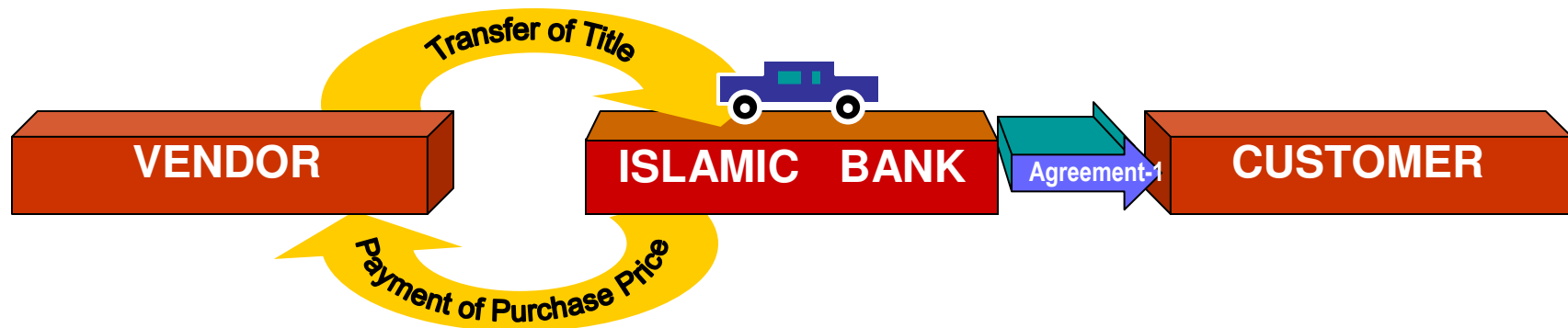


Ijaarah as a mode of financing

- Ijaarah is an Islamic alternative to Leasing.
- Several characteristics of conventional agreements may not conform to Shariah thus making the transaction un-Islamic and thereby invoking a prohibition.
- Risk and rewards of ownership lie with the owner i.e. any loss to the asset beyond the control of the lessee (مستأجر) should be borne by the Lessor (مؤجر).
- Late payment penalty cannot be charged to the income of the Lessor.

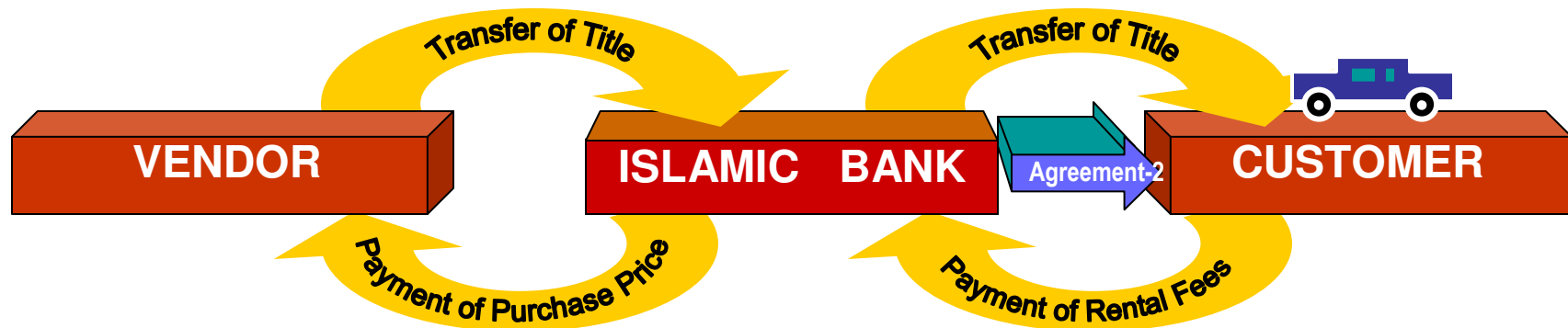


Process of Ijaarah



- The customer approaches the Bank with a request for financing and enters into a promise to lease agreement.
- The Bank purchases the item required for leasing and receives title of ownership from the vendor
- The Bank makes payment to the vendor (بائع)

Ijaarah as a mode of financing



- The Bank leases the asset to the customer after execution of lease agreement.
- The customer makes periodic payments as per the contract
- Title transfers to the customer

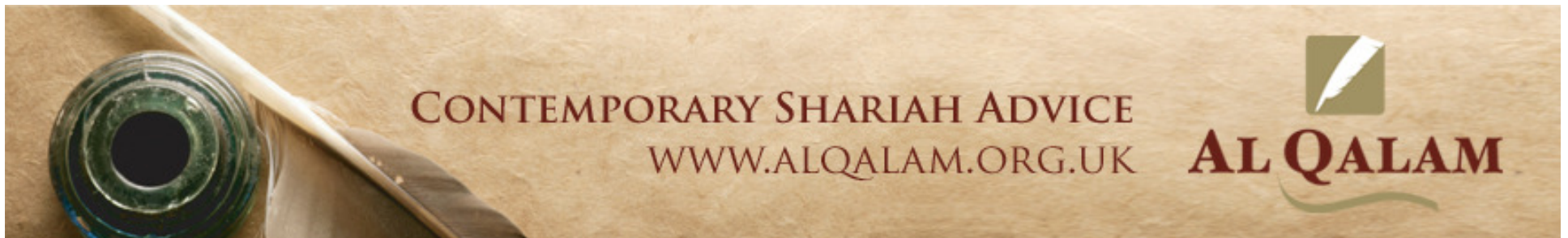
Rules of Ijaarah

- Since ownership of the leased asset remains with the Lessor, all rights and liabilities relating to ownership are borne by the Lessor.
- All rights and liabilities relating to use are borne by the Lessee e.g. "A" gives his house to "B" on rent. Property taxes are to be borne by the owner. Water tax, electricity bill etc are to be borne by the Lessee.
- The Lessee is responsible for damage to the asset caused by fraud or negligence.



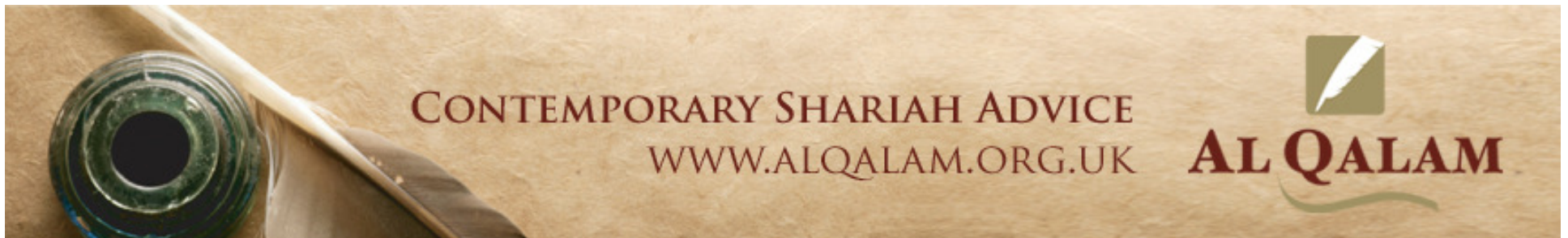
Rules of Ijaarah

- Lease rentals for the entire lease period must be fixed;
 - a) Different amounts of rents can be fixed for different periods, but they must be known.
 - b) The rent may be tied to a known benchmark, acceptable to both the parties. (e.g. inflation)
- Rent may only be charged after delivery of the asset to the Lessee in a usable condition.
- Insurance is a cost related to ownership of the assets and must be borne by the Lessor.



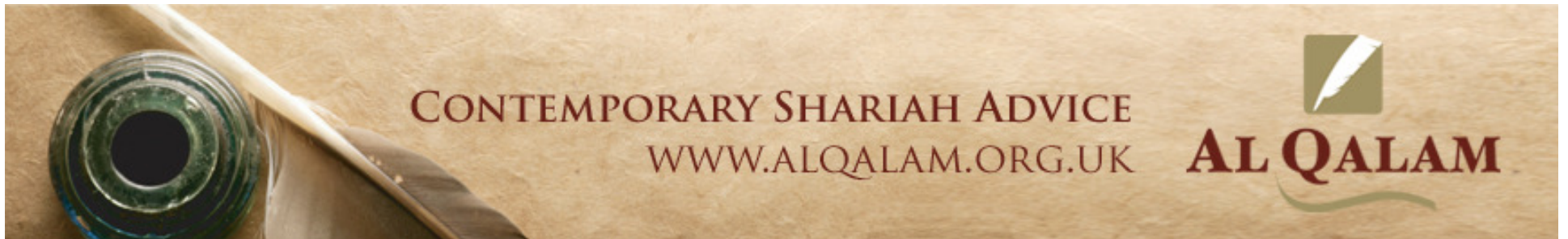
Application of Ijaarah

- For long and medium term fixed asset financing like plant, equipment, generators etc
- Retail products like Car financing, Durable financing



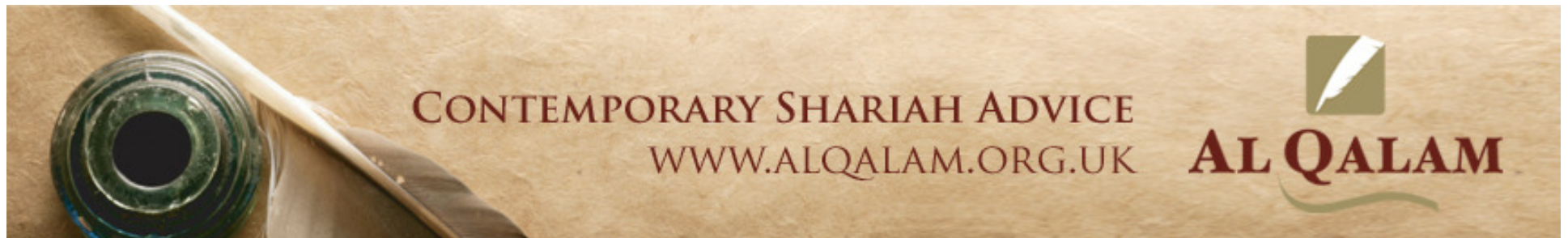
Salam - سلم & Istisnaa' - استصناع

- Ordinarily, Islamic Law of Contract requires a commodity to be in existence in order for the contract to be valid.
- However Salam & Istisnaa' are exceptions to the rule of possession - 'Qabdhah' and allow a transaction to occur without possession.



Salam - Definition

- Seller undertakes to supply specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot.
- Price is in cash but the supply of goods is deferred.



Purpose

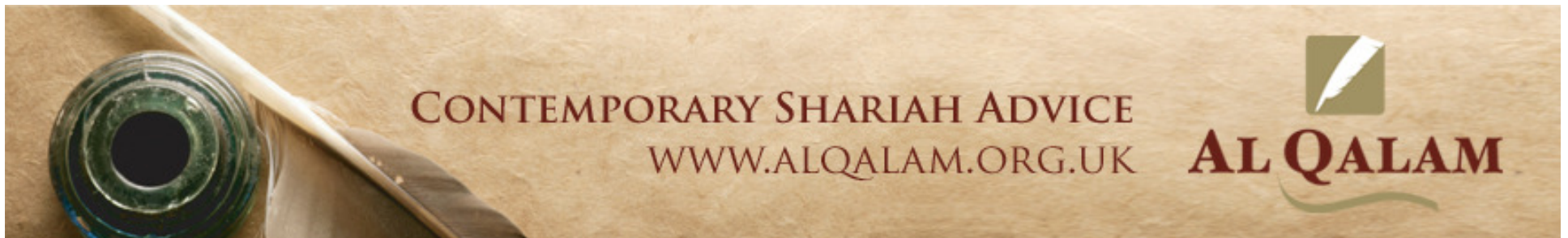
- To meet the need of small farmers who need money to grow their crops and to feed their family up to the time of harvest.
- To meet the need of traders for import and export business.

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Istisna - Definition

- Istisna' is sale transaction where commodity is transacted before it comes into existence.
- It is an order to producer to manufacture a specific commodity for the purchaser.



Difference b.w Istisnaa' & Salam Definition

ISTISNAA'

- The subject on which transaction of Istisnaa' is based, is always a thing which needs to be manufactured.
- Price must be fixed, but need not to be paid in advance

SALAM

- Subject can be anything.
- Price has to be paid in full in advance

Difference b.w Istisna & Salam Definition

ISTISNA'

- Time of Delivery does not have to be fixed
- The contract can be cancelled before the manufacturer starts working.

SALAM

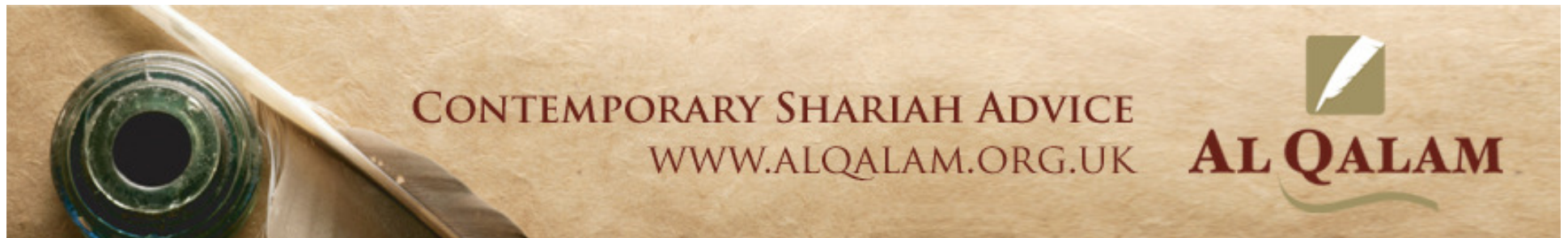
- Time of delivery is an essential part of the sale
- The contract cannot be cancelled unilaterally.

Tawarruq

- 'Tawarruq' is derived from الورق - minted silver coins
- 'Tawarruq' is not found in Arabic lexicons, only الإيقاق – to have abundant wealth and الاستيقاق – to seek الورق
- 'Tawarruq' is coined by [hanbali] fuqahaa' لمن يتكلف الحصول على الورق

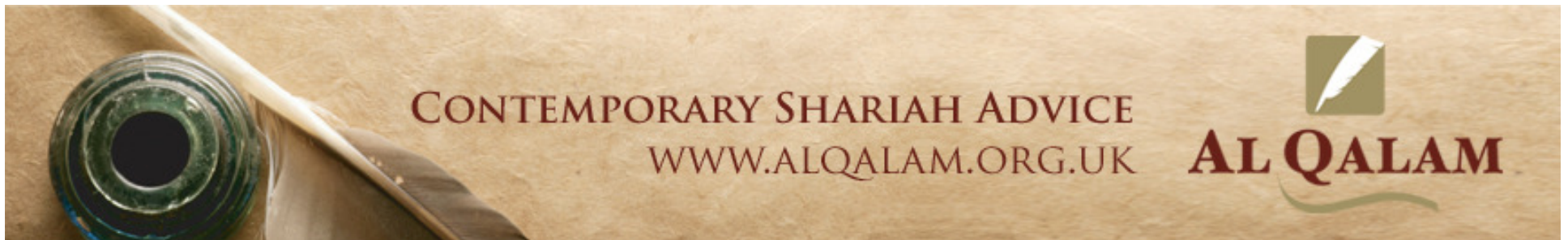
Tawarruq = 'to purchase a commodity on credit and then sell at spot to a third party at a loss with the objective of acquiring cash'

- The dominant opinion of Imam Ahmad and the math-hab of the school – permitted
 - According Ibn Teymiyyah and Ibn al-Qayyim – makruh
- The Shaafi'ee school – permitted as they also allow bey' al-'eenah
- The Maliki school – permitted but do not allow bey' al-'eenah
- Hanafi school – most have considered tawarruq and bey' al-'eenah to be the same
 - According to Imam Muhammad – makruh
 - According to Imam Abu Yusuf – permitted
 - Ibn al-Humam has reconciled the two (which many hanafi fuqahaa' have also adopted) by attributing the above two opinions to bey' al-'eenah and tawarruq respectively. However, the latter is khilaaf al-awlaa.



Application of Tawarruq

- Mutawarriq as agent
 - If the bank appoints the mutawarriq as its agent to purchase a commodity on its behalf and then sell it to himself, it is not valid – purchase and sale are interdependent and لأن الواحد لا يتولى طرفى العقد
 - However, if the mutawarriq is appointed only to purchase, and the bank then sells the commodity itself to the mutawarriq through a separate contract, it is valid but not advisable as it resembles interest based financing. – the mutawarriq returns more than he receives from the bank.
- Bank as agent
 - If the mutawarriq appoints the bank as his agent to purchase the commodity from the bank, it is not valid. لأن الواحد لا يتولى طرفى العقد
 - If the mutawarriq appoints the bank as his agent to sell a commodity that he would purchase from the bank as a condition of the purchase from the bank, it is not valid – sale and agency are interdependent.
 - However, if the agency is via a separate contract, it is valid but not advisable as it again resembles interest based financing. – the bank (in its capacity as agent) gives the mutawarriq less than it will receive from him subsequently.
- In both of the above, the difference is only evidenced in the sequence of the signing of the documentation.



Tawarruq in Action

- Customer requires £10,000 for 12 months
- Customer promises to purchase a commodity [copper] from the bank on deferred payment basis over 12 months
- Customer appoints bank's employee as his agent through a restricted Power of Attorney to purchase the commodity on his behalf
- Bank sells commodity to customer [through his Attorney/bank employee] at cost plus profit [12.5%] payable over 12 months
- After possession, customer sells the commodity through a previously appointed third party broker
- Payment [£10,000] credited to the customer's account
- Customer makes monthly payments [£1,250] to the bank