Arab and Islamic Laws Series

An Introduction to Islamic Finance

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FOREWORD

بسم الله الرحمن الرحيم
الحمد لله رب العالمين، والصلاة والسلام على رسوله الكريم
وعلى آله وصحبه اجمعين، وعلى كل من تبعهم بإحسان
إلى يوم الدين - أما بعد :

Over the last few decades, Muslims have been trying to restructure their lives on the basis of Islamic principles. They strongly feel that the political and economic dominance of the West during past centuries has deprived them of divine guidance, especially in the socio-economic fields. Therefore, after acquiring political freedom, the masses are striving for the revival of their Islamic identity to organize their collective life in accordance with Islamic teachings.

In the economic field, the biggest challenge for Muslims was to reform their financial institutions to bring them in harmony with the dictates of *Shari'ah*. In an environment where the entire financial system was based on interest, it was a formidable task to structure the financial institutions on an interest-free basis.

The people not conversant with the principles of *Shari'ah* and its economic philosophy sometimes believe that abolishing interest from the banks and financial institutions would make them charitable, rather than commercial, concerns which offer financial services without a return.

Obviously, this is a totally wrong assumption. According to *Shari'ah*, interest free loans are meant for cooperative and charitable activities, and not normally for commercial transactions, except in a very limited range. So far as commercial financing is concerned, the Islamic *Shari'ah* has a different set-up for that purpose. The principle is that the person extending money to another person must decide whether he wishes to help the opposite party or he wants to share his profits. If he wants to help the borrower, he must rescind from any claim to any additional amount. His principal will be secured and guaranteed, but no return over and above the principal amount is legitimate. But if he is advancing money to share the profits earned by the other party, he can claim a stipulated proportion of profit actually earned by him, and must share his loss also, if he suffers a loss.

It is thus obvious that exclusion of interest from financial activities does not necessarily mean that the financier cannot earn a profit. If financing is meant for a commercial purpose, it can be based on the concept of profit and loss sharing, for which *musharakah* and *mudarabah* have been designed since the very inception of the Islamic commercial law.

There are, however, some sectors where financing on the basis of *musharakah* or *mudarabah* is not workable or feasible for one reason or another. For such sectors the contemporary scholars have suggested some other instruments which can be used for the purpose of financing, like *murabahah, ijarah, salam* or *istisna'*.

For the last two decades, these modes of financing are being used by the Islamic banks and financial institutions. But all these instruments are not the substitutes of interest in

the strict sense, and it will be wrong to presume that they may be used exactly in the same fashion as interest is used. They have their own set of principles, philosophy and conditions without which it is not allowed in *Shari'ah* to use them as modes of financing. Therefore the ignorance of their basic concept and relevant details may lead to confusing the Islamic financing with the conventional system based on interest.

The present book is a revised collection of different articles that aimed at providing basic information about the principles and precepts of Islamic finance, with special reference to the modes of financing used by the Islamic banks and non-banking financial institutions. I have tried to explain the basic concept underlying these instruments, the necessary requirements for their acceptability from the *Shari'ah* standpoint, and the correct method of their application. I have also dealt with the practical issues involved in the application of these instruments and their possible solutions in the light of *Shari'ah*.

In my capacity as chairman / member of the *Shari'ah* Supervisory Boards of a number of Islamic banks in different parts of the world, I came across the points of weakness in their operations caused mainly by the lack of clear perception of the relevant rules and principles of *Shari'ah*. This experience emphasized the need for the present book in which I have tried to discuss the relevant subject in a simple way which may be easily understood by a common reader who had no opportunities to study the Islamic financial principles in depth.

This humble effort, I hope, will facilitate to understand the basic principles of Islamic finance and the main points of difference between conventional and Islamic banking. May Allah Ta'ala accept this humble effort, honour it with His pleasure and make it beneficial for the readers.

وما توفيقى إلا بالله

Muhammad Taqi Usmani
Karachi, 04.03.1419 A.H. 29.06.1998 A.D.

ABOUT THE AUTHOR

Mohamed Taqi Usmani is the son of Maulana Mufti Muhamed Shafi (*Mufti-e-Azam Pakistan* and founder of the Darul Uloom in Karachi).

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He has taught several branches of Islamic learnings, including *Fiqh* (Islamic Jurisprudence) and *Hadith* for 42 years.

Dr Usmani has been a Judge of the *Shari'ah* Apellate Branch of the Supreme Court of Pakistan from 1982 up to the present date, is a permanent member of the International Islamic *Fiqh* Academy in Jeddah, an organ of the OIC and is a Vice-President of the Darul Uloom in Karachi.

The author is the Chairman of the International *Shari'ah*t Council of the Accounting and Auditing Organization for Islamic Financial Institutions in Bahrain and is a Chairman and member of *Shari'ah* supervisory boards of a dozen Islamic banks and financial institutions throughout the world.

Dr Usmani is the Chief Editor of the monthly *Albalagh* (published in Urdu) since 1967 and of the monthly *Albalagh International* (published in English) since 1990.

He has written articles on various issues in the country's leading newspapers and is the author of more than 50 books in Arabic, Urdu and English.

Some Preliminary Points

Before the details of Islamic modes of financing are discussed, it seems necessary to explain some points concerning the basic principles that govern the whole economic set-up in an Islamic way of life.

1. Belief in Divine Guidance

The foremost belief around which all the Islamic concepts revolve is that the whole universe is created and controlled by One, the only One God. He has created man and appointed him as His vice-regent on the Earth to fulfil certain objectives through obeying His commands. These commands are not restricted to some modes of worship or so-called religious rituals. They, on the contrary, cover a substantial area of almost every aspect of our life. These commands are neither so exhaustive that straiten the human activities within a narrow circle, leaving no role for human intellect to play, nor are they so little or ambiguous that they leave every sphere of life at the mercy of human perception and desire. Far from these two extremes, Islam has a balanced approach to govern human life. On the one hand, it has left a very wide area of human activities to man's own rational judgment where he can take decisions on the basis of his reason, assessment of facts and expedience. On the other hand, Islam has subjected human activities to a set of principles which have eternal application and cannot be violated on superficial grounds of expediency based on human assessment.

The fact behind this scheme is that human reason, despite its vast capabilities, cannot claim to have unlimited power to reach the truth. After all, it has some limits beyond which it either cannot properly work or may fall prey to errors. There are numerous domains of human life where 'reason' is often confused with 'desires' and where unhealthy instincts, under the disguise of rational arguments, misguide humanity to wrong and destructive decisions. All those theories of the past which are held today to be fallacious, claimed, in their respective times, to be 'rational' but it was after centuries that their fallacy was discovered and their absurdity was universally proved.

It is thus evident that the sphere of work delegated to human 'reason' by its Creator is not unlimited. There are areas in which human reason cannot give proper guidance or, at least, is susceptible to errors. It is these areas in which Allah Almighty, the Creator of the universe, has provided guidance through His revelations sent down to His prophets. On the basis of this approach it is the firm belief of every Muslim that the commands given by the divine revelations through the last messenger صلى الله عليه وسلم are to be followed in letter and spirit and cannot be violated or ignored on the basis of one's rational arguments or his inner desires. Therefore, all human activities must always be subject to these commands and must work within the limits prescribed by them. Unlike other religions, Islam is not confined to some moral teachings, some rituals or some modes of worship. It rather contains guidance in every sphere of life including socio-economic fields. The obedience from servants of Allah is required not only in worship, but also in their economic activities, even though it is at the price of some apparent benefits, because these apparent benefits may go against the collective interest of the society.

2. The Basic Difference Between Capitalist and Islamic Economy

Islam does not deny market forces and market economy. Even the profit motive is acceptable to a reasonable extent. Private ownership is not totally negated. Yet, the basic difference between capitalist and Islamic economy is that in secular capitalism, the profit motive or private ownership are given unbridled power to make economic decisions. Their liberty is not controlled by any divine injunctions. If there are some restrictions, they are imposed by human beings and are always subject to change through democratic legislation, which accepts no authority of any super-human power. This attitude has allowed a number of practices which cause imbalances in the society. Interest, gambling, speculative transactions tend to concentrate wealth in the hands of a few. Unhealthy human instincts are exploited to make money through immoral and injurious products. Unbridled profit making creates monopolies which paralyse market forces or, at least, hinder their natural operation. Thus the capitalist economy which claims to be based on market forces, practically stops the natural process of supply and demand, because these forces can properly work only in an atmosphere of free competition, and not in monopolies. It is sometimes appreciated in a secular capitalist economy that a certain economic activity is not in the interest of the society, yet, it is allowed to continue because it goes against the interest of some influential circles who dominate the legislature on the strength of their majority. Since every authority beyond the democratic rule is totally denied and 'trust in God' (which is affirmed on the face of every U.S. dollar) has been practically expelled from the socio-economic domain, no divine guidance is recognized to control the economic activities.

The evils emanating from this attitude can never be curbed unless humanity submits to divine authority and obeys its commands by accepting them as absolute truth and super-human injunctions which should be followed in any case and at any price. This is exactly what Islam does. After recognizing private ownership, profit motive and market forces, Islam has put certain divine restrictions on economic activities. These restrictions being imposed by Allah Almighty, Whose knowledge has no limits, cannot be removed by any human authority. The prohibition of *riba* (usury or interest), gambling, hoarding, dealing in unlawful goods or services, short sales and speculative transactions are some examples of these divine restrictions. All these prohibitions combined together have a cumulative effect of maintaining balance, distributive justice and equality of opportunities.

3. Asset-backed Financing

One of the most important characteristics of Islamic financing is that it is an asset-backed financing. The conventional/capitalist concept of financing is that the banks and financial institutions deal in money and monetary papers only. That is why they are forbidden, in most countries, from trading in goods and making inventories. Islam, on the other hand, does not recognize money as a subject-matter of trade, except in some special cases. Money has no intrinsic utility; it is only a medium of exchange; each unit of money is

100 per cent equal to another unit of the same denomination, therefore, there is no room for making profit through the exchange of these units *inter se*. Profit is generated when something having intrinsic utility is sold for money or when different currencies are exchanged, one for another. The profit earned through dealing in money (of the same currency) or the papers representing them is interest, hence prohibited. Therefore, unlike conventional financial institutions, financing in Islam is always based on non-liquid assets which creates real assets and inventories.

The real and ideal instruments of financing in *Shari'ah* are *musharakah* and *mudarabah*. When a financier contributes money on the basis of these two instruments it is bound to be converted into the assets having intrinsic utility. Profits are generated through the sale of these real assets.

Financing on the basis of *salam* and *istisna'* also creates real assets. The financier in the case of *salam* receives real goods and can make profit by selling them in the market. In the case of *istisna'*, financing is effected through manufacturing some real assets, as a reward of which the financier earns profit.

Financial leases and *murabahah*, as will be seen later in the relevant chapters, are not originally modes of financing. But, in order to meet some needs they have been reshaped in a manner that they can be used as modes of financing, subject to certain conditions, in those sectors where *musharakah*, *mudarabah salam* or *istisna'* are not workable for some reasons. The instruments of leasing and *murabahah* are sometimes criticized on the ground that their net result is often the same as the net result of an interest-based borrowing. This criticism is justified to some extent, and that is why the *Shari'ah* Supervisory Boards are unanimous on the point that they are not ideal modes of financing and they should be used only in cases of need with full observation of the conditions prescribed by *Shari'ah*. Despite all this, the instruments of leasing and *murabahah*, too, are fully backed by assets and financing through these instruments is clearly distinguishable from the interest-based financing on the following grounds:

1. In conventional financing, the financier gives money to his client as an interest-bearing loan, after which he has no concern as to how the money is used by the client. In the case of *murabahah*, on the contrary, no money is advanced by the financier. Instead, the financier himself purchases the commodity required by the client. Since this transaction cannot be completed unless the client assures the financier that he wishes to purchase a commodity, therefore, *murabahah* is not possible at all, unless the financier creates an inventory. In this manner, financing is always backed by assets.
2. In the conventional financing system, loans may be advanced for any profitable purpose. A gambling casino can borrow money from a bank to develop its gambling business. A pornographic magazine or a company making nude films are as good customers of a conventional bank as a house-builder. Thus, conventional financing is not bound by any divine or religious restrictions. But the Islamic banks and financial institutions cannot remain indifferent about the nature of the activity for which the facility is required. They cannot effect

murabahah for any purpose which is either prohibited in *Shari'ah* or is harmful to the moral health of the society.

3. It is one of the basic requirements for the validity of *murabahah* that the commodity is purchased by the financier which means that he assumes the risk of the commodity before selling it to the customer. The profit claimed by the financier is the reward of the risk he assumes. No such risk is assumed in an interest-based loan.
4. In an interest bearing loan, the amount to be repaid by the borrower keeps on increasing with the passage of time. In *Murabahah*, on the other hand, a selling price once agreed upon becomes and remains fixed. As a result, even if the purchaser (client of the Bank) does not pay on time, the seller (Bank) cannot ask for a higher price, due to delay in settlement of dues. This is because in *Shari'ah*, there is no concept of time value of money.
5. In leasing too, financing is offered through providing an asset having usufruct. The risk of the leased property is assumed by the lessor/financier throughout the lease period in the sense that if the leased asset is totally destroyed without any misuse or negligence on the part of the lessee, it is the financier/lessor who will suffer the loss.

It is evident from the above discussion that every financing in an Islamic system creates real assets. This is true even in the case of *murabahah* and leasing, despite the fact that they are not believed to be ideal modes of financing and are often criticized for their being close to the interest-based financing in their net results. It is known, on the other hand, that interest-based financing does not necessarily create real assets, therefore, the supply of money through the loans advanced by the financial institutions does not normally match with the real goods and services produced in the society, because the loans create artificial money through which the amount of money supply is increased, and sometimes multiplied without creating real assets in the same quantity. This gap between the supply of money and production of real assets creates or fuels inflation.

That the modern debt-based financial system is the major cause of inflation and of many imbalances found in the present economic system is admitted by many modern economists, even in the societies dominated by interest. John Tomlinson, for example, is an Oxford-based Canadian economist. In his creative work *Honest Money* he has analysed the evil effects of the present debt-based financial system and has advocated for converting it into an equity-based financial set-up. He observes:

> "The creation of money by the commercial banking sector is one of the principal causes of economic and business cycles. These are a direct effect of the money-lending function of the. Its role becomes more apparent when we consider the role of money as a store of exchange value.
>
> Each identical unit of money must contain an exactly equal amount of exchange value.

> When new units are created without any substance behind them the value needed to fill them must come from the value already stored by the previously existing units."[1]

Since financing in an Islamic system is backed by assets, it is always matched with corresponding goods and services.

4. Capital and Entrepreneur

According to the capitalist theory, capital and entrepreneur are two separate factors of production. The former gets interest while the latter is entitled to profit. Interest is a fixed return for providing capital, while profit can be earned only when there is a surplus after distributing the fixed return to land, labour and capital (in the form of rent, wages and interest).

Islam, on the contrary, does not recognize capital and entrepreneur as two separate factors of production. Every person who contributes capital (in the form of money) to a commercial enterprise assumes the risk of loss and therefore he is entitled to a proportionate share in the actual profit. In this manner 'capital' has an intrinsic element of 'entrepreneurship', so far as the risk of the business is concerned. Therefore, instead of a fixed return as interest, it derives profit. The more the profit of the business, the higher the return on capital. In this way the profits generated by commercial activities in society are equitably distributed to all those persons who have contributed capital to the enterprise, however little it may be. Since in the context of the modern practice, it is the banks and financial institutions who provide capital to the commercial activities, out of the deposits made with them, the flow of the actual profits earned by the society may be directed towards the depositors in equitable proportions which may distribute wealth in a wider circle and may hamper concentration of wealth in the hands of a few.

5. Present Practices of Islamic Banks

It is sometimes argued against the Islamic financial system that the Islamic banks and financial institutions, working for the last three decades, did not bring any visible change in the economic set-up, not even in the field of financing. This indicates that the boastful claims of creating 'distributive justice' under the umbrella of Islamic banking are exaggerated.

This criticism is not realistic, because it does not take into account the fact that, in proportion to conventional banking, the Islamic banks and financial institutions are no more than a small drop in the ocean, and therefore, they cannot be supposed to revolutionize the economy in a short period.

[1] John Tomlinson: *Honest Money*, Helix, 1993, p. 51.

Secondly, these institutions are passing through their age of infancy. They have to work under a large number of constraints, therefore, some of them have not been able to comply with all the requirements of *Shari'ah* in all their transactions, therefore, each and every transaction carried out by them cannot be attributed to *Shari'ah*.

Thirdly, the Islamic banks and financial institutions are not normally supported by the governments, legal and taxation systems and the central banks of their respective countries. Under these circumstances, they have been given certain concessions, on the grounds of need or necessity, which are not based on the original and ideal principles of *Shari'ah*.

Islam, being a practical way of life, has two sets of rules; one is based on the ideal objectives of *Shari'ah* which is applicable in normal conditions, and the second is based on some relaxations given in abnormal situations. The real Islamic order is based on the former set of principles, while the latter is a concession which can be availed at times of need, but it does not reflect the true picture of the real Islamic order.

Living under constraints, the Islamic banks are mostly relying on the second set of rules, therefore, their activities could not bring a visible change even in the limited circle of their operations. However, if the whole financing system is based on the ideal Islamic principles, it will certainly have a visible impact on the economy.

It is to be noted that the present book, being a guide book to the present day financial institutions, has dealt with both types of Islamic rules. At the outset, the ideal Islamic principles of finance have been elaborated and later on we have discussed the best possible concessions that may be availed of in the transitory period where the Islamic institutions are working under the pressure of the existing legal and fiscal system. *Shari'ah* has specific principles about such concessions as well, and their basic purpose is to avoid clear prohibitions by adopting a less desirable line of action. This may not serve the basic purpose of establishing a true Islamic order, yet it may help one refrain from a glaring sin and save him from the evil fate of disobedience, which, in itself, is a cherished goal of a Muslim, though at an individual level. Moreover, this may help the society to advance gradually to the ideal target of establishing a total Islamic order. This book should be studied in the light of this scheme of Islamic *Shari'ah*.

CHAPTER 1

Musharakah

1. INTRODUCTION

'*Musharakah*' is a word of Arabic origin which literally means sharing. In the context of business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture. It is an ideal alternative for the interest-based financing with far reaching effects on both production and distribution. In the modern capitalist economy, interest is the sole instrument indiscriminately used in financing of every type. Since Islam has prohibited interest, this instrument cannot be used for providing funds of any kind. Therefore, *musharakah* can play a vital role in an economy based on Islamic principles.

'Interest' predetermines a fixed rate of return on a loan advanced by the financier irrespective of the profit earned or loss suffered by the debtor, while *musharakah* does not envisage a fixed rate of return. Rather, the return in *musharakah* is based on the actual profit earned by the joint venture. The financier in an interest-bearing loan cannot suffer loss while the financier in *musharakah* can suffer loss, if the joint venture fails to produce fruits. Islam has termed interest as an unjust instrument of financing because it results in injustice either to the creditor or to the debtor. If the debtor suffers a loss, it is unjust on the part of the creditor to claim a fixed rate of return; and if the debtor earns a very high rate of profit, it is injustice to the creditor to give him only a small proportion of the profit leaving the rest for the debtor.

In the modern economic system, it is the banks which advance depositors' money as loans to industrialists and traders. If the entrepreneurs having only ten million of their own, acquire 90 million from banks and embark on a huge profitable project, it means that 90 per cent of the project has been created by the money of the depositors, while only 10 per cent has been created by their own capital. If this huge project brings enormous profits, only a small proportion i.e. 8 or 9 per cent will go to the depositors through the bank, while all the rest will be gained by the entrepreneur whose real contribution to the project is not more than 10 per cent. Even this small proportion of 8 or 9 per cent is taken back by the industrialists, because this proportion is included by them in the cost of their production. The net result is that all the profit of the enterprise is earned by the persons whose own capital does not exceed 10 per cent of the total investment, while the people owning 90 per cent of the investment get no more than the fixed rate of interest which is often repaid by them through the increased prices of the products. On the contrary, if in an extreme situation, the industrialists go insolvent, their own loss is no more than 10 per cent, while the rest of the 90 per cent is totally borne by

the bank, and in some cases, by the depositors. In this way, the rate of interest is the main cause for imbalances in the system of distribution, which has a constant tendency in favour of the rich and against the interests of the poor.

This unjust role of interest in the present economic system is now increasingly recognized by the modern economists. James Robertson has succinctly explained the evil results of the interest-based system in the following words:

> "The pervasive role of interest in the economic system results in the systematic transfer of money from those who have less to those who have more. Again, this transfer of resources from poor to rich has been made shockingly clear by the Third World debt crises. But it applies universally. It is partly because those who have more money to lend, get more in interest than those who have less; it is partly because those who have less often have to borrow more; and it is partly because the cost of interest repayments now forms a substantial element in the cost of all goods and services, and the necessary goods and services looms much larger in the finances of the rich. When we look at the money system that way and when we begin to think about how it should be redesigned to carry out its functions fairly and efficiently as part of an enabling and conserving economy, the arguments for an interest-free money system for the twenty-first century seems to be very strong."[1]

The horrible results brought by the present interest-based financial system have compelled many modern economists to suggest that the interest-based system should be replaced by an equity-based system. To quote James Robertson again:

> "Would it be desirable and possible to limit the role of interest more drastically than that, for example by converting debt into equity throughout the economy? This would be in line with Islamic teaching and with earlier Christian teaching, that usury is sin. Although the practical complications would make this a goal for the longer term, there are strong arguments for exploring it."[2]

John Tomlinson has strongly advocated for transforming the existing financial system on the basis of equity financing. The prospects of this equity-based system are analysed by him in the following words:

> "Converting debt to equity is not a panacea for all economic ills. It can, however, produce many positive benefits. These benefits will not necessarily follow automatically from conversion. Concentrated effort will be required to ensure they do. Without conversion they will not happen at all.
>
> Not the least of these benefits will be those brought to the banking community itself. The banking and monetary system will not collapse. Nor should there ever need to be the threat of collapse again. Owners of banks will find the value of their shares underpinned as liabilities disappear from balance sheets and are replaced by assets of a specific value. Each and every depositor will be able simultaneously to withdraw his or her total deposits.
>
> Demand for the bank's current or cheque account services will not diminish. Longer term depositors will now have to pay for storage: it will be a less attractive option than exchange, so the velocity with which money moves from bank to market-place to bank again, from one

[1] James Robertson, *Future Wealth: A New Economics for the 21st Century*, Cassell Publications, London 1990. pp. 130–131.

[2] James Robertson: *Transforming Economic Life: A Millennial Challenge*, Green Books, Devon, 1998, p. 54.

account to another, is likely to increase. There will be a continuous flow of money available for new equity investment.

The market-place in general will also receive benefits. Conversion will also cause the value of money to stabilize. Savings can then retain their value. Prices need only vary according to the supply and demand of the product being priced. Measurements of exchange value made by different people at different times can be validly compared. The unit of money will once more be a valid unit of measurement of exchange value. The field of economics can become a science.

Many of the distortions which now exist in our individual frames of reference will be corrected. For instance, an investment which took an investor, ten, fifteen or twenty years to recoup used to be considered sound. Now, too often the maximum period envisaged is five years or even three. This short-term view has precluded many useful businesses from being created. The re-establishment of stable money and the emphasis on security which will be required within an equity investment programme will encourage people to take a longer view. More businesses will then be considered viable and the number of new jobs can increase dramatically.

Existing savers will also be protected. The conversion to equity will eliminate the possibility of collapse for individual banks and for the system as a whole. Savings will not disappear. The nature of savings will change from just units of money to units of money and shares. The exchange value of both the shares and the money will have to be re-assessed. But they will have value. If no action is taken and the system collapses, they may end up having no value.

The changes proposed will also free many from the enslavement of debt. Both nations and individuals can regain their dignity. They will be free to make their own choices. No longer will managers have to face the choice between paying interest and disemploying some or not paying interest and disemploying all.

Nor shall we need to experience the stresses caused by current economic and business cycles. There will be a steady flow of money into investments. New investment opportunities will continually be sought as a home for both individual saving and business profits. Both will wish to avoid storage charges.

Growth will be dependent upon the continuing development of new ideas and new productive capacity. Growth will no longer be dependent upon the creation of new debt. Economic expansion will depend upon the positive flow of new savings and new profits.

Re-establishing the integrity of money will eliminate at least one of the causes of human conflict. Money will no longer secretly steal from those who save, those on fixed income and those who enter long-term contracts.

Further, it can lead to a greater premium being placed on personal integrity. The character traits of honest, honourable and forthright behaviour will be in demand. Investors' security will depend on them. Recognition of the degree of interdependence in an equity-oriented market-place can lead to more consideration of the needs of others, and, ultimately, to a more caring and compassionate society.

Of course, life is never roses all the way. Many mistakes will be made. When new paths are trodden, the way is sometimes uncertain. Some will find it difficult to break the habitual patterns of thought which govern behaviour in a debt-oriented society. No doubt some readers will have already experienced this.

Some will be hard-pressed when the actual exchange value of their investments becomes apparent. Yet, the conversion process can be controlled. Collapse cannot. We should be able, as part of the conversion process, to identify those who might suffer unduly. Then we can be prepared to assist them and cushion any hardship.

The case of honest money is a compelling one. Honest money is not a thief. It does not steal from the thrifty. It is not socially divisive. It does not promote economic and business

> cycles, creating unemployment. On the contrary, it encourages thrift. It promotes sustainable economic growth. It rewards merit. It demands integrity.
>
> These are worthwhile goals. They can be achieved. What is needed now is the will to make them happen."[3]

The system suggested by these economists is closer to the principles of financing laid down and developed by Islamic injunctions. Islam has a clear-cut principle for the financier. According to Islamic principles, a financier must determine whether he is advancing a loan to assist the debtor on humanitarian grounds or he desires to share his profits. If he wants to assist the debtor, he should resist from claiming any excess on the principal of his loan, because his aim is to assist him. However, if he wants to have a share in the profits of his debtor, it is necessary that he should also share in his losses. Thus the returns of the financier in *musharakah* have been tied up with the actual profits accrued through the enterprise. The greater the profits of the enterprise, the higher the rate of return to the financier. If the enterprise earns enormous profits, all of it cannot be secured by the industrialist exclusively, but they will be shared by the common people as depositors in the bank. In this way, *musharakah* has a tendency to favour the common people rather than the rich only.

This is the basic philosophy which explains why Islam has suggested *musharakah* as an alternative to the interest based financing. No doubt, *musharakah* embodies a number of practical problems in its full implementation as a universal mode of financing. It is sometimes presumed that *musharakah* is an old-fashioned instrument which cannot keep pace with the ever-advancing need for speedy transactions. However, this presumption is due to lack of proper knowledge concerning the principles of *musharakah.* In fact, Islam has not prescribed a specific form or procedure for *musharakah.* It has rather set some broad principles which can accommodate numerous forms and procedures. A new form or procedure in *musharakah* cannot be rejected merely because it has no precedent in the past. In fact, every new form can be acceptable to the *Shari'ah* in so far as it does not violate any basic principle laid down by the Holy Qur'an, the *sunnah* or the consensus of the Muslim jurists. Therefore, it is not necessary that *musharakah* be implemented only in its traditional old form.

The present chapter contains a discussion of the basic principles of *musharakah* and the way it can be implemented in the context of modern business and trade. This discussion is aimed at introducing *musharakah* as a modern mode of financing without violating its basic principles in any way. *musharakah* has been introduced in the light of the books of Islamic jurisprudence, with reference to the basic problems which may be faced in implementing it in a modern situation. It is hoped that this brief discussion will open new horizons for the thinking of Muslim jurists and economists and may help in implementing a true Islamic economy.

[3] John Tomlinson: *Honest Money*, Helix, 1993, pp. 115, 118.

2. THE CONCEPT OF *MUSHARAKAH*

Musharakah is a term frequently referred to in the context of Islamic modes of financing. The connotation of this term is limited as compared to the term *shirkah* more commonly used in the Islamic jurisprudence. For the purpose of clarity in the basic concepts, it will be pertinent at the outset to explain the meaning of each term, as distinguished from the other.

Shirkah means "sharing" and in the terminology of Islamic *Fiqh*, it has been divided into two kinds:

(1) *Shirkat-ul-milk*: It means joint ownership of two or more persons in a particular property. This kind of *shirkah* may come into existence in two different ways: Sometimes it comes into operation at the option of the parties. For example, if two or more persons purchase an equipment, it will be owned jointly by all of them and the relationship between them with regard to that property is called *shirkat-ul-milk*. Here this relationship has come into existence at their own option, as they themselves elected to purchase the equipment jointly.

But there are cases where this kind of "*shirkah*" comes to operate automatically without any action taken by the parties. For example, after the death of a person, all his heirs inherit his property which comes into their joint ownership as an automatic consequence of the death of that person.

(2) *Shirkat-ul-'aqd*: This is the second type of *shirkah* which means "a partnership in business effected by a mutual contract". For the purpose of brevity it may also be translated as "joint commercial enterprise".

Shirkat-ul-'aqd is further divided into three kinds:

(i) *Shirkat-ul-amwal* where all the partners invest some capital into a commercial enterprise.

(ii) *Shirkat-ul-a'mal* where all the partners jointly undertake to render some services for their customers, and the fee charged from them is distributed among them according to an agreed ratio. For example, if two persons agree to undertake tailoring services for their customers on the condition that the income so earned will go to a joint pool which shall be distributed between them irrespective of the size of the work each partner has actually done, this partnership will be a *shirkat-ul-a'mal* which is also called *shirkat-ut-taqabbul* or *shirkat-us-sana'i'* or *shirkat-ul-abdan*.

(iii) The third kind of *shirkat-ul-'aqd* is *shirkat-ulwujooh*. Here the partners have no investment at all. All they do is that they purchase commodities on a deferred price and sell them on the spot. The profit so earned is distributed between them at an agreed ratio.

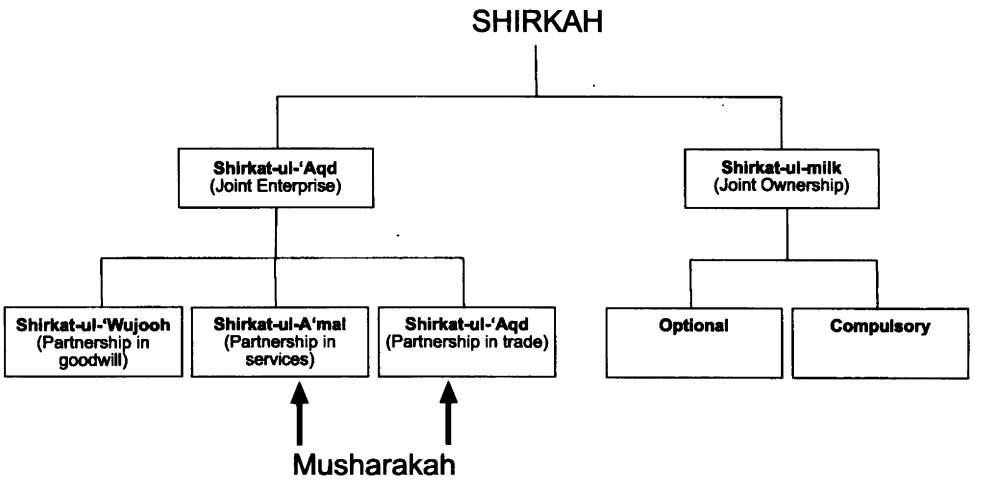
All these modes of sharing or partnership are termed as *shirkah* in the terminology of Islamic *Fiqh*, while the term *musharakah* is not found in the books of *Fiqh*. This term (i.e. *musharakah*) has been introduced recently by those who have written on the subject of Islamic modes of financing and it is normally restricted to a particular type of *shirkah*,

that is, the *shirkatul-amwal,* where two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes *shirkat-ul-a'mal* also where partnership takes place in the business of services.

It is evident from this discussion that the term *shirkah* has a much wider sense than the term *musharakah* as is being used today. The latter is limited to the *shirkat-ul-amwal* only, while the former includes all types of joint ownership and those of partnership. Table 1 will show the different kinds of *shirkah* and the two kinds which are called *musharakah* in the modern terminology.

Since *musharakah* is more relevant for the purpose of our discussion, and it is almost analogous to *shirkatul-amwal,* we shall now dwell upon it, explaining at the first instance, the traditional concept of this type of *shirkah,* then giving a brief account of its application to the concept of financing in the modern context.

Table 1



3. THE BASIC RULES OF *MUSHARAKAH*

1. *Musharakah* or *shirkat-ul-amwal* is a relationship established by the parties through a mutual contract. Therefore, it goes without saying that all the necessary ingredients of a valid contract must be present here also. For example, the parties should be capable of entering into a contract; the contract must take place with free consent of the parties without any duress, fraud or misrepresentation, etc., etc.
   But there are certain ingredients which are peculiar to the contract of *musharakah.* They are summarized here:

3.1 Distribution of Profit

2. The proportion of profit to be distributed between the partners must be agreed upon at the time of effecting the contract. If no such proportion has been determined, the contract is not valid in *Shari'ah*.
3. The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business, and not in proportion to the capital invested by him. It is not allowed to fix a lump sum for any one of the partners, or any rate of profit tied up with his investment.

Therefore, if A and B enter into a partnership and it is agreed between them that A shall be given Rs 10,000/per month as his share in the profit, and the rest will go to B, the partnership is invalid.[4] Similarly, if it is agreed between them that A will get 15 per cent of his investment, the contract is not valid. The correct basis for distribution would be an agreed percentage of the actual profit accrued to the business.

If a lump sum or a certain percentage of the investment has been agreed for any one of the partners, it must be expressly mentioned in the agreement that it will be subject to the final settlement at the end of the term, meaning thereby that any amount so drawn by any partner shall be treated as 'on account payment' and will be adjusted to the actual profit he may deserve at the end of the term. But if no profit is actually earned or is less than anticipated, the amount drawn by the partner shall have to be returned.

3.2 Ratio of Profit

4. Is it necessary that the ratio of profit of each partner conforms to the ratio of capital invested by him? There is a difference of opinion among the Muslim jurists about this question.

In the view of Imam Malik and Imam Shafi'i, it is necessary for the validity of *musharakah* that each partner gets the profit exactly in the proportion of his investment. Therefore, if A has invested 40 per cent of the total capital, he must get 40 per cent of the profit. Any agreement to the contrary which makes him entitled to get more or less than 40 per cent will render the *musharakah* invalid in *Shari'ah*.

On the contrary, the view of Imam Ahmad is that the ratio of profit may differ from the ratio of investment if it is agreed between the partners of their own free will. Therefore, it is permissible that a partner with 40 per cent of the investment gets 60 per cent or 70 per cent of the profit, while the other partner with 60 per cent of the investment gets only 30 or 40 per cent.[5]

[4] Ibn Qudamah: Almughni v. 5, p. 140.

[5] Ibn Qudamah. Almughni, v. 5 p. 140. Darul-Kitab al-arabi, Beirut 1972.

The third view is presented by Imam Abu Hanifah which can be taken as a via media between the two opinions mentioned above. He says that the ratio of profit may differ from the ratio of investment in normal conditions. However, if a partner has put an express condition in the agreement that he will never work for the *musharakah* and will remain a sleeping partner throughout the term of *musharakah*, then his share of profit cannot be more than the ratio of his investment.[6]

3.3 Sharing of Loss

But in the case of loss, all the Muslim jurists are unanimous on the point that each partner shall suffer the loss exactly according to the ratio of his investment. Therefore, if a partner has invested 40 per cent of the capital, he must suffer 40 per cent of the loss, no more, no less, and any condition to the contrary shall render the contract invalid. There is a complete consensus of jurists on this principle.[7]

Therefore, according to Imam Shafi'i, the ratio of the share of a partner in profit and loss both must conform to the ratio of his investment. But according to Imam Abu Hanifah and Imam Ahmad, the ratio of the profit may differ from the ratio of investment according to the agreement of the partners, but the loss must be divided between them exactly in accordance with the ratio of the capital invested by each one of them. It is this principle that has been mentioned in the famous maxim:

الربح على ما اصطلحا عليه والوضيعة على قد رالمال

Profit is based on the agreement of the parties, but loss is always subject to the ratio of investment.

3.4 The Nature of the Capital

Most of the Muslim jurists are of the opinion that the capital invested by each partner must be in liquid form. It means that the contract of *musharakah* can be based only on money, and not on commodities. In other words, the share capital of a joint venture must be in monetary form. No part of it can be contributed in kind. However, there are different views in this respect.

1. Imam Malik is of the view that the liquidity of capital is not a condition for the validity *of musharakah,* therefore, it is permissible that a partner contributes to the *musharakah* in kind, but his share shall be determined on the basis of evaluation according to the market price prevalent at the date of the contract. This view is also adopted by some Hanbali jurists.[8]

[6] al-Kasani. Bada'i'-us-sanai' v. 6 pp. 162–163.
[7] Ibn Qudamah, Almughni v. 5 p. 147.
[8] Ibn Qudamah: Almughni v. 5 p. 125.

2. Imam Abu Hanifah and Imam Ahmad are of the view that no contribution in kind is acceptable in a *musharakah.* Their standpoint is based on two reasons:

Firstly, they say that the commodities of each partner are always distinguishable from the commodities of the other. For example, if A has contributed one motor car to the business, and B has come with another motor car, each one of the two cars is the exclusive property of its original owner. Now, if A's car is sold, its sale-proceeds should go to A. B has no right to claim a share in its sale price. Therefore, so far as the property of each partner is distinguished from the property of the other, no partnership can take place. On the contrary, if the capital invested by every partner is in the form of money, the share capital of each partner cannot be distinguished from that of the other, because the units of money are not distinguishable, therefore, they will be deemed to form a common pool, and thus the partnership comes into existence.[9]

Secondly, they say, there are a number of situations in a contract of *musharakah* where the partners have to resort to redistribution of the share-capital to each partner. If the share-capital was in the form of commodities, such redistribution cannot take place, because the commodities may have been sold at that time. If the capital is repaid on the basis of its value, the value may have increased, and there is a possibility that a partner gets all the profit of the business, because of the appreciation in the value of the commodities he has invested, leaving nothing for the other partner. Conversely, if the value of those commodities decreases, there is a possibility that one partner secures some part of the original price of the commodity of the other partner in addition to his own investment.[10]

3. Imam al-Shafi'i has come with a *via media* between the two points of view explained above. He says that commodities are of two kinds:

(i) *Dhawat-ul-amthal* (ذوات الأمثال) i.e. the commodities which, if destroyed, can be compensated by similar commodities in quality and quantity e.g. wheat, rice etc. If 100 kilograms of wheat are destroyed, they can easily be replaced by another 100 kilograms of wheat of the same quality.

(ii) *Dhawat-ul-qeemah* (ذوات القيمة) i.e. the commodities which cannot be compensated by similar commodities, like the cattle. Each head of sheep, for example, has its own characteristics which cannot be found in any other head. Therefore, if somebody kills a man's sheep, he cannot compensate him by giving him similar sheep. Rather, he is required to pay their price.

Now, Imam al-Shafi'i says that the commodities of the first kind (i.e. *dhawat-ul-amthal)* may be contributed to the *musharakah* as the share of a partner in the capital, while the commodities of the second kind (i.e. the *dhawat-ul-qeemah)* cannot form part of the share capital.[11]

[9] Al kasani: Bada'i'-us-Sana'i' v. 6, p. 59.
[10] Ibn Qudamah: Almughni v. 5, pp. 124–125.
[11] *Ibid.*, p. 125.

By this distinction between *dhawat-ul-amthal* and *dhawat-ul-qeemah,* Imam al-Shafi'i has met the second objection on 'participation by commodities' as was raised by Imam Ahmad. For in the case of *dhawat-ul-amthal,* redistribution of capital may take place by giving to each partner the similar commodities he had invested. However, the first objection remains still unanswered by Imam al-Shafi'i.

In order to meet this objection also, Imam Abu Hanifah says that the commodities falling under the category of *dhawat-ul-amthal* can form part of the share capital only if the commodities contributed by each partner have been mixed together, in such a way that the commodity of one partner cannot be distinguished from that of the other.[12]

In short, if a partner wants to participate in a *musharakah* by contributing some commodities to it, he can do so according to Imam Malik without any restriction, and his share in the *musharakah* shall be determined on the basis of the current market value of the commodities, prevalent at the date of commencement of *musharakah.* According to Imam al-Shafi'i, however, this can be done only if the commodity is from the category of *dhawat-ul-amthal.*

According to Imam Abu Hanifah, if the commodities are *dhawat-ul-amthal,* this can be done by mixing the commodities of each partner together. And if the commodities are *dhawat-ul-qeemah,* then, they cannot form part of the share capital.

It seems that the view of Imam Malik is more simple and reasonable and meets the needs of the modern business. Therefore, this view can be acted upon.[13]

We may, therefore, conclude from the above discussion that the share capital in a *musharakah* can be contributed either in cash or in the form of commodities. In the latter case, the market value of the commodities shall determine the share of the partner in the capital.

3.5. Management of *Musharakah*

The normal principle of *musharakah* is that every partner has a right to take part in its management and to work for it. However, the partners may agree upon a condition that the management shall be carried out by one of them, and no other partner shall work for the *musharakah.* But in this case the sleeping partner shall be entitled to the profit only to the extent of his investment, and the ratio of profit allocated to him should not exceed the ratio of his investment, as discussed earlier.

However, if all the partners agree to work for the joint venture, each one of them shall be treated as the agent of the other in all the matters of the business and any work done by one of them in the normal course of business shall be deemed to be authorized by all the partners.

[12] Al-Kasani, *op. cit.*

[13] Thanawi, Ashraf Ali, Imdad-ul-fatawa.v. 3, p. 495, Maktabah Darul-Uloom, Karachi, 1406 AH.

3.6. Termination of *Musharakah*

Musharakah is deemed to be terminated in any one of the following events:

(1) Every partner has a right to terminate the *musharakah* at any time after giving his partner a notice to this effect, whereby the *musharakah* will come to an end.

In this case, if the assets of the *musharakah* are in cash form, all of them will be distributed *pro rata* between the partners. But if the assets are not liquidated, the partners may agree either on the liquidation of the assets, or on their distribution or partition between the partners as they are. If there is a dispute between the partners in this matter i.e. one partner seeks liquidation while the other wants partition or distribution of the non-liquid assets themselves, the latter shall be preferred, because after the termination of *musharakah,* all the assets are in the joint ownership of the partners, and a co-owner has a right to seek partition or separation, and no one can compel him on liquidation. However, if the assets are such that they cannot be separated or partitioned, such as machinery, then they shall be sold and the sale-proceeds shall be distributed.[14]

(2) If any one of the partners dies during the currency of *musharakah,* the contract of *musharakah* with him stands terminated. His heirs in this case, will have the option either to draw the share of the deceased from the business, or to continue with the contract of *musharakah.*[15]

(3) If any one of the partners becomes insane or otherwise becomes incapable of effecting commercial transactions, the *musharakah* stands terminated.[16]

3.7. Termination of *Musharakah* without Closing the Business

If one of the partners wants termination of the *musharakah,* while the other partner or partners like to continue with the business, this purpose can be achieved by mutual agreement. The partners who want to run the business may purchase the share of the partner who wants to terminate his partnership, because the termination of *musharakah* with one partner does not imply its termination between the other partners.[17]

However, in this case, the price of the share of the leaving partner must be determined by mutual consent, and if there is a dispute about the valuation of the share and the partners do not arrive at an agreed price, the leaving partner may compel other partners on the liquidation or on the distribution of the assets themselves.

The question arises whether the partners can agree, while entering into a contract of *musharakah,* on a condition that the liquidation or separation of the business shall not be

[14] Ibn Qudamah, Almughni v. 5, pp. 133–134.
[15] *Ibid.*
[16] *Op. cit.*
[17] *See* al-Fatawa-al-Hindiyyah v. 2, pp. 335–336.

effected unless all the partners, or the majority of them wants to do so, and that a single partner who wants to come out of the partnership shall have to sell his share to the other partners and shall not force them on liquidation or separation.

Most of the traditional books of Islamic *Fiqh* seem to be silent on this question. However, it appears that there is no bar from the *Shari'ah* point of view if the partners agree to such a condition right at the beginning of *musharakah.* This is expressly permitted by some *Hanbali* jurists.[18]

This condition may be justified, especially in the modern situations, on the ground that the nature of business, in most cases today, requires continuity for its success, and the liquidation or separation at the instance of a single partner only may cause irreparable damage to the other partners.

If a particular business has been started with huge amounts of money which has been invested in a long term project, and one of the partners seeks liquidation in the infancy of the project, it may be fatal to the interests of the partners, as well as to the economic growth of the society, to give him such an arbitrary power of liquidation or separation. Therefore, such a condition seems to be justified, and it can be supported by the general principle laid down by the Holy Prophet صلى الله عليه وسلم, in his famous *hadith*:

المسلمون على شروطهم الا شرطا أحلّ حراما أو حرّم حلالا

All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful.[19]

So far the basic concept of *shirkat-ul-amwal* or *musharakah* in its original and traditional sense has been summarized.

Now we are in a position to discuss some basic issues involved in its application to the modern conditions as an approved mode of financing. But it seems more pertinent to discuss these issues after giving an introductory account of *mudarabah* which is another type of profit-sharing and a typical mode of financing. Since the rules of financing in both *musharakah* and *mudarabah* are similar and the issues involved in their application are inter related, it will be more useful to discuss the concept of *mudarabah* before embarking on these issues.

4. THE CONCEPT OF *MUDARABAH*

Mudarabah is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who

[18] *See* Almardawi, Al-insaf 5:423, Beirut 1400 AH.

[19] Al-Tirmidhi, Al-Jami' Kitab-al-Ahkam (Book 13) Ch. 17, Hadith 1352. See also: Al-Bukhari, Al-Sahih Kitab-al-ljarah (Book 37) Chapter 14.

is called *rabb-ul-mal*, while the management and work is the exclusive responsibility of the other, who is called *mudarib*.

The difference between *musharakah* and *mudarabah* can be summarized in the following points:

(1) The investment in *musharakah* comes from all the partners, while in *mudarabah*, investment is the sole responsibility of *rabb-ul-mal*.

(2) In *musharakah*, all the partners can participate in the management of the business and can work for it, while in *mudarabah*, the *rabb-ul-mal* has no right to participate in the management which is carried out by the *mudarib* only.

(3) In *musharakah* all the partners share the loss to the extent of the ratio of their investment while in *mudarabah* the loss, if any, is suffered by the *rabb-ul-mal* only, because the *mudarib* does not invest anything. His loss is restricted to the fact that his labour has gone in vain and his work has not brought any fruit to him.

However, this principle is subject to a condition that the *mudarib* has worked with due diligence which is normally required for the business of that type. If he has worked with negligence or has committed dishonesty, he shall be liable for the loss caused by his negligence or misconduct.

(4) The liability of the partners in *musharakah* is normally unlimited. Therefore, if the liabilities of the business exceed its assets and the business goes in liquidation, all the exceeding liabilities shall be borne pro rata by all the partners. However, if all the partners have agreed that no partner shall incur any debt during the course of business, then the exceeding liabilities shall be borne by that partner alone who has incurred a debt on the business in violation of the aforesaid condition.

Contrary to this is the case of *mudarabah*. Here the liability of *rabb-ul-mal* is limited to his investment, unless he has permitted the *mudarib* to incur debts on his behalf.

(5) In *musharakah*, as soon as the partners mix up their capital in a joint pool, all the assets of the *musharakah* become jointly owned by all of them according to the proportion of their respective investment. Therefore, each one of them can benefit from the appreciation in the value of the assets, even if profit has not accrued through sales.

The case of *mudarabah* is different. Here all the goods purchased by the *mudarib* are solely owned by the *rabb-ul-mal*, and the *mudarib* can earn his share in the profit only in case he sells the goods profitably. Therefore, he is not entitled to claim his share in the assets themselves, even if their value has increased.[20]

[20] However, some jurists have opined that any natural increase in the capital may be taken as a profit distributable between *Rabbul-mal* and *mudarib*. For example, if the capital was in the form of sheep, and lambs were born to some of them, these lambs will be taken as profit and will be shared between the parties according to the agreed proportions (*see* Alnawawi: Raudah-al-Talibin v. 5, p. 125). But this is a minority view.

4.1. Business of the *Mudarabah*

The rabb-ul-mal may specify a particular business for the *mudarib,* in which case he shall invest the money in that particular business only. This is called *al-mudarabah al-muqayyadah* (restricted *mudarabah).* But if he has left it open for the *mudarib* to undertake whatever business he wishes, the *mudarib* shall be authorized to invest the money in any business he deems fit. This type of *mudarabah* is called *'al-mudarabah al-mutlaqah'* (unrestricted *mudarabah)*

A *rabbul-mal* can contract *mudarabah* with more than one person through a single transaction. It means that he can offer his money to A and B both, so that each one of them can act for him as *mudarib* and the capital of the *mudarabah* shall be utilized by both of them jointly, and the share of the *mudarib* shall be distributed between them according to the agreed proportion.[21] In this case both the *mudaribs* shall run the business as if they were partners *inter se.*

The *mudarib* or *mudaribs,* as the case may be, are authorized to do anything which is normally done in the course of business. However, if they want to do an extraordinary work, which is beyond the normal routine of the traders, they cannot do so without express permission from the *rabb-ul-mal.*

4.2. Distribution of the Profit

It is necessary for the validity of *mudarabah* that the parties agree, right at the beginning, on a definite proportion of the actual profit to which each one of them is entitled. No particular proportion has been prescribed by the *Shari'ah*; rather, it has been left to their mutual consent. They can share the profit in equal proportions, and they can also allocate different proportions for the *ruhb-ul-mal* and the *mudarib.* However, they 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. For example, if the capital is Rs. 100,000/- they cannot agree on a condition that Rs. 10,000/- out of the profit shall be the share of the *mudarib,* nor can they say that 20 per cent of the capital shall be given to *rabb-ul-mal.* However, they can agree on that 40 per cent of the actual profit shall go to the *mudarib* and 60 per cent to the *rabb-ul-mal* or vice versa.

It is also allowed that different proportions are agreed in different situations. For example the rabbul-mal can say to mudarib, "If you trade in wheat, you will get 50 per cent of the profit and if you trade in flour, you will have 33 per cent of the profit". Similarly, he can say "If you do the business in your town, you will be entitled to 30 per cent of the profit, and if you do it in another town, your share will be 50 per cent of the profit.[22]

[21] *See* Ibn Qudamah: Almughni v. 5, p. 145.
[22] Badai'al-Sanai' v. 6, p. 99.

Apart from the agreed proportion of the profit, as determined in the above manner, the *mudarib* cannot claim any periodical salary or a fee or remuneration for the work done by him for the *mudarabah.*[23]

All the schools of Islamic *Fiqh* are unanimous on this point. However, Imam Ahmad has allowed for the *mudarib* to draw his daily expenses of food only from the *mudarabah* account.[24]

The *Hanafi* jurists restrict this right of the *mudarib* only to a situation when he is on a business trip outside his own city. In this case he can claim his personal expenses, accommodation, food, etc., but he is not entitled to get anything as daily allowances when he is in his own city.[25]

If the business has incurred loss in some transactions and has gained profit in some others, the profit shall be used to offset the loss at the first instance, then the remainder, if any, shall be distributed between the parties according to the agreed ratio.[26]

4.3. Termination of *Mudarabah*

The contract of *mudarabah* can be terminated at any time by either of the two parties. The only condition is to give a notice to the other party. If all the assets of the *mudarabah are* in cash form at the time of termination, and some profit has been earned on the principal amount, it shall be distributed between the parties according to the agreed ratio. However, if the assets of the *mudarabah* are not in cash form, the *mudarib* shall be given an opportunity to sell and liquidate them, so that the actual profit may be determined.[27]

There is a difference of opinion among the Muslim jurists about the question whether the contract of *mudarabah* can be effected for a specified period after which it terminates automatically. The Hanafi and Hanbali schools are of the view that the *mudarabah* can be restricted to a particular term, like one year, six months, etc, after which it will come to an end without a notice. On the contrary, Shafi'i and Maliki schools are of the opinion that the *mudarabah* cannot be restricted to a particular time.[28]

However, this difference of opinion relates only to the maximum time-limit of the *mudarabah.* Can a minimum time-limit also be fixed by the parties before which *mudarabah* cannot be terminated? No express answer to this question is found in the books of Islamic *Fiqh,* but it appears from the general principles enumerated therein that no such limit can be fixed, and each party is at liberty to terminate the contract whenever he wishes.

[23] Sarakhsi. Almabsut v. 22, pp. 149–150.
[24] Ibn Qudamah: Almughni v. 5, p. 186.
[25] AI-Kasani; Badai'-us-Sanai' v. 6. p. 109.
[26] Ibn Qudamah. v. 5, p. 168.
[27] AI-Kasani; Badai'-us-Sanai' v. 6. p. 109.
[28] *Ibid.*, v. 6, p. 99. See also Ibn Qudamah v. 5, pp. 185–186, and al-Sarakhsi, al-Mabsut v. 22, p. 133.

This unlimited power of the parties to terminate the *mudarabah* at their pleasure may create some difficulties in the context of the present circumstances, because most of the commercial enterprises today need time to bring fruits. They also demand constant and concerted efforts. Therefore, it may be disastrous to the project, if the *rabb-ul-mal* terminates the *mudarabah* right in the beginning of the enterprise. Specially, it may bring a severe set-back to the *mudarib* who will earn nothing despite all his labour and efforts. Therefore, if the parties agree, when entering into the *mudarabah,* that no party shall terminate it during a specified period, except in specified circumstances, it does not seem to violate any principle of *Shari'ah*, particularly in the light of the famous *hadith,* already quoted, which says:

المسلمون على شروطهم الا شرطا أحلّ حراما أو حرّم حلالا

All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful.

5. COMBINATION OF *MUSHARAKAH* AND *MUDARABAH*

A contract *of mudarabah* normally presumes that the *mudarib* has not invested anything to the *mudarabah.* He is responsible for the management only, while all the investment comes from *rabb-ul-mal.* But there may be situations where *mudarib* also wants to invest some of his money into the business of *mudarabah.* In such cases, *musharakah* and *mudarabah* are combined together. For example, A gave to B Rs. 100,000/- in a contract of *mudarabah.* B added Rs. 50,000/- from his own pocket with the permission of A. This type of partnership will be treated as a combination of *musharakah* and *mudarabah.* Here the *mudarib* may allocate for himself a certain percentage of profit on account of his investment as a *sharik,* and at the same time he may allocate another percentage for his management and work as a *mudarib.* The normal basis for allocation of the profit in the above example would be that B shall secure one third of the actual profit on account of his investment, and the remaining two-thirds of the profit shall be distributed between them equally. However, the parties may agree on any other proportion. The only condition is that the sleeping partner should not get a greater percentage than the proportion of his investment.

Therefore, in the aforesaid example, A cannot allocate for himself more than two-thirds of the total profit, because he has not invested more than two-thirds of the total capital. Short of that, they can agree on any proportion. If they have agreed that the total profit will be distributed equally, it means that one-third of the profit will go to B as an investor, while one-quarter of the remaining two-thirds will go to him as a *mudarib.* The rest will be given to A as *rabb-ul-mal.*[29]

[29] See Ibn Qudamah, Almughni v. 5, pp. 136–137 and al-Kasani, Badai'-us-Sana'i' v. 6, p. 86

6. MUSHARAKAH AND MUDARABAH AS MODES OF FINANCING

In the foregoing sections, the traditional concept of *musharakah* and *mudarabah* and the basic principles of *Shari'ah* governing them have been explained. It is pertinent now to discuss the way these instruments may be used for the purpose of financing in the context of modern trade and industry.

The concept of *musharakah* and *mudarabah* envisaged in the books of Islamic *Fiqh* generally presumes that these contracts are meant for initiating a joint venture whereby all the partners participate in the business right from its inception and continue to be partners up to the end of the business when all the assets are liquidated. One can hardly find in the traditional books of Islamic *Fiqh* the concept of a running business where partners join and leave the enterprise without affecting in any way the continuity of the business. Obviously, the classical books of Islamic *Fiqh* were written in an environment where the large scale commercial enterprises were not in vogue and the commercial activities were not so complex as they are today. Therefore, they did not generally dwell upon the question of such a running business.

However, it does not mean that the concept of *musharakah* and *mudarabah* cannot be used for financing a running business. The concept of *musharakah* and *mudarabah* is based on some basic principles. As long as these principles are fully complied with, the details of their application may vary from time to time. Let us have a look at these basic principles before entering the details:

(1) Financing through *musharakah* and *mudarabah* does never mean the advancing of money. It means participation in the business and in the case of *musharakah*, sharing in the assets of the business to the extent of the ratio of financing.

(2) An investor/financier must share the loss incurred by the business to the extent of his financing.

(3) The partners are at liberty to determine, with mutual consent, the ratio of profit allocated to each one of them, which may differ from the ratio of investment. However, the partner who has expressly excluded himself from the responsibility of work for the business cannot claim more than the ratio of his investment.

(4) The loss suffered by each partner must be exactly in the proportion of his investment.

Keeping these broad principles in view, we proceed to see how *musharakah* and *mudarabah* can be used in different sectors of financing:

6.1. Project Financing

In the case of project financing, the traditional method of *musharakah* or *mudarabah* can be easily adopted. If the financier wants to finance the whole project, the form of *mudarabah* can come into operation. If investment comes from both sides, the form of *musharakah* can be adopted. In this case, if the management is the sole responsibility of one party, while the investment comes from both, a combination of *musharakah* and *mudarabah* can be brought into play according to the rules already discussed.

Since *musharakah* or *mudarabah* would have been effected from the very inception of the project, no problem with regard to the valuation of capital should arise. Similarly, the distribution of profits according to the normal accounting standards should not be difficult. However, if the financier wants to withdraw from the *musharakah*, while the other party wants to continue the business, the latter can purchase the share of the former at an agreed price. In this way the financier may get back the amount he has invested along with a profit, if the business has earned a profit. The basis for determining the price of his share shall be discussed in detail later on (while discussing the financing of working capital).

On the other hand, the businessman can continue with his project, either on his own or by selling the first financier's share to some other person who can substitute the financier.

Since financial institutions do not normally want to remain partner of a specific project for good, they can sell their share to other partners of the project as aforesaid. If the sale of the share on one time basis is not feasible for the lack of liquidity in the project, the share of the financier can be divided into smaller units and each unit can be sold after a suitable interval. Whenever a unit is sold, the share of the financier in the project is reduced to that extent, and when all the units are sold, the financier comes out of the project totally.

6.2. Securitization of *Musharakah*

Musharakah is a mode of financing which can be securitized easily, especially, in the case of big projects where huge amounts are required which a limited number of people cannot afford to subscribe. Every subscriber can be given a *musharakah* certificate which represents his proportionate ownership in the assets of the *musharakah*, and after the project is started by acquiring substantial non-liquid assets, these *musharakah* certificates can be treated as negotiable instruments and can be bought and sold in the secondary market. However, trading in these certificates is not allowed when all the assets of the *musharakah* are still in liquid form (i.e., in the shape of cash or receivables or advances due from others).

For proper understanding of this point, it must be noted that subscribing to a *musharakah* is different from advancing a loan. A bond issued to evidence a loan has nothing to do with the actual business undertaken with the borrowed money. The bond stands for a loan repayable to the holder in any case, and mostly with interest. The *musharakah* certificate, on the contrary, represents the direct pro rata ownership of the holder in the assets of the project. If all the assets of the joint project are in liquid form, the certificate will represent a certain proportion of money owned by the project. For example, one hundred certificates, having a value of Rs. one million each, have been issued. It means that the total worth of the project is Rs. 100 million. If nothing has been purchased with this money, every certificate will represent Rs. one million. In this case, this certificate cannot be sold in the market except at par value, because if one certificate

is sold for more than Rs. one million, it will mean that Rs. one million are being sold in exchange for more than Rs. one million, which is not allowed in *Shari'ah*, because where money is exchanged for money, both must be equal. Any excess at either side is *riba*.

However, when the subscribed money is employed in purchasing non-liquid assets like land, building, machinery, raw material, furniture etc. the *musharakah* certificates will represent the holders' proportionate ownership in these assets. Thus, in the above example, one certificate will stand for one-hundredth share in these assets. In this case it will be allowed by the *Shari'ah* to sell these certificates in the secondary market for any price agreed upon between the parties which may be more than the face value of the certificate, because the subject matter of the sale is a share in the tangible assets and not in money only, therefore the certificates may be taken as any other commodities which may be sold with profit or at a loss.

In most cases, the assets of the project are a mixture of liquid and non-liquid assets. This comes to happen when the working partner has converted a part of the subscribed money into fixed assets or raw material, while the rest of the money is still liquid. Or, the project, after converting all its money into non-liquid assets may have sold some of them and has acquired their sale proceeds in the form of money. In some cases the price of its sales may have become due from its customers but may not yet have been received. These receivable amounts, being a debt, are also treated as liquid money. The question arises about the rule of *Shari'ah* in a situation where the assets of the project are a mixture of liquid and non-liquid assets, whether the *musharakah* certificates of such a project can be traded in? The opinions of the contemporary Muslim jurists are different on this point. According to the traditional *Shafi'i* school, this type of certificate cannot be sold. Their classic view is that whenever there is a combination of liquid and non-liquid assets, it cannot be sold unless the non-liquid part of the business is separated and is sold independently.

The *hanafi* school, however, is of the opinion that whenever there is a combination of liquid and non-liquid assets, it can be sold and purchased for an amount greater than the amount of liquid assets in the combination, in which case money will be taken as sold at an equal amount and the excess will be taken as the price of the non-liquid assets owned by the business.

1. This view is based on the famous principle of *mudd-ul-'ajwah'* explained in the traditional books of Islamic *Fiqh*.[30]

Suppose the *musharakah* project contains 40 per cent non-liquid assets i.e. machinery, fixtures etc. and 60 per cent liquid assets, i.e. cash and receivables. Now each musharakah certificate having the face value of Rs. 100/- represents Rs. 60/- worth of liquid assets, and Rs. 40/- worth of non-liquid assets. This certificate may be sold at any price more than Rs. 60/-. If it is sold at Rs. 110/- it will mean that Rs. 60 of the price are against Rs. 60/- contained in the certificate and Rs. 50/- is against the proportionate share in the non-liquid assets. But it will never be allowed to sell the certificate for a price of

[30] See for example, al-Khattabi, Ma'alim al-Sunan 5:23.

Rs. 60/- or less, because in the case of Rs. 60/- it will not set off the amount of Rs. 60/-, let alone the other assets.

According to the *Hanafi* view, no specific proportion of non-liquid assets in the whole is prescribed. Therefore, even if the non-liquid assets represent less than 50 per cent in the whole, its trading according to the above formula is allowed.

However, most of the contemporary scholars, including those of Shafi'i school, have allowed trading in the units of the whole only if the non-liquid assets of the business are more than 50 per cent.

Therefore, for a valid trading of the *musharakah* certificates acceptable to all schools, it is necessary that the portfolio of *musharakah* consists of non-liquid assets valued more than 50 per cent of its total worth. However, if the *hanafi* view is adopted, trading will be allowed even if the non-liquid assets are less than 50 per cent, but the size of the non-liquid assets should not be negligible.

6.3. Financing of a Single Transaction

Musharakah and *mudarabah* can be used more easily for financing a single transaction. Apart from fulfilling the day to-day needs of small traders, these instruments can be employed for financing imports and exports. An importer can approach a financier to finance him for that single transaction of import alone on the basis of *musharakah* or *mudarabah*. The banks can also use these instruments for import financing. If the letter of credit has been opened without any margin, the form of *mudarabah* can be adopted, and if the letter of credit is opened with some margin, the form of *musharakah* or a combination of both will be relevant. After the imported goods are cleared from the port, their sale proceeds may be shared by the importer and the financier according to a pre-agreed ratio.

In this case, the ownership of the imported goods shall remain with the financier to the extent of the ratio of his investment. This *musharakah* can be restricted to an agreed term, and if the imported goods are not sold in the market up to the expiry of the term, the importer may himself purchase the share of the financier, making himself the sole owner of the goods. However, the sale in this case should take place at the market rate or at a price agreed between the parties on the date of sale, and not at a pre-agreed price at the time of entering into *musharakah*. If the price is pre-agreed, the financier cannot compel the client/importer to purchase it.

Similarly, *musharakah* will be even easier in the case of export financing. The exporter has a specific order from abroad. The price on which the goods will be exported is well-known before hand, and the financier can easily calculate the expected profit. He may finance him on the basis of *musharakah* or *mudarabah*, and may share the amount of export bill on a pre-agreed percentage. In order to secure himself from any negligence on the part of the exporter, the financier may put a condition that it will be the responsibility of the exporter to export the goods in full conformity with the conditions of the letter of credit. In this case, if some discrepancies are found, the exporter alone

shall be responsible, and the financier shall be immune from any loss due to such discrepancies, because it is caused by the negligence of the exporter. However, being a partner of the exporter, the financier will be liable to bear any loss which may be caused due to any reason other than the negligence or misconduct of the exporter.

6.4. Financing of the Working Capital

Where finances are required for the working capital of a running business, the instrument of *musharakah* may be used in the following manner:

(1) The capital of the running business may be evaluated with mutual consent. It is already mentioned while discussing the traditional concept of *musharakah* that it is not necessary, according to Imam Malik, رحمه الله تعالى that the capital of *musharakah* is contributed in cash form. Non-liquid assets can also form part of the capital on the basis of evaluation. This view can be adopted here. In this way, the value of the business can be treated as the investment of the person who seeks finance, while the amount given by the financier can be treated as his share of investment. The *musharakah* may be effected for a particular period, like one year or six months or less. Both the parties agree on a certain percentage of the profit to be given to the financier, which should not exceed the percentage of his investment, because he shall not work for the business. On the expiry of the term, all liquid and non-liquid assets of the business are again evaluated, and the profit may be distributed on the basis of this evaluation.

Although, according to the traditional concept, the profit cannot be determined unless all the assets of the business are liquidated, yet the valuation of the assets can be treated as "constructive liquidation" with mutual consent of the parties, because there is no specific prohibition in *Shari'ah* against it. It can also mean that the working partner has purchased the share of the financier in the assets of the business, and the price of his share has been determined on the basis of valuation, keeping in view the ratio of profit allocated for him according to the terms of *musharakah.*

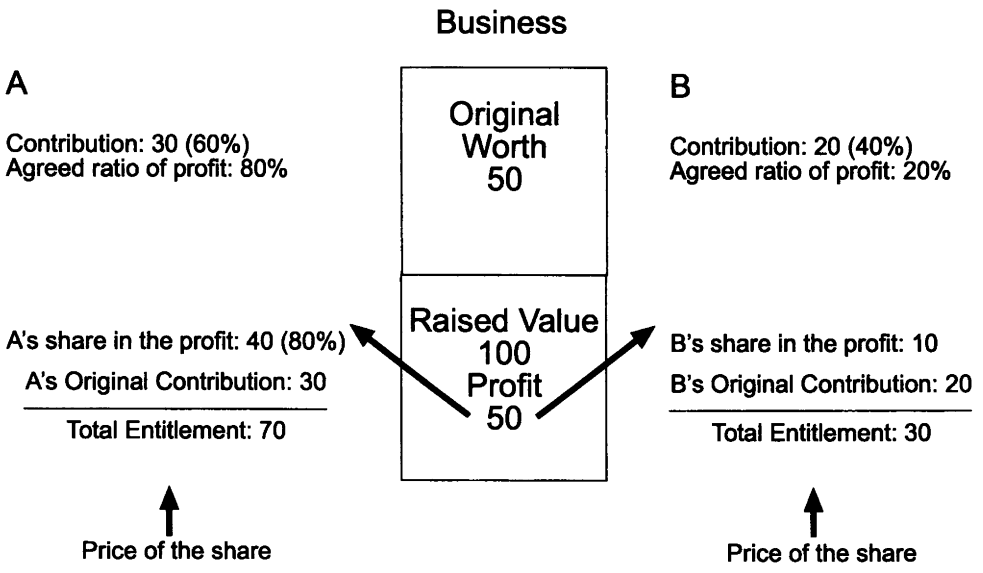
For example, the total value of the business of A is 30 units. B finances another 20 units, raising the total worth to 50 units; 40 per cent having been contributed by B, and 60 per cent by A. It is agreed that B shall get 20 per cent of the actual profit. At the end of the term, the total worth of the business has increased to 100 units. Now, if the share of B is purchased by A, he should have paid to him 40 units, because he owns 40 per cent of the assets of the business. But in order to reflect the agreed ratio of profit in the price of his share, the formula of pricing will be different. Any increase in the value of the business shall be divided between the parties in the ratio of 20 per cent and 80 per cent, because this ratio was determined in the contract for the purpose of distribution of profit.

Since the increase in the value of the business is 50 units, these 50 units are divided in the ratio of 20:80, meaning thereby that 10 units will have been earned by B. These 10 units will be added to his original 20 units, and the price of his share will be 30 units.

In the case of loss, however, any decrease in the total value of the assets should be divided between them exactly in the ratio of their investment, i.e., in the ratio of 40/60.

Therefore, if the value of the business has decreased, in the above example, by 10 units reducing the total number of units to 40, the loss of 4 units shall be borne by B (being 40 per cent' of the loss). These 4 units shall be deducted from his original 20 units, and the price of his share shall be determined as 16 units. Table 2 (below) will explain the formula more clearly.

Table 2



6.5. Sharing in the Gross Profit Only

2. Financing on the basis of *musharakah* according to the above procedure may be difficult in a business having a large number of fixed assets, particularly in a running industry, because the valuation of all its assets and their depreciation or appreciation may create accounting problems giving rise to disputes. In such cases, *musharakah* may be applied in another way.

The major difficulties in these cases arise in the calculation of indirect expenses, like depreciation of the machinery, salaries of the staff etc. In order to solve this problem, the parties may agree on the principle that, instead of net profit, the gross profit will be distributed between the parties, that is, the indirect expenses shall not be deducted from the distributable profit. It will mean that all the indirect expenses shall be borne by the industrialist voluntarily, and only direct expenses (like those of raw material, direct labour, electricity etc.) shall be borne by the *musharakah.* But since the industrialist is

offering his machinery, building and staff to the *musharakah* voluntarily, the percentage of his profit may be increased to compensate him to some extent.

This arrangement may be justified on the ground that the clients of financial institutions do not restrict themselves to the operations for which they seek finance from the financial institutions. Their machinery and staff etc. is, therefore, engaged in some other business also which may not be subject to *musharakah,* and in such a case the whole cost of these expenses cannot be imposed on the *musharakah.*

Let us take a practical example. Suppose a ginning factory has a building worth Rs. 22 million, plant and machinery valuing Rs. 2 million and the staff is paid Rs. 50,000/- per month. The factory sought finance of Rs. 5,000,000/- from a bank on the basis of *musharakah* for a term of one year. It means that after one year the *musharakah* will be terminated, and the profits accrued up to that point will be distributed between the parties according to the agreed ratio. While determining the profit, all direct expenses will be deducted from the income. The direct expenses may include the following:

1. the amount spent in purchasing raw material
2. the wages of the labour directly involved in processing the raw material
3. the expenses for electricity consumed in the process of ginning
4. the bills for other services directly rendered for the *musharakah*

So far as the building, the machinery and the salary of other staff is concerned, it is obvious that they are not meant for the business of the *musharakah* alone, because the *musharakah* will terminate within one year, while the building and the machinery are purchased for a much longer term in which the ginning factory will use them for its own business which is not subject to this one-year *musharakah.* Therefore, the whole cost of the building and the machinery cannot be borne by this short-term *musharakah.* What can be done at the most is that the depreciation caused to the building and the machinery during the term of the *musharakah* is included in its expenses. But in practical terms, it will be very difficult to determine the cost of depreciation, and it may cause disputes also. Therefore, there are two practical ways to solve this problem.

In the first instance, the parties may agree that the *musharakah* portfolio will pay an agreed rent to the client for the use of the machinery and the building owned by him. This rent will be paid to him from the *musharakah* fund irrespective of profit or loss accruing to the business.

The second option is that, instead of paying rent to the client, the ratio of his profit is increased.

From the point of view of *Shari'ah,* it may be justified on the analogy of *mudarabah* in services which is allowed in the view of Imam Ahmad bin Hanbal رحمه الله تعالى

6.6. Running *Musharakah* Account on the Basis of Daily Products

3. Many financial institutions finance the working capital of an enterprise by opening a running account for them from where the clients draw different amounts at different intervals, but at the same time, they keep returning their surplus amounts. Thus the

process of debit and credit goes on up to the date of maturity, and the interest is calculated on the basis of daily products.

Can such an arrangement be possible under the *musharakah* or *mudarabah* modes of financing? Obviously, being a new phenomenon, no express answer to this question can be found in the classical works of Islamic *Fiqh.* However, keeping in view the basic principles of *musharakah* the following procedure may be suggested for this purpose:

(i) A certain percentage of the actual profit must be allocated for the management.

(ii) The remaining percentage of the profit must be allocated for the investors.

(iii) The loss, if any, should be borne by the investors only in exact proportion of their respective investments.

(iv) The average balance of the contributions made to the *musharakah* account calculated on the basis of daily products shall be treated as the share capital of the financier.

(v) The profit accruing at the end of the term shall be calculated on a daily product basis, and shall be distributed accordingly.

If such an arrangement is agreed upon between the parties, it does not seem to violate any basic principle of the *musharakah.* However, this suggestion needs further consideration and research by the experts of Islamic jurisprudence. Practically, it means that the parties have agreed to the principle that the profit accrued to the *musharakah* portfolio at the end of the term will be divided on the capital utilized per day, which will lead to the average of the profit earned by each rupee per day. The amount of this average profit per rupee per day will be multiplied by the number of the days each investor has put his money into the business, which will determine his profit entitlement on a daily product basis.

Some contemporary scholars do not allow this method of calculating profits on the ground that it is just a conjectural method which does not reflect the actual profits really earned by a partner of the *musharakah*, because the business may have earned huge profits during a period when a particular investor had no money invested in the business at all, or had a very negligible amount invested, still, he will be treated at par with other investors who had huge amounts invested in the business during that period. Conversely, the business may have suffered a great loss during a period when a particular investor had huge amounts invested in it. Still, he will pass on some of his loss to other investors who had no investment in that period or their size of investment was negligible.

This argument can be refuted on the ground that it is not necessary in a *musharakah* that a partner should earn profit on his own money only. Once a *musharakah* pool comes into existence, the profits accruing to the joint pool are earned by all the participants, regardless of whether their money is or is not utilized in a particular transaction. This is particularly true of the *Hanafi* school which does not deem it necessary for a valid *musharakah* that the monetary contributions of the partners are mixed up together. It means that if A has entered into a *musharakah* contract with B, but has not yet disbursed his money into the joint pool, he will still be entitled to a share in the profit of the

transactions effected by B for the *musharakah* through his own money.[31] Although his entitlement to a share in the profit will be subject to the disbursement of money undertaken by him, yet the fact remains that the profit of this particular transaction did not accrue to his money, because the money disbursed by him at a later stage may be used for another transaction. Suppose, A and B entered into a *musharakah* to conduct a business of Rs. 100,000/- They agreed that each one of them shall contribute Rs. 50,000/- and the profits will be distributed by them equally. A did not yet invest his Rs. 50,000/- into the joint pool. B found a profitable deal and purchased two air conditioners for the *musharakah* for Rs. 50,000/- contributed by himself and sold them for Rs. 60,000/-, thus earning a profit of Rs. 10000/-. A contributed his share of Rs. 50,000/- after this deal. The partners purchased two refrigerators through this contribution which could not be sold at a greater price than Rs. 48000/- meaning thereby that this deal resulted in a loss of Rs. 2000/- Although the transaction effected by A's money brought loss of Rs. 2000/- while the profitable deal of air conditioners was financed entirely by B's money in which A had no contribution, yet A will be entitled to a share in the profit of the first deal. The loss of Rs. 2000/- in the second deal will be set off from the profit of the first deal reducing the aggregate profit to Rs. 8000/-. This profit of Rs. 8000/- will be shared by both partners equally. It means that A will get Rs. 4000/-, even though the transaction effected by his money has suffered loss.

The reason is that once a *musharakah* contract is entered into by the parties, all the subsequent transactions effected for *musharakah* belong to the joint pool, regardless of whose individual money is utilized in them. Each partner is a party to each transaction by virtue of his entering into the contract *of musharakah.*

A possible objection to the above explanation may be that in the above example, A had undertaken to pay Rs. 50,000/- and it was known before hand that he will contribute a specified amount to the *musharakah.* But in the proposed running account of *musharakah* where the partners are coming in and going out every day, nobody has undertaken to contribute any specific amount. Therefore, the capital contributed by each partner is unknown at the time of entering into *musharakah,* which should render the *musharakah* invalid.

The answer to the above objection is that the classical scholars of Islamic *Fiqh* have different views about whether it is necessary for a valid *musharakah* that the capital is pre-known to the partners. The Hanafi scholars are unanimous on the point that it is not a pre-condition. Al-Kasani, the famous Hanafi jurist, writes:

وأما العلم بمقدار رأس المال وقت العقد، فليس بشرط
لجواز الشركة بالأموال عندنا . وعند الشافعي شرط...
ولنا أن الجهالة لاتمنع جواز العقد لعينها، بل لإفضاءها
إلى المنازعة. وجهالة رأس المال وقت العقد لا تفضي
إلى المنازعة, لأنه يعلم مقداره ظاهرا وغالبا لأن الدراهم

[31] See Badai'-us-sanai' v. 6, pp. 54, 60.

والدنانير توزنان وقت الشراء فيعلم مقدارها فلا يؤدى
إلى جهالة مقدار الربح وقت القسمة.

According to our Hanafi School, it is not a condition for the validity of *musharakah* that the amount of capital is known, while it is a condition according to Imam Shafi'i. Our argument is that *Jahalah* (uncertainty) in itself does not render a contract invalid, unless it leads to disputes. And the uncertainty in the capital at the time of *musharakah* does not lead to disputes, because it is generally known when the commodities are purchased for the *musharakah,* therefore it does not lead to uncertainty in the profit at the time of distribution.[32]

It is, therefore, clear from the above that even if the amount of the capital is not known at the time of *musharakah,* the contract is valid. The only condition is that it should not lead to the uncertainty in the profit at the time of distribution. Distribution of profit on daily product basis fulfils this condition.

It is true that the concept of a running *musharakah* where the partners at times draw some amounts and at other times inject new money and the profits are calculated on daily products basis is not found in the classical books of Islamic *Fiqh.* But merely this fact cannot render a new arrangement invalid in *Shari'ah,* so far as it does not violate any basic principle of *musharakah.* In the proposed system, all the partners are treated at par. The profit of each partner is calculated on the basis of the period for which his money remained in the joint pool. There is no doubt in the fact that the aggregate profits accrued to the pool are generated by the joint utilizations of different amounts contributed by the participants at different times. Therefore, if all of them agree with mutual consent to distribute the profits on daily products basis, there is no injunction of *Shari'ah* which makes it impermissible; rather, it is covered under the general guideline given by the Holy Prophet صلى الله عليه وسلم in his famous hadith quoted in this book more than once:

المسلمون على شروطهم الا شرطا حرّم حلالا او احلّ حراما

Muslims are bound by their mutual agreements unless they hold a permissible thing as prohibited or a prohibited thing as permissible.

2. If distribution on a daily products basis is not accepted, it will mean that no partner can draw any amount from, nor can he inject new amounts to the joint pool. Similarly, nobody will be able to subscribe to the joint pool except at the particular dates of the commencement of a new term. This arrangement is totally impracticable on the deposits side of the banks and financial institutions where the accounts are debited and credited by the depositors many times a day. The rejection of the concept of the daily products will compel them to wait for months before they deposit their surplus money in a profitable account. This will hinder the utilization of savings for the development of industry and trade, and will keep the wheel of financial activities jammed for long periods. There is no other solution for this problem except to apply the method of daily products for the

[32] Badai'-us-sanai' v. 6, p. 63

calculation of profits, and since there is no specific injunction of *Shari'ah* against it, there is no reason why this method should not be adopted.

7. SOME OBJECTIONS TO *MUSHARAKAH* FINANCING

Let us now examine some objections raised from the practical point of view against using *musharakah* as a mode of financing.

7.1. Risk of Loss

1. It is argued that the arrangement of *musharakah* is more likely to pass on losses of the business to the financier bank or institution. This loss will be passed on to depositors also. The depositors, being constantly exposed to the risk of loss, will not like to deposit their money in the banks and financial institutions and thus their savings will either remain idle or will be used in transactions outside the banking channels, which will not contribute to economic development at a national level.

This argument is, however, misconceived. Before financing on the basis of *musharakah,* banks and financial institutions will study the feasibility of the proposed business for which funds are needed. Even in the present system of interest-based loans the banks do not advance loans to each and every applicant. They study not only the financial position of the client but in cases of large loans they have to examine the potential of the business and if they consider that the business is not profitable, they can refuse to advance a loan. In the case of *musharakah,* they will have to carry out this study with more depth and precaution.

Moreover, no bank or financial institution can restrict itself to a single *musharakah.* There will always be a diversified portfolio of *musharakah.* If a bank has financed 100 of its clients on the basis of *musharakah,* after studying the feasibility of the proposal of each one of them, it is hardly conceivable that all of these *musharakahs,* or the majority of them will result in a loss. After taking proper measures and due care, what can happen at the most is that some of them will suffer a loss. But, on the other hand, the profitable *musharakahs* are expected to give more return than the interest-based loans, because the actual profit is supposed to be distributed between the client and the bank. Therefore, the *musharakah* portfolio, as a whole, is not expected to suffer a loss, and the possibility of a loss to the whole portfolio is merely a theoretical assumption, which should not discourage depositors. This theoretical possibility of a loss in a financial institution is much less than the probability of loss in a joint stock company whose business is restricted to a limited sector of commercial activities. Still, the people purchase its shares and the possibility of a loss does not deter them from investing in these shares. The case of banks and financial institutions is much stronger, because their *musharakah* activities will be so diversified that any possible loss in one *musharakah* will be more than compensated by the profits earned in other *musharakahs.*

The experience of Pakistan banks is an empirical evidence. Since 1 July 1995 all deposits in Pakistan are based on profit and loss sharing basis, except current accounts. No guarantee, even of the principal, is provided to the depositors by the banks, and thus the liabilities side of our present banks is fully equity-based, but still deposits are being made as before.

Apart from this, an Islamic economy must create a mentality which believes that any profit earned on money is the reward of bearing risks of the business. This risk may be minimized through expertise and diversifying the portfolio where it may become a hypothetical or theoretical risk only. But there is no way to eliminate this risk totally. The one who wants to earn profit, must accept this minimal risk. Since this understanding is already there in the case of normal joint stock companies, nobody has ever raised the objection that the money of the shareholders is exposed to loss. The problem is created by the system that separates banking and financing from the normal trade activities, and which has compelled people to believe that banks and financial institutions deal in money and papers only, and that they have nothing to do with the actual results emerging in trade and industry. It is this basic premise on the basis of which, it is argued that they deserve a fixed return in any case. This essential separation of the financing sector from the sector of trade and industry has brought great harms to the economy at macro-level. Obviously, when we speak of Islamic banking, we never mean that it will follow this conventional system in each and every respect. Islam has its own values and principles which do not believe in separation of financing from trade and industry. Once this Islamic system is understood, people will invest in the financing sector, despite the theoretical risk of loss, more readily than they invest in profitable joint stock companies.

7.2. Dishonesty

Another concern with *musharakah* financing is that dishonest clients may exploit the instrument of *musharakah* by not paying any return to the financiers. They can always show that the business did not earn any profit. Indeed, they can claim that it has suffered a loss in which case not only the profit, but also the principal amount will be jeopardized.

This is, no doubt, a valid concern, especially in societies where corruption is widespread. However, the solution to this problem is not as difficult as is generally believed or exaggerated.

If all the banks in a country are run on a pure Islamic pattern with careful support from the Central Bank and the government, the problem of dishonesty is not hard to overcome. First of all, the system of credit rating will have to be implemented with full force. Every company or corporate body should be compelled by law to subject itself to an independent credit rating. Even the big firms seeking finance above a certain level may also be subjected to the same rule. Secondly, a well-designed system of auditing should be implemented whereby the accounts of all the clients are fully maintained and properly monitored. It has already been discussed that profits may be calculated on the basis of gross margins only. It will reduce the possibility of disputes and

misappropriation. However, if any misconduct, dishonesty or negligence is established against a client, he will be subjected to punitive actions, and may be deprived of availing any facility from any bank in the country, at least for a specified period.

These steps will serve as a strong deterrent against concealing the actual profits or committing any other act of dishonesty. Otherwise also, the clients of the banks cannot afford to show artificial losses constantly, because it will be against their own interest in many respects. It is true that even after taking all such precautions, there will remain a possibility of some cases where dishonest clients may succeed in their evil designs, but the punitive steps and the general atmosphere of business will gradually reduce the number of such cases. Even in an interest-based economy, defaulters have always created the problem of bad debts, but it should not be taken as a justification, or as an excuse, for rejecting the whole system of *musharakah*.

7.3. Secrecy of the Business

Another criticism against *musharakah* is that, by making the financier a partner in the business of the client, it may disclose the secrets of the business to the financier, and through him to other traders.

However, the solution to this problem is very easy. The client, while entering into the *musharakah*, may put a condition that the financier will not interfere with the management affairs, and he will not disclose any information about the business to any person without prior permission of the client. Such agreements of maintaining secrecy are always honoured by the prestigious institutions, especially by the banks and financial institutions whose entire business is based on confidentiality.

7.4. Clients' Unwillingness to Share Profits

It is frequently mentioned that clients are not willing to share the actual profits of their business with banks. The reluctance is based on two reasons:

1. They think that the bank has no right to share in the actual profit, which may be substantial, because the bank has nothing to do with the management or running of the business and why should the bank share the fruit of their labour while it has merely provided funds. The clients also argue that conventional banks are content with a meagre rate of interest and so should be the Islamic Banks.
2. Even if the above was not a factor, the clients are afraid to reveal their true profits to the banks, lest the information is also passed on to the tax authorities and clients' tax liability increases.

The solution to the first part, though not easy, is not difficult or impossible either. Such Clients need to be convinced and persuaded that borrowing on interest is a cardinal sin, unless there is a dire necessity for such borrowing. Mere expansion of business is not a dire need, by any stretch of imagination. By making a legitimate arrangement for

obtaining funds for their business, by way of *musharakah,* not only do they earn Allah's pleasure but also a legitimate return for themselves, as well as for the Islamic Banks.

In respect of the second factor, all that can be said is that in some Muslim countries, rates of taxation are indeed exorbitant and unjust. Islamic Banks as well as their clients must lobby the governments and struggle to change the laws which hamper the progress towards Islamic banking. The governments should also try to appreciate the fact that if rates of taxation are reasonable and if the tax-payers are convinced that they will benefit by honestly paying their taxes, this would increase, and not decrease, government revenues.

8. DIMINISHING *MUSHARAKAH*

Another form of *musharakah*, developed in the near past, is diminishing *musharakah.* According to this concept, a financier and his client participate either in the joint ownership of a property or equipment, or in a joint commercial enterprise. The share of the financier is further divided into a number of units and it is understood that the client will purchase the units of the share of the financier one by one periodically, thus increasing his own share till all the units of the financier are purchased by him so as to make him the sole owner of the property, or the commercial enterprise, as the case may be.

The diminishing *musharakah* based on the above concept has taken different shapes in different transactions. Some examples are given below:

1. It has been used mostly in house financing. The client wants to purchase a house for which he does not have adequate funds. He approaches the financier who agrees to participate with him in purchasing the required house. 20 per cent of the price is paid by the client and 80 per cent of the price by the financier. Thus the financier owns 80 per cent of the house while the client owns 20 per cent. After purchasing the property jointly, the client uses the house for his residential requirement and pays rent to the financier for using his share in the property. At the same time the share of financier is further divided in eight equal units, each unit representing 10 per cent ownership of the house. The client promises to the financier that he will purchase one unit after three months. Accordingly, after the first term of three months he purchases one unit of the share of the financier by paying 1/10th of the price of the house. It reduces the share of the financier from 80 per cent to 70 per cent. Hence, the rent payable to the financier is also reduced to that extent. At the end of the second term, he purchases another unit increasing his share in the property to 40 per cent and reducing the share of the financier to 60 per cent and consequentially reducing the rent to that proportion. This process goes on in the same fashion until after the end of two years, the client purchases the whole share of the financier reducing the share of the financier to 'zero' and increasing his own share to 100 per cent.

This arrangement allows the financier to claim rent according to his proportion of

ownership in the property and at the same time allows him periodical return of a part of his principal through purchases of the units of his share.

2. A wants to purchase a taxi to use it for offering transport services to passengers and to earn income through fares recovered from them, but he is short of funds. B agrees to participate in the purchase of the taxi, therefore, both of them purchase a taxi jointly, where 80 per cent of the price is paid by B and 20 per cent is paid by A. After the taxi is purchased, it is employed to provide transport to passengers whereby the net income of Rs. 1000/- is earned on a daily basis. Since B has an 80 per cent share in the taxi it is agreed that 80 per cent of the fare will be given to him and the rest (20 per cent) will be retained by A who has a 20 per cent share in the taxi. This means that daily earnings of Rs. 800/- are due to B and Rs. 200/- to A. At the same time, B's share is further divided into eight units. After three months A purchases one unit from the share of B. Consequently B's share is reduced to 70 per cent and A's share is increased to 30 per cent meaning thereby that as from that date A will be entitled to Rs. 300/- from the daily income of the taxi and B will earn Rs. 700/-. This process will go on until after two years, the whole taxi will be owned by A and B will have his original investment returned to him along with income earned as aforesaid.

3. A wishes to start a ready-made tailoring business but lacks the funds required for that purpose. B agrees to participate with him for a specified period, say two years. Initially, 40 per cent of the investment is contributed by A and 60 per cent by B. Both start the business on the basis of *Musharakah*. The proportion of profit allocated to each of them is expressly agreed upon. But at the same time B's share in the business is divided to six equal units and A keeps purchasing these units on a gradual basis until after the end of two years B comes out of the business, leaving its exclusive ownership to A. Apart from periodical profits earned by B, he gains the price of the units of his share which repay him the original amount he invested.

Analysed from the *Shari'ah* point of view this arrangement is composed of different transactions which come into play at different stages. Therefore, each one of the foregoing three forms of diminishing *musharakah* is discussed below in the light of Islamic principles:

House financing on the basis of diminishing *musharakah*

The proposed arrangement is composed of the following transactions:

1. To create joint ownership in the property (Shirkat-al-Milk).
2. Giving the share of the financier to the client on rent.
3. Promise from the client to purchase the units of share of the financier.
4. Actual purchase of the units at different stages.
5. Adjustment of the rental according to the remaining share of the financier in the property.

Let me discuss each ingredient of the arrangement in greater detail.

(i) The first step in the above arrangement is to create a joint ownership in the property. It has already been explained in the beginning of this chapter that 'Shirkat-al-Milk' (joint ownership) can come into existence in different ways including joint purchase by the

parties. This has been expressly allowed by all schools of Islamic jurisprudence.[33] Therefore no objection can be raised against creating this joint ownership.

(ii) The second part of the arrangement is that the financier leases his share in the house to his client and charges rent from him. This arrangement is also above board because there is no difference of opinion among the Muslim jurists in the permissibility of leasing one's undivided share in a property to his partner. If the undivided share is leased out to a third party its permissibility is a point of difference between the Muslim jurists. Imam Abu Hanifa and Imam Zufar are of the view that the undivided share cannot be leased out to a third party, while Imam Malik and Imam Shafi'i, Abu Yusuf and Muhammad Ibn Hasan hold that the undivided share can be leased out to any person. But so far as the property is leased to the partner himself, all of them are unanimous on the validity of 'Ijarah'.[34]

(iii) The third step in the aforesaid arrangement is that the client purchases different units of the undivided share of the financier. This transaction is also allowed. If the undivided share relates to both land and building, the sale of both is allowed according to all the Islamic schools. Similarly if the undivided share of the building is intended to be sold to a partner, it is also allowed unanimously by all the Muslim jurists. However, there is a difference of opinion if it is sold to a third party.[35]

It is clear from the foregoing three points that each one of the transactions mentioned hereinabove is allowed *per se,* but the question is whether this transaction may be combined in a single arrangement. The answer is that if all these transactions have been combined by making each one of them a condition to the other, then this is not allowed in *Shari'ah,* because it is a well settled rule in the Islamic legal system that one transaction cannot be made a pre-condition for another. However, the proposed scheme suggests that instead of making two transactions conditional to each other, there should be a one-sided promise from the client, firstly, to take the share of the financier on lease and pay the agreed rent, and secondly, to purchase different units of the share of the financier of the house at different stages. This leads us to the fourth issue, which is, the enforceability of such a promise.

It is generally believed that a promise to do something creates only a moral obligation on the promisor which cannot be enforced through courts of law. However, there are a number of Muslim jurists who opine that promises are enforceable, and the court of law can compel a promisor to fulfil his promise, especially, in the context of commercial activities. Some Maliki and Hanafi jurists can be cited, in particular, who have declared that the promises can be enforced through courts of law in cases of need. The Hanafi jurists have adopted this view with regard to a particular sale called *'bai-bilwafa* . This *bai-bilwafa is* a special arrangement of sale of a house whereby the buyer promises to the seller that whenever the latter gives him back the price of the house, he will resell the

[33] See for example Radd-al-Muhtar v. 3, pp. 364–365.

[34] See Ibn Qudamah, Al-Mughni, v. 6, p. 137 and 'Radd-al-Muhtar' v. 6, pp. 47–48

[35] See 'Radd-al-Muhtar v. 3, p. 365.

house to him. This arrangement was in vogue in countries of central Asia, and the Hanafi jurists have opined that if the resale of the house to the original seller is made a condition for the initial sale, it is not allowed. However, if the first sale is effected without any condition, but after effecting the sale, the buyer promises to resell the house whenever the seller offers to him the same price, this promise is acceptable and it creates not only a moral obligation, but also an enforceable right of the original seller. The Muslim jurists allowing this arrangement have based their view on the principle that "قد تجعل المواعيد لازمة لحاجة الناس" (the promise can be made enforceable at the time of need).

Even if the promise has been made before effecting the first sale, after which the sale has been effected without a condition, it is also allowed by certain Hanafi jurists.[36]

One may raise an objection that if the promise of resale has been taken before entering into an actual sale, it practically amounts to putting a condition on the sale itself, because the promise is understood to have been entered into between the parties at the time of sale, and therefore, even if the sale is without an express condition, it should be taken as conditional because a promise in an express term has preceded it.

This objection can be answered by saying that there is a big difference between putting a condition in the sale and making a separate promise without making it a condition. If the condition is expressly mentioned at the time of sale, it means that the sale will be valid only if the condition is fulfilled, meaning thereby that if the condition is not fulfilled in future, the present sale will become void. This makes the transaction of sale contingent on a future event which may or may not occur. It leads to uncertainty (*gharar*) in the transaction which is totally prohibited in *Shari'ah*.

Conversely, if the sale is without any condition, but one of the two parties has promised to do something separately, then the sale cannot be held to be contingent or conditional with fulfilling of the promise made. It will take effect irrespective of whether or not the promisor fulfils his promise. Even if the promisor backs out of his promise, the sale will remain effective. The most the promisee can do is to compel the promisor through a court of law to fulfil his promise and if the promisor is unable to fulfil the promise, the promisee can claim the actual damages he has suffered because of the default.

This makes it clear that a separate and independent promise to purchase does not render the original contract conditional or contingent. Therefore, it can be enforced.

On the basis of this analysis, diminishing *musharakah* may be used for House Financing with the following conditions:

(a) The agreement of joint purchase, leasing and selling different units of the share of the financier should not be tied-up together in one single contract. However, the joint purchase and the contract of lease may be joined in one document whereby the financier agrees to lease his share, after joint purchase, to the client.

This is allowed because, as explained in the relevant chapter, *ijarah* can be effected for a future date. At the same time the client may sign a one-sided promise to

[36] See Jami'ul-Fusoolain v. 2, p. 237 and Radd al-Muhtar v. 4, p. 135

purchase different units of the share of the financier periodically and the financier may undertake that when the client will purchase a unit of his share, the rent of the remaining units will be reduced accordingly.

(a) At the time of the purchase of each unit, sale must be effected by the exchange of offer and acceptance at that particular date.

(b) It will be preferable that the purchase of different units by the client is effected on the basis of the market value of the house as prevalent on the date of purchase of that unit, but it is also permissible that a particular price is agreed in the promise of purchase signed by the client.

8.1. Diminishing Musharakah for Carrying Business of Services:

The second example given above for diminishing *musharakah* is the joint purchase of a taxi to earn income by using it as a hired vehicle. This arrangement consists of the following ingredients:

(i) Creating joint ownership in a taxi in the form of *shirkah al-milk*. As already stated this is allowed in *Shari'ah*.

(ii) *Musharakah* in the income generated through the services of taxi. It is also allowed as mentioned earlier in this chapter.

(iii) Purchase of different units of the share of the financier by the client. This is again subject to the conditions already detailed in the case of House financing. However, there is a slight difference between House financing and the arrangement suggested in this second example. The taxi, when used as a hired vehicle, normally depreciates in value over time, therefore, depreciation in the value of the taxi must be kept in mind while determining the price of different units of the share of the financier.

8.2. Diminishing *Musharakah* in Trade:

The third example of diminishing *musharakah* as given above is that the financier contributes 60 per cent of the capital for launching a business of ready made garments. This arrangement is composed of two ingredients only:

1. In the first place, the arrangement is simply a *musharakah* whereby two partners invest different amounts of capital in a joint enterprise. This is obviously permissible subject to the conditions of *musharakah* already spelled out earlier in this chapter.

2. Purchase of different units of the share of the financier by the client. This may be in the form of a separate and independent promise by the client. The requirements of *Shari'ah* regarding this promise are the same as explained in the case of house financing with one very important difference. Here the price of units of the financier cannot be fixed in the promise to purchase, because if the price is fixed before hand at the time of entering into *musharakah,* it will practically mean that the client has ensured the principal invested by the financier with or without profit, which is strictly prohibited in

the case of *musharakah.* Therefore, there are two options for the financier about fixing the price of his units to be purchased by the client. One option is that he agrees to sell the units on the basis of valuation of the business at the time of the purchase of each unit. If the value of the business has increased, the price will be higher and if it has decreased the price will be less. Such valuation may be carried out in accordance with the recognized principles through the experts, whose identity may be agreed upon between the parties when the promise is signed. The second option is that the financier allows the client to sell these units to any body else at whatever price he can, but at the same time he offers a specific price to the client, meaning thereby that if he finds a purchaser of that unit at a higher price, he may sell it to him, but if he wants to sell it to the financier, the latter will be agreeable to purchase it at the price fixed by him before hand.

Although both these options are available according to the principles of *Shari'ah*, the second option does not seem to be feasible for the financier, because it would lead to injecting new partners in the *musharakah* which will disturb the whole arrangement and defeat the purpose of diminishing *musharakah* in which the financier wants to get his money back within a specified period. Therefore, in order to implement the objective of diminishing *musharakah,* only the first option is practical.

CHAPTER 2

Murabahah

1. INTRODUCTION

Most of the Islamic banks and financial institutions are using *murabahah* as an Islamic mode of financing, and most of their financing operations are based on *murabahah.* That is why this term has been taken in the economic circles today as a method of banking operations, while the original concept of *murabahah* is different from this assumption.

Murabahah is, in fact, a term of Islamic *Fiqh* and it refers to a particular kind of sale having nothing to do with financing in its original sense. If a seller agrees with his purchaser to provide him a specific commodity on a certain profit added to his cost, it is called a *murabahah* transaction. The basic ingredient of *murabahah* is that the seller discloses the actual cost he has incurred in acquiring the commodity, and then adds some profit thereon. This profit may be in lump sum or may be based on a percentage.

The payment in the case of *murabahah* may be on the spot, and may be on a subsequent date agreed upon by the parties. Therefore, *murabahah* does not necessarily imply the concept of deferred payment, as generally believed by some people who are not acquainted with the Islamic jurisprudence and who have heard about *murabahah* only in relation to banking transactions.

Murahabah, in its original Islamic connotation, is simply a sale. The only feature distinguishing it from other kinds of sale is that the seller in *murabahah* expressly tells the purchaser how much cost he has incurred and how much profit he is going to charge in addition to the cost.

If a person sells a commodity for a lump sum price without any reference to the cost, this is not a *murabahah,* even though he is earning some profit on his cost because the sale is not based on a "cost-plus" concept. In this case, the sale is called *musawamah.*

This is the actual sense of the term *murabahah* which is a sale, pure and simple. However, this kind of sale is being used by the Islamic banks and financial institutions by adding some other concepts to it, as a mode of financing. But the validity of such transactions depends on some conditions which should be duly observed to make them acceptable to *Shari'ah.*

In order to understand these conditions correctly, one should, in the first instance, appreciate that *murabahah* is a sale with all its implications, and that all the basic ingredients of a valid sale should be present in *murabahah* also.

Therefore, this discussion will start with some fundamental rules of sale without which a sale cannot be held as valid in *Shari'ah.* Then, we shall discuss some special rules

governing the sale *of murabahah* in particular, and in the end the correct procedure for using the *murabahah* as an acceptable mode of financing will be explained.

An attempt has been made to reduce the detailed principles into concise notes in the shortest possible sentences, so that the basic points of the subject may be grasped at a glance, and may be preserved for easy reference.

2. SOME BASIC RULES OF SALE

'Sale' is defined in *Shari'ah* as 'the exchange of a thing of value by another thing of value with mutual consent'. Islamic jurisprudence has laid down many rules governing the contract of sale, and the Muslim jurists have written a large number of books, in a number of volumes, to elaborate them in detail. What is meant here is to give a summary of only those rules which are more relevant to the transactions of *murabahah* as carried out by financial institutions:

1. The subject of sale must be existing at the time of sale. Thus, a thing which has not yet come into existence cannot be sold. If a non-existent thing has been sold, though by mutual consent, the sale is void according to *Shari'ah*.

Example: A sells his cow's unborn calf to B. The sale is void.

2. The subject of sale must be in the ownership of the seller at the time of sale. Thus, what is not owned by the seller cannot be sold. If he sells something before acquiring its ownership, the sale is void.

Example: A sells a car to B, which is presently owned by C, but A is hopeful that he will buy it from C and will deliver it to B subsequently. The sale is void, because the car was not owned by A at the time of sale.

3. The subject of sale must be in the physical or constructive possession of the seller when he sells it to another person. "Constructive possession" means a situation where the possessor has not taken the physical delivery of the commodity, yet the commodity has come into his control, and all the rights and liabilities of the commodity are passed on to him, including the risk of its destruction.

Examples:

(i) A has purchased a car from B. B has not yet delivered it to A or to his agent. A cannot sell the car to C. If he sells it before taking its delivery from B, the sale is void.

(ii) A has purchased a car from B. B, after identifying the Car has placed it in a garage to which A has free access and B has allowed him to take the delivery from that place whenever he wishes. Thus the risk of the Car has passed on to A.. The car is in the constructive possession of A. If A sells the car to C without acquiring physical possession, the sale is valid.

Explanation 1: The gist of the rules mentioned in paragraphs 1 to 3 is that a person cannot sell a commodity unless:

(a) It has come into existence,

(b) It is owned by the seller,

(c) It is in the physical or constructive possession of the seller.

Explanation 2: There is a big difference between an actual sale and a mere promise to sell. The actual sale cannot be effected unless the above three conditions are fulfilled. However one can promise to sell something which is not yet owned or possessed by him. This promise initially creates only a moral obligation on the promisor to fulfil his promise, which is normally not justiciable. Nevertheless, in certain situations, specially where such promise has burdened the promisee with some liability, it can be enforceable through the courts of law. In such cases the court may force the promisor to fulfil his promise, i.e. to effect the sale, and if he fails to do so, the court may order him to pay the promisee the actual damages he has incurred due to the default of the promisor.[1]

But the actual sale will have to be effected after the commodity comes into the possession of the seller. This will require separate offer and acceptance, and unless the sale is effected in this manner, the legal consequences of the sale shall not follow.

Exception: The rules mentioned in paragraphs 1 to 3 are relaxed with respect to two types of sale, namely:

(a) Bai' Salam

(b) Istisna'

These two types of rules will be discussed later in a separate chapter.

4. The sale must be instant and absolute. Thus a sale attributed to a future date or a sale contingent on a future event is void. If the parties wish to effect a valid sale, they will have to effect it afresh when the future date comes or the contingency actually occurs.

Examples:

(1) A says to B on the first of January: "I sell my car to you on the first of February". The sale is void, because it is attributed to a future date.

(2) A says to B, "If party X wins the elections, my car stands sold to you". The sale is void, because it is contingent on a future event.

5. The subject of the sale must be a property of value. Thus, a thing having no value according to the usage of trade cannot be sold or purchased.

6. The subject of sale should not be a thing which is not used except for a *haram* purpose, like pork, wine etc.

7. The subject of sale must be specifically known and identified to the buyer.

Explanation: The subject of sale may be specified either by identification or by detailed specification which can distinguish it from other things not sold.

Example: There is a building comprising a number of apartments built in the same pattern. A, the owner of the building says to B, "I sell one of these apartments to you"; B accepts. The sale is void unless the apartment intended to be sold is specifically identified or pointed out to the buyer.

8. The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.

[1] Resolution No. 2, 3 of the Fifth Session of the Islamic *Fiqh* Academy held in Kuwait in the year 1409AH. See مجلة مجمع الفقه الاسلامي، العدد الخامس 2:1599

Example: A sells his car stolen by some anonymous person and the buyer purchases it under the hope that he will manage to take it back. The sale is void.

9. The certainty of price is a necessary condition for the validity of a sale. If the price is uncertain, the sale is void.

Example: A says to B, "If you pay within a month, the price is Rs. 50. But if you pay after two months, the price is Rs. 55". B agrees. The price is uncertain and the sale is void, unless anyone of the two alternatives is agreed upon by the parties at the time of sale.

10. The sale must be unconditional. A conditional sale is invalid, unless the condition is recognized according to the usage of trade as a part of the transaction.

Example 1: A buys a car from B with a condition that B will employ his son in his firm. The sale is conditional, hence invalid.

Example 2: A buys a refrigerator from B, with a condition that B undertakes its free service for 2 years. The condition, being recognized as a part of the transaction, is valid and the sale is lawful.

2.1. *Bai' Mu'ajjal* (Sale on Deferred Payment Basis)

1. A sale in which the parties agree that the payment of price shall be deferred is called a *bai' mu'ajjal.*

2. *Bai' mu'ajjal* is valid if the due date of payment is fixed in an unambiguous manner.

3. The due time of payment can be fixed either with reference to a particular date, or by specifying a period, like three months, but it cannot be fixed with reference to a future event the exact date of which is unknown or is uncertain. If the time of payment is unknown or uncertain, the sale is void.

4. If a particular period is fixed for payment, like one month, it will be deemed to commence from the time of delivery, unless the parties have agreed otherwise.

5. The deferred price may be more than the cash price, but it must be fixed at the time of sale.

6. Once the price is fixed, it cannot be decreased in case of earlier payment, nor can it be increased in case of default.

7. In order to pressurize the buyer to pay the instalments on time, the buyer may be asked to promise that in case of default, he will donate some specified amount for a charitable purpose. In this case the seller may receive such amount from the buyer, not to make it a part of his income, but to use it for a charitable purpose on behalf of the buyer. The detailed discussion on this subject will be found later in this chapter.

8. If the commodity is sold on instalments, the seller may put a condition on the buyer that if he fails to pay any instalment on its due date, the remaining instalments will become due immediately.

9. In order to secure the payment of price, the seller may ask the buyer to furnish a security whether in the form of a mortgage or in the form of a lien or a charge on any of his existing assets.

10. The buyer can also be asked to sign a promissory note or a bill of exchange, but the note or the bill cannot be sold to a third party at a price different from its face value.

3. *MURABAHAH*

1. *Murabahah* is a particular kind of sale where the seller expressly mentions the cost of the sold commodity he has incurred, and sells it to another person by adding some profit or mark-up thereon.
2. The profit in *murabahah* can be determined by mutual consent, either in lump sum or through an agreed ratio of profit to be charged over the cost.
3. All the expenses incurred by the seller in acquiring the commodity like freight, custom duty etc. shall be included in the cost price and the mark-up can be applied on the aggregate cost. However, recurring expenses of the business like salaries of the staff, the rent of the premises etc. cannot be included in the cost of an individual transaction. In fact, the profit claimed over the cost takes care of these expenses.
4. *Murabahah* is valid only where the exact cost of a commodity can be ascertained. If the exact cost cannot be ascertained, the commodity cannot be sold on *murabahah* basis. In this case the commodity must be sold on *musawamah* (bargaining) basis i.e. without any reference to the cost or to the ratio of profit/mark-up. The price of the commodity in such cases shall be determined in lump sum by mutual consent.
Example 1: A purchased a pair of shoes for Rs. 100/ -. He wants to sell it on *murabahah* with 10 per cent mark-up. The exact cost is known. The *murabahah* sale is valid.
Example 2: A purchased a ready-made suit and a pair of shoes in a single transaction, for a lump sum price of Rs. 500/-. A can sell the suit with the shoes on *murabahah*. But he cannot sell the shoes separately on *murabahah*, because the individual cost of the shoes is unknown. If he wants to sell the shoes separately, he must sell it at a lump sum price without reference to the cost or to the mark-up.

3.1. *Murabahah* as a Mode of Financing

Originally, *murabahah* is a particular type of sale and not a mode of financing. The ideal mode of financing according to *Shari'ah* is *mudarabah* or *musharakah* which were discussed in the first chapter. However, in the perspective of the current economic set up, there are certain practical difficulties in using *mudarabah* and *musharakah* instruments in some areas of financing. Therefore, the contemporary *Shari'ah* experts have allowed, subject to certain conditions, the use of the *murabahah* on deferred payment basis as a mode of financing. But there are two essential points which must be fully understood in this respect:
1. It should never be overlooked that, originally, *murabahah* was not a mode of financing. It was only a device to escape interest and not the ideal instrument for carrying out the real economic objectives of Islam.

Therefore, this instrument should be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted only to those cases where *mudarabah* or *musharakah* are not practicable.

2. The second important point is that the *murabahah* transaction does not come into existence by merely replacing the word "interest" by the words "profit" or "mark-up". Actually, *murabahah* as a mode of finance, has been allowed by the *Shari'ah* scholars with some conditions. Unless these conditions are fully observed, *murabahah* is not permissible. In fact, it is the observance of these conditions which can draw a clear line of distinction between an interest-bearing loan and a transaction of *murabahah*. If these conditions are neglected, the transaction becomes invalid according to *Shari'ah*.

4. BASIC FEATURES OF *MURABAHAH* FINANCING

1. *Murabahah* is not a loan given on interest. It is the sale of a commodity for a deferred price which includes an agreed profit added to the cost.
2. Being a sale, and not a loan, *murabahah* should fulfil all the conditions necessary for a valid sale, especially those enumerated earlier in this chapter.
3. *Murabahah* cannot be used as a mode of financing except where the client needs funds actually to purchase some commodities. For example, if he wants funds to purchase cotton as a raw material for his ginning factory, the bank can sell him the cotton on the basis of *murabahah*. But where the funds are required for some other purposes, like paying the price of commodities already purchased by him, or the bills of electricity or other utilities or for paying the salaries of his staff, *murabahah* cannot be effected, because *murabahah* requires a real sale of some commodities, and not merely advancing a loan.
4. The financier must have owned the commodity before he sells it to his client.
5. The commodity must come into the possession of the financier, whether physical or constructive, in the sense that the commodity must be in his risk, though for a short period.
6. The best method of *murabahah*, according to *Shari'ah*, is that the financier himself purchases the commodity and keeps it in his own possession, or purchases the commodity through a third person appointed by him as agent, before he sells it to the customer. However, in exceptional cases, where direct purchase from the supplier is not practicable for some reason, it is also allowed that he makes the customer himself his agent to buy the commodity on his behalf. In this case the client first purchases the commodity on behalf of his financier and takes its possession as such. Thereafter, he purchases the commodity from the financier for a deferred price. His possession over the commodity in the first instance is in the capacity of an agent of his financier. In this capacity he is only a trustee, while the ownership vests in the financier and the risk of the commodity is also borne by him as a logical consequence of the ownership. But when the client purchases the commodity from his financier, the ownership, as well as the risk, is transferred to the client.

7. As mentioned earlier, the sale cannot take place unless the commodity comes into the possession of the seller, but the seller can promise to sell even when the commodity is not in his possession. The same rule is applicable to *murabahah.*

8. In the light of the aforementioned principles, a financial institution can use the *Murabahah* as a mode of finance by adopting the following procedure:

Firstly: The client and the institution sign an overall agreement whereby the institution promises to sell and the client promises to buy commodities from time to time on an agreed ratio of profit added to the cost. This agreement may specify the limit up to which the facility may be availed.

Secondly: When a specific commodity is required by a customer, the institution appoints the client as his agent for purchasing the commodity on its behalf, and an agreement of agency is signed by both the parties.

Thirdly: The client purchases the commodity on behalf of the institution and takes its possession as an agent of the institution.

Fourthly: The client informs the institution that he has purchased the commodity on its behalf, and at the same time, makes an offer to purchase it from the institution.

Fifthly: The institution accepts the offer and the sale is concluded whereby the ownership as well as the risk of the commodity is transferred to the client.

All these five stages are necessary to effect a valid *murabahah.* If the institution purchases the commodity directly from the supplier (which is preferable) it does not need any agency agreement. In this case, the second phase will be dropped and at the third stage the institution itself will purchase the commodity from the supplier, and the fourth phase will be restricted to making an offer by the client.

The most essential element of the transaction is that the commodity must remain in the risk of the institution during the period between the third and the fifth stage.

This is the only feature of *murabahah* which can distinguish it from an interest-based transaction. Therefore, it must be observed with due diligence at all costs, otherwise the *murabahah* transaction becomes invalid according to *Shari'ah.*

9. It is also a necessary condition for the validity of *murabahah* that the commodity is purchased from a third party. The purchase of the commodity from the client himself on 'buy back' agreement is not allowed in *Shari'ah.* Thus *murabahah* based on 'buy back' agreement is nothing more than an interest-based transaction.

10. The above mentioned procedure of the *murabahah* financing is a complex transaction where the parties involved have different capacities at different stages.

(a) At the first stage, the institution and the client promise to sell and purchase a commodity in future. This is not an actual sale. It is just a promise to effect a sale in future on *murabahah* basis. Thus at this stage the relation between the institution and the client is that of a promisor and a promisee.

(b) At the second stage, the relation between the parties is that of a principal and an agent.

(c) At the third stage, the relation between the institution and the supplier is that of a buyer and seller.

(d) At the fourth and fifth stage, the relation of buyer *and* seller comes into operation between the institution and the client, and since the sale is effected on deferred payment basis, the relation of a debtor and creditor also emerges between them simultaneously.

All these capacities must be kept in mind and must come into operation with all their consequential effects, each at its relevant stage, and these different capacities should never be mixed up or confused with each other.

11. The institution may ask the client to furnish a security to its satisfaction for the timely payment of the deferred price. He may also ask him to sign a promissory note or a bill of exchange, but it must be after the actual sale takes place, i.e. at the fifth stage mentioned above. The reason is that the promissory note is signed by a debtor in favour of his creditor, but the relation of debtor and creditor between the institution and the client begins only at the fifth stage, whereupon the actual sale takes place between them.

12. In the case of default by the buyer in the payment of the price on the due date, the price cannot be increased. However, if he has undertaken, in the agreement to pay an amount for a charitable purpose, as mentioned in paragraph 7 of the rules of *bai' mu'ajjal*, he shall be liable to pay the amount undertaken by him. But the amount so recovered from the buyer shall not form part of the income of the seller/the financier. He is bound to spend it for a charitable purpose on behalf of the buyer, as will be explained later in detail.

5. SOME ISSUES INVOLVED IN *MURABAHAH*

So far the basic concept of *murabahah* has been explained. Now, it is proposed to discuss some relevant issues with reference to the underlying Islamic principles and their practical applicability in *murabahah* transaction, because without correct understanding of these issues, the concept may remain ambiguous and its practical application may be susceptible to errors and misconceptions.

5.1. Different Pricing for Cash and Credit Sales

The first and foremost question about *murabahah* is that, when used as a mode of financing, it is always effected on the basis of deferred payment. The financier purchases the commodity on cash payment and sells it to the client on credit. While selling the commodity on credit, he takes into account the period in which the price is to be paid by the client and increases the price accordingly. The longer the maturity of the *murabahah* payment, the higher the price. Therefore the price in a *murabahah* transaction, as practised by the Islamic banks, is always higher than the market price. If the client is able to purchase the same commodity from the market on cash payment, he will have to pay much less than he has to pay in a *murabahah* transaction on deferred payment basis. The

question arises as to whether the price of a commodity in a credit sale may be increased from the price of a cash sale. Some people argue that the increase of price in a credit sale, being in consideration of the time given to the purchaser, should be treated analogous to the interest charged on a loan, because in both cases an additional amount is charged for the deferment of payment. On this basis they argue that the *murabahah* transactions, as practiced in the Islamic banks, are not different in essence from the interest-based loans advanced by the conventional banks.

This argument, which seems to be logical in appearance, is based on a misunderstanding about the principles of *Shari'ah* regarding the prohibition of riba. For the correct comprehension of the concept the following points must be kept in view:

1. The modern capitalist theory does not differentiate between money and commodity in so far as commercial transactions are concerned. In the matter of exchange, money and commodity both are treated at par. Both can be traded in. Both can be sold at whatever price the parties agree upon. One can sell one dollar for two dollars on the spot as well as on credit, just as he can sell a commodity valuing one dollar for two dollars. The only condition is that it should be with mutual consent.

Islamic principles, however, do not subscribe to this theory. According to Islamic principles, money and commodity have different characteristics and therefore, they are treated differently. The basic points of difference between money and commodity are the following:

(a) Money has no intrinsic utility. It cannot be utilized for fulfilling human needs directly. It can only be used for acquiring some goods or services. The commodities, on the other hand, have intrinsic utility. They can be utilized directly without exchanging them for some other thing.

(b) The commodities can be of different qualities, while money has no quality except that it is a measure of value or a medium of exchange. Therefore, all the units of money, of same denomination, are 100 per cent equal to each other. An old and dirty note of Rs. 1000/- has the same value as a brand new note of Rs. 1000/-, unlike the commodities which may have different qualities, and obviously an old and used car may be much less in value than a brand new car.

(c) In commodities, the transaction of sale and purchase is effected on a particular individual commodity or, at least, on the commodities having particular specifications. If A has purchased a particular car by pinpointing it and the seller has agreed, he deserves to receive the same car. The seller cannot compel him to take the delivery of another car, though of the same type or quality. This can only be done if the purchaser agrees to it which implies that the earlier transaction is cancelled and a new transaction on the new car is effected by mutual consent.

Money, on the other hand, cannot be pinpointed in a transaction of exchange. If A has purchased a commodity from B by showing him a particular note of Rs. 1000, he can still pay him another note of the same denomination, while B cannot insist that he will take the same note as was shown to him.

Keeping these differences in view, Islam has treated money and commodities differently. Since money has no intrinsic utility, but is only a medium of exchange

which has no different qualities, the exchange of a unit of money for another unit of the same denomination cannot be effected except at par value. If a currency note of Rs. 1000/- is exchanged for another note of Pakistani Rupees, it must be of the value of Rs. 1000/- The price of the former note can neither be increased nor decreased from Rs. 1000/- even in a spot transaction, because the currency note has no intrinsic utility nor a different quality (recognized legally), therefore any excess on either side is without consideration, hence not allowed in *Shari'ah*. As this is true in a spot exchange transaction, it is also true in a credit transaction where there is money on both sides, because if some excess is claimed in a credit transaction (where money is exchanged for money) it will be against nothing but time.

The case of normal commodities is different. Since they have intrinsic utility and have different qualities, the owner is at liberty to sell them at whatever price he wants, subject to the forces of supply and demand. If the seller does not commit a fraud or misrepresentation, he can sell a commodity at a price higher than the market rate with the consent of the purchaser. If the purchaser accepts to buy it at that increased price, the excess charged from him is quite permissible for the seller. When he can sell his commodity at a higher price in a cash transaction, he can also charge a higher price in a credit sale, subject only to the condition that he neither deceives the purchaser, nor compels him to purchase, and the buyer agrees to pay the price with his free will.

It is sometimes argued that the increase of price in a cash transaction is not based on the deferred payment, therefore it is permissible while in a sale based on deferred payment, the increase is purely against time which makes it analogous to interest. This argument is again based on the misconception that whenever the price is increased taking the time of payment into consideration, the transaction comes within the ambit of interest. This presumption is not correct. Any excess amount charged against late payment is *riba* only where the subject matter is money on both sides. But if a commodity is sold in exchange of money, the seller, when fixing the price, may take into consideration different factors, including the time of payment. A seller, being the owner of a commodity which has intrinsic utility may charge a higher price and the purchaser may agree to pay it due to various reasons, for example:

(a) his shop is nearer to the buyer who does not want to go to the market which is not so near,
(b) the seller is more trustworthy for the purchaser than others, and the purchaser has more confidence in him that he will give him the required thing without any defect,
(c) the seller gives him priority in selling commodities having more demand,
(d) the atmosphere of the shop of the seller is cleaner and more comfortable than other shops,
(e) the seller is more courteous in his dealings than others.

These and similar other considerations play their role in charging a higher price from the customer. In the same way, if a seller increases the price because he allows credit to his client, it is not prohibited by *Shari'ah* if there is no cheating and the purchaser accepts it with open eyes, because whatever the reason of increase, the whole price is against a commodity and not against money. It is true that, while increasing the price of the

commodity, the seller has kept in view the time of its payment, but once the price is fixed, it relates to the commodity, and not to the time. That is why if the purchaser fails to pay at the stipulated time, the price will remain the same and can never be increased by the seller. Had it been against time, it might have been increased, if the seller allows him more time after the maturity.

To put it another way, since money can only be traded in at par value, as explained earlier, any excess claimed in a credit transaction (of money in exchange of money) is against nothing but time. That is why if the debtor is allowed more time at maturity, some more money is claimed from him. Conversely, in a credit sale of a commodity, time is not the exclusive consideration while fixing the price. The price is fixed for commodity, not for time. However, time may act as an ancillary factor to determine the price of the commodity, like any other factor from those mentioned above, but once this factor has played its role, every part of the price is attributed to the commodity.

The upshot of this discussion is that when money is exchanged for money, no excess is allowed, neither in cash transaction, nor in credit, but where a commodity is sold for money, the price agreed upon by the parties may be higher than the market price, both in cash and in credit transactions. Time of payment may act as an ancillary factor to determine the price of a commodity, but it cannot act as an exclusive basis for and the sole consideration of an excess claimed in exchange of money for money.

This position is accepted unanimously by all the four schools of Islamic law and the majority of the Muslim jurists. They say that if a seller determines two different prices for cash and credit sales, the price of the credit sale being higher than the cash price, it is allowed in *Shari'ah*. The only condition is that at the time of actual sale, one of the two options must be determined, leaving no ambiguity in the nature of the transaction. For example, it is allowed for the seller, at the time of bargaining, to say to purchaser, "If you purchase the commodity on cash payment, the price would be Rs. 100/- and if you purchase it on a credit of six months, the price would be Rs. 110/-" But the purchaser shall have to select either of the two options. He should say that he would purchase it on credit for Rs. 110/- Thus, at the time of actual sale, the price will be known to both parties.[2]

However, if either of the two options is not determined in specific terms, the sale will not be valid. This may happen in those instalment sales in which different prices are claimed for different maturities. In this case the seller draws a schedule of prices according to schedule of payment. For example, Rs. 1000/- are charged for the credit of 3 months Rs. 1100/- for the credit of 6 months, Rs. 1200/- for 9 month and so on. The purchaser takes the commodity without specifying the option he will exercise, on the assumption that he will pay the price in future according to his convenience. This transaction is not valid, because the time of payment, as well as the price, is not determined. But if he chooses one of these options specifically and says, for example,

[2] See Ibn Qudamah, Al-Mughni 4:290, Al-Sarakhsi, Al-Mabsut 13:8 Al-Dasuqi, 3:58 and Mughni-al-Muhtaj 2:31.

that he purchases the commodity on 6 months' credit with a price of 1100/- the sale will be valid.

Another point must be noted here. What has been allowed above is that the price fixed for the commodity in a credit sale is more than the cash price. But if the sale has taken place at cash price, and the seller has imposed a condition that in case of late payment, he will charge 10 per cent per annum as a penalty or as interest, this is totally prohibited; because what is being charged is not a part of the price; it is an interest charged on a debt.

The practical difference between the two situations is that where the additional amount is a part of the price, it may be charged on a one-time basis only. If the purchaser fails to pay it on time, the seller cannot charge another additional amount. The price will remain the same without any addition. Conversely, where the additional amount is not a part of the price it will keep on increasing with the period of default.

5.2. The Use of The Interest-Rate as a Benchmark

Many institutions financing by way of *murabahah* determine their profit or mark-up on the basis of the current interest rate, mostly using LIBOR (Inter-bank offered rate in London) as the criterion. For example, if LIBOR is 6 per cent, they determine their mark-up on *murabahah* equal to LIBOR or some percentage above LIBOR. This practice is often criticized on the ground that profit based on a rate of interest should be as prohibited as interest itself.

No doubt, the use of the rate of interest for determining a *halal* profit cannot be considered desirable. It certainly makes the transaction resemble an interest-based financing, at least in appearance, and keeping in view the severity of prohibition of interest, even this apparent resemblance should be avoided as far a possible. But one should not ignore the fact that the most important requirement for the validity of *murabahah* is that it is a genuine sale with all its ingredients and necessary consequences. If a *murabahah* transaction fulfils all the conditions enumerated in this chapter, merely using the interest rate as a benchmark for determining the profit of *murabahah* does not render the transaction as invalid, *haram* or prohibited, because the deal itself does not contain interest. The rate of interest has been used only as an indicator or as a benchmark. In order to explain the point, let me give an example.

A and B are two brothers. A trades in liquor, which is totally prohibited in *Shari'ah*. B, being a practising Muslim dislikes A's business and starts a soft drinks business, but he wants his business to earn as much profit as A earns through trading in liquor, therefore he resolves that he will charge the same rate of profit to his customers as A charges over the sale of liquor. Thus he has tied his rate of profit to the rate used by A in his prohibited business. One may question the propriety of his approach in determining the rate of his profit, but obviously no one can say that the profit charged by him in his halal business is *haram*, because he has used the rate of profit of the business of liquor as a benchmark.

Similarly, so far as the transaction of *murabahah* is based on Islamic principles and fulfils all its necessary requirements, the rate of profit determined on the basis of the rate of interest will not render the transaction as *haram*.

It is, however true that Islamic banks and financial institutions should get rid of this practice as soon as possible, because, firstly, it takes the rate of interest as an ideal for a halal business which is not desirable, and secondly because it does not advance the basic philosophy of Islamic economy having no impact on the system of distribution. Therefore, the Islamic banks and financial institutions should strive for developing their own benchmark. This can be done by creating their own inter-bank market based on Islamic principles. The purpose can be achieved by creating a common pool which invests in asset-backed instruments like *musharakah, ijarah* etc. If the majority of the assets of the pool is in tangible form, like leased property or equipment and shares in business concerns etc., its units can be sold and purchased on the basis of their net asset value determined on a periodical basis. These units may be negotiable and may be used for overnight financing as well. The banks having surplus liquidity can purchase these units and when they need liquidity, they can sell them. This arrangement may create an inter-bank market and the value of the units may serve as an indicator for determining the profit in *murabahah* and leasing also.

5.3. Promise to Purchase

Another important issue in *murabahah* financing which has been the subject of debate between the contemporary *Shari'ah* scholars is that the bank/financier cannot enter into an actual sale at the time when the client seeks *murabhaha* financing from him, because the required commodity is not owned by the bank at this stage and, as explained earlier, one cannot sell a commodity not owned by him, nor can he effect a forward sale. He is, therefore, bound to purchase the commodity from the supplier, then he can sell it to the client after having its physical or constructive possession. On the other hand, if the client is not bound to purchase the commodity after the financier has purchased it from the supplier, the financier may be confronted with a situation where he has incurred huge expenses to acquire the commodity, but the client refuses to purchase it. The commodity may be of such a nature that it has no common demand in the market and is very difficult to dispose of. In this case the financier may suffer an unbearable loss.

Solution to this problem is sought in the *murabahah* arrangement by asking the client to sign a promise to purchase the commodity when it is acquired by the financier. Instead of being a bilateral contract of forward sale, it is a unilateral promise from the client which binds himself and not the financier. Being a one-sided promise, it is distinguishable from the bilateral forward contract.

This solution is subjected to the objection that a unilateral promise creates a moral obligation but it cannot be enforced, according to *Shari'ah*, by the courts of law. This leads us to the question whether or not a one-sided promise is enforceable in *Shari'ah*.

The general impression is that it is not, but before accepting this impression at its face value, we will have to examine it in the light of the original sources of *Shari'ah.*

A thorough study of the relevant material in the books of Islamic jurisprudence would show that the fuqaha' (the Muslim jurists) have different views on the subject. Their views may be summarized as follows:

1. Many of them are of the opinion that 'fulfilling a promise' is a noble quality and it is advisable for the promisor to observe it, and its violation is reproachable, but it is neither mandatory *(wajib),* nor enforceable through courts. This view is attributed to Imam Abu Hanifah, Imam al-Shafi'i, Imam Ahmad and to some *Maliki* jurists[3] However as will be shown later, many Hanafis and Malikis and some Shafi'i jurists do not subscribe to this view.

2. A number of Muslim jurists are of the view that fulfilling a promise is mandatory and a promisor is under moral as well as legal obligation to fulfil his promise. According to them, a promise can be enforced through courts of law. This view is ascribed to Samurah b. Jundub رضى الله عنه the well known companion of the Holy Prophet صلى الله عليه وسلم 'Umar b. Abdul Aziz, Hasan alBasri, Sa'id b. al-Ashwa', Ishaq b. Rahwaih and Imam al-Bukhari.[4] The same is the view of some Maliki jurists, and it is preferred by Ibn-al-'Arabi and Ibn-al-Shat, and endorsed by al-Ghazzali, the famous Shafi'i jurist, who says that a promise is binding, if it is made in absolute terms. The same is the view of Ibn Shubrumah.[5] The third view is presented by some Maliki jurists. They say that in normal conditions, a promise is not binding, but if the promisor has caused the promisee to incur some expenses or undertake some labour or liability on the basis of promise, it is mandatory on him to fulfil his promise for which he may be compelled by the courts.[6]

Some contemporary scholars have claimed that the jurists who have accepted the binding nature of a promise have done so only with regard to unilateral gifts or other voluntary payments, but *none* of them has accepted the binding nature of a promise to effect a bilateral commercial or monetary transaction. However, based on a close study, this notion does not seem to be correct, because the Maliki and Hanafi jurists have allowed *'Bai' bil wafa* on the basis of binding promise. *'Bai' bil wafa* is a special kind of sale whereby the purchaser of an immovable property undertakes that whenever the seller will give him the price back, he will resell the house to him. The question of the validity of *'Bai'bil wafa* has already been discussed in detail in the first chapter while explaining the concept of house financing on the basis of 'diminishing *musharakah'.* The gist of the discussion is that if repurchase by the seller is made a condition for the original sale, it is not a valid transaction, but if the parties have entered into the original sale unconditionally, and the seller has signed a separate and independent promise to

[3] See عمدة القارى 121:12 ومرقاة المفاتيح 653:4 والأنكار للنووى ص 282 وفتح العلى المالك 254:1

[4] See Sahih al-Bukhakri, Shahadat, where this view is reported from all the aforesaid jurists.

[5] وإحياء علوم الدين للغزالى الجامع لأحكام القرآن للقرطبى 29:18 وحاشية ابن الشاط على فروق القرافى 24:4 والمحلى لابن حزم 133:3 28:8

[6] الفورق للقرافى 25:4 وفتح العلى المالك 254:1

repurchase the sold property, this promise will be binding on the promisor and enforceable through the courts. The binding nature of the promise in this case has been admitted by both Maliki and Hanafi jurists.[7]

Obviously, this promise does not relate to a gift. It is a promise to effect a sale in future. Still, the Maliki and Hanafi jurists have accepted it as binding on the promisor and enforceable through the courts. It is a clear proof of the fact that the jurists who hold the promises to be binding do not restrict it to the promises of gifts etc. The same principle is applicable, according to them, to the promises whereby the promisor undertakes to enter into a bilateral contract in future.

In fact, the Holy Qur'an and the Sunnah of the Holy Prophet صلى الله عليه وسلم are very particular about fulfilling promises. The Holy Qur'an says:

واوفوا بالعهد إن العهد كان مسؤلاً (بنى اسرائيل " 34)

and fulfil the covenant. Surely, the covenant will be asked about (in the Hereafter) (Bani Isra'il : 34)

يا ايها الذين آمنوا لِم تقولون ما لا تفعلون كبر مقتاً عند الله
أن تقولوا ما لا تفعلونَ (الصف: 3.2)

O those who believe, why do you say what you not do? It invites Allah's anger that you say what you not do. (al-Saf:2 to 3)

Imam Abu Bakr al-Jassas has said that this verse of the Holy Qur'an indicates that if one undertakes to do something, no matter whether it is a worship or a contract, it is obligatory on him to do it.[8]

The Holy Prophet صلى الله عليه وسلم is reported to have said:

آية المنافق ثلاث: إذا حدث كذب، وإذا وعد أخلف وإذا 1 اؤتمن خان

There are three distinguishing features of a hypocrite: when he speaks, tells a lie, when he promises, he backs out and when he is given something in trust, he breaches the trust.[9]

This is only an example. There is a large number of injunctions in the *ahadith* of the Holy Prophet صلى الله عليه وسلم where it is ordained to fulfil the promises and it is clearly prohibited to back out, except for a valid reason.

Therefore, it is evident from these injunctions that fulfilling a promise is obligatory. However, the question whether or not a promise is enforceable in courts depends on the nature of the promise. There are certainly some sorts of promises which cannot be enforced through courts. For example, at the time of engagement the parties promise to go through with a marriage. These promises create a moral obligation, but obviously they cannot be enforced through courts of law. But in commercial dealings, where a party has

[7] Al-Hattab, Tahrir-al-Kalam p. 239, Beirut 1404.
[8] Al-Jassas, Ahkamul Quran 3:420.
[9] Sahih-al-Bukhari, Kitab al-'iman.

given an absolute promise to sell or purchase something and the other party has incurred liabilities on that basis, there is no reason why such a promise should not be enforced. Therefore, on the basis of the clear injunctions of Islam, if the parties have agreed that this particular promise will be binding on the promisor, it will be enforceable.

This is not a question pertaining to *murabahah* alone. If promises are not enforceable in commercial transactions, it may seriously jeopardise commercial activities. If somebody orders a trader to bring for him a certain commodity and promises to purchase it from him, on the basis of which the trader imports it from abroad by incurring huge expenses, how can it be allowed for the former to refuse to purchase it? There is nothing in the Holy Qur'an or *Sunnah* which prohibits the making of such promises enforceable.

It is on these grounds that the Islamic *Fiqh* Academy Jeddah has made the promises in commercial dealings binding on the promisor with the following conditions,

(a) it should be a one-sided promise;
(b) the promise must have caused the promisee to incur some liabilities;
(c) if the promise is to purchase something, the actual sale must take place at the appointed time by the exchange of offer and acceptance. Mere promise itself should not be taken as the concluded sale;
(d) if the promisor backs out of his promise, the court may force him either to purchase the commodity or pay actual damages to the seller.[10] The actual damages will include the actual monetary loss suffered by him, but will not include the opportunity cost.

On this basis, it is allowed that the client promises to the financier that he will purchase the commodity after the latter acquires it from the supplier. This promise will be binding on him and may be enforced through courts in the manner explained above. This promise does not amount to actual sale. It will be simply a promise and the actual sale will take place after the commodity is acquired by the financier for which exchange of offer and acceptance will be necessary.

5.4. Securities Against *Murabahah* Price

Another issue regarding *murabahah* financing is that the *murabahah* price is payable at a later date. The seller/financier naturally wants to make sure that the price will be paid at the due date. For this purpose, he may ask the client to furnish a security to his satisfaction. The security may be in the form of a mortgage or a hypothecation or some kind of lien or charge. Some basic rules about this security must, therefore, be kept in mind.

1. The security can be claimed rightfully where the transaction has created a liability or a debt. No security can be asked from a person who has not incurred a liability or debt. As explained earlier, the procedure of *murabahah* financing comprises of different

[10] Resolution Nos 2 and 3, Vth Conference of the Islamic *Fiqh* Academy held in Kuwait 1409AH. see Academy's Journal No. 5, v. 2, p. 1599.

transactions carried out at different stages. In the earlier stages of the procedure, the client does not incur a debt. It is only after the commodity is sold to him by the financier on credit that the relationship of a creditor and debtor comes into existence. Therefore, the proper way in a transaction of *murabahah* would be that the financier asks for a security after he has actually sold the commodity to the client and the price has become due on him, because at this stage the client incurs a debt. However, it is also permissible that the client furnishes a security at earlier stages, but after the *murabahah* price is determined. In this case, if the security is possessed by the financier, it will remain at his risk, meaning thereby that if it is destroyed before the actual sale to the client, he will have either to pay the market price of the mortgaged asset, and cancel the agreement *of murabahah,* or sell the commodity required by the client and deduct the market price of the mortgaged asset from the price of the sold property.[11]

It is also permissible that the sold commodity itself is given to the seller as a security. Some scholars are of the opinion that this can only be done after the purchaser has taken its delivery and not before. It means that the purchaser shall take its delivery, either physical or constructive, from the seller, then give it back to him as mortgage, so that the transaction of mortgage is distinguished from the transaction of sale. However, after studying the relevant material, it can be concluded that the earlier jurists have put this condition in cash sales only and not in credit sales.[12]

Therefore, it is not necessary that the purchaser takes the delivery of the sold property before he surrenders it as mortgage to the seller. The only requirement would be that the point of time whereby the property is held to be mortgaged should necessarily be specified, because from that point of time, the property will be held by the seller in a different capacity which should be clearly earmarked. For example, A sold a car to B on 1 January for a price of Rs. 500,000/- to be paid on 30 June. A asked B to give a security for payment at the due date. B has not yet taken delivery of the car and he offered to A that he should keep the car as a mortgage from 2 January. If the car is destroyed before 2 January the sale will be terminated and nothing will be payable by B. But if the car is destroyed after 2 January, the sale is not terminated, but it will be subject to the rules prescribed for the destruction of a mortgage. According to Hanafi jurists, in this case, the seller will have to bear the loss of the car, to the extent of its market price or its agreed sale price, whichever is lesser. Therefore, if the market price of the car was 450,000/- he can claim only the remaining part of the agreed sale price (i.e. Rs. 50,000/- in the above example). If the market price of the car is Rs. 500,000/- or higher, nothing can be claimed from the purchaser.

[11] Ibn Nujaim writes:

وإنما يصح (الرهن) بدين ولو موعودا ... ولو أخذ الرهن بشرط أن يقرضه كذا، فهلك فى يده قبل أن يقرضه هلك بالأقل من قيمة ومما سعى له من القرض (البحر الرائق 45:8 طبع مكة)

[12] The detailed discussion on the subject may be found in the revised edition of my Arabic book بحوث فى قضايا فقهية معاصرة

This is the view of the Hanafi School. Shafi'i and Hanbali jurists hold that if the car is destroyed by the negligence of the mortgagee, *he* will have to bear the loss, according to its market price, but if the car is destroyed without any fault on his part, he will not be liable to anything, and the purchaser will bear the loss and will have to pay the full price.[13]

It is clear from the above example that the possession of A over the car as a seller carries effects and consequences different from his possession as a mortgagee and therefore it is necessary that the point of time on which the car is held by him as a mortgagee should clearly be defined. Otherwise different capacities will be mixed up giving rise to dispute and rendering the security invalid.

5.5. Guaranteeing the *Murabahah*

The seller in a *murabahah* financing can also ask the purchaser/client to furnish a guarantee from a third party. In case of default in the payment of price on the due date, the seller may have recourse to the guarantor, who will be liable to pay the amount guaranteed by him. The rules of *Shari'ah* regarding guarantee are fully discussed in the books of Islamic *Fiqh.* However, I should pinpoint two burning issues in the context of Islamic banking.

1. The guarantor in the contemporary commercial atmosphere does not normally guarantee a payment without a fee charged from the original debtor. The classical *Fiqh* literature is almost unanimous on the point that the guarantee is a voluntary transaction and no fee can be charged on a guarantee. The most the guarantor can do is to claim his actual secretarial expenses incurred in offering the guarantee, but the guarantee itself should be free of charge. The reason for this prohibition is that the person who advances money to another person as a loan cannot charge a fee for advancing a loan, because it falls under the definition of *riba* or interest which is prohibited. The guarantor should be subject to this prohibition all the more, because he does not advance money. He only undertakes to pay a certain amount on behalf of the original debtor in case he defaults in payment. If the person who actually pays money cannot charge a fee, how can a fee be charged by a person who has merely undertaken to pay and did not pay anything in actual terms?

Suppose A has borrowed US $100 from B who asked him to produce a guarantor. C says to A, "I pay off your debt to B right now, but you will have to pay me 110 dollars at a later date." Obviously 10 dollars charged from A are not allowed, being interest. Then D comes to A and says, "I stand as a guarantor to you, but you will have to pay me 10 dollars for this service." If we allow to charge a fee for guarantee, it will mean that C cannot charge 10 dollars, despite the fact that he has actually paid the amount, and D can

[13] See Ibn Qudamah, Almughni v. 4, p. 442, Alghazzali, Al-Wasit 3:509. Ibn 'Abidin, Radd-al-Muhtar v. 5, p. 341

charge 10 dollars, despite the fact that he has merely committed himself to pay only when A fails to pay. This being unfair apparently, the classical Muslim jurists have forbidden the charging of a fee for guarantee, so that both C and D, in the above example, may stand on equal footing.

However, some contemporary scholars are looking at the problem from a different angle. They feel that guarantee has become a necessity, especially in international trade where the sellers and the buyers do not know each other, and the payment of the price by the purchaser cannot be simultaneous with the supply of the goods. There has to be an intermediary who can guarantee the payment. It is quite difficult to find guarantors who can provide this service free of charge in the required numbers. Keeping these realities in view, some *Shari'ah* scholars of our time are adopting a different approach. They say that the prohibition of guarantee fee is not based on any specific injunction of the Holy Qur'an or the Sunnah of the Holy Prophet صلى الله عليه وسلم It has been deduced from the prohibition of *riba* as one of its ancillary consequences. Moreover, guarantees in the past were of simple nature. In today's commercial activities, the guarantor sometimes needs a number of studies and a lot of secretarial work. Therefore they believe the prohibition of the guarantee fee should be reviewed in this perspective. The question still needs further research and should be placed before a larger forum of scholars. However, unless a definite ruling is given by such a forum, no guarantee fee should be charged or paid by an Islamic financial institution. Instead, they can charge or pay a fee to cover expenses incurred in the process of issuing a guarantee.

5.6. Penalty of Default

Another problem in *murabahah* financing is that if the client defaults in payment of the price on the due date, the price cannot be increased. In interest-based loans, the amount of loan keeps on increasing according to the period of default. But in *murabahah* financing, once the price is fixed, it cannot be increased. This restriction is sometimes exploited by dishonest clients who deliberately avoid to pay the price on its due date, because they know that they will not have to pay any additional amount on account of default.

This characteristic of *murabahah* should not create a big problem in a country where all the banks and financial institutions are run on Islamic principles, because the government or the central bank may develop a system where such defaulters may be penalized by debarring them from obtaining any facility from any financial institution. This system may serve as a deterrent against deliberate defaults. However, in the countries where the Islamic banks and financial institutions are working in isolation from the majority of financial institutions run on the basis of interest, this system can hardly work, because even if the client is deprived to avail of a facility from an Islamic bank, he can approach the conventional institutions.

In order to solve this problem, some contemporary scholars have suggested that the dishonest clients who default in payment deliberately should be made liable to pay

compensation to the Islamic bank for the loss it may have suffered on account of default. They suggest that the amount of this compensation may be equal to the profit given by that bank to its depositors during the period of default. For example, the defaulter has paid the price three months after the due date. If the bank has given to its depositors a profit at the rate of 5 per cent during this period, the client has to pay 5 per cent more as compensation for the loss of the bank. However, the scholars who allow this compensation make it subject to the following conditions:

(a) The defaulter should be given a grace period of at least one month after the maturity date during which he must be given weekly notices warning him that he should pay the price, otherwise he will have to pay compensation.

(b) It is proved beyond doubt that the client is defaulting without valid excuse. If it appears that his default is due to poverty, no compensation can be claimed from him. Indeed, he must be given respite until he is able to pay, because the Holy Qur'an has expressly said,

وان كان ذو عسرة فنظرة إلى ميسرة

And if he (the debtor) is short of funds, then he must be given respite until he is well-off. (2:280)

(c) The compensation is allowed only if the investment account of the Islamic bank has earned some profit to be distributed to the depositors. If the investment account of the bank has not earned profit during the period of default, *no* compensation shall be claimed from the client.

This concept of compensation, however, is not accepted by the majority of the present-day scholars (including the author). It is the considered opinion of such scholars that this suggestion neither conforms to the principles of *Shari'ah* nor is it able to solve the problem of default.

First of all, any additional amount charged from a debtor is *riba.* In the days of *jahiliyyah* (before Islam) the people used to charge additional amounts from their debtors when they were not able to pay on the due date. They used to say:

إمّا أن تقضى وإمّا أن تربى

Either you pay off the debt or you increase the payable amount.

The aforementioned suggestion of paying compensation to the creditor/seller resembles the same attitude.

It can be argued that the above suggestion is theoretically different from the practice of *jahilliyah* in that the suggestion is to grant the debtor a grace period of one month to make sure that he is avoiding payment without a valid cause and to exempt him from compensation if it appears that his non-payment is due to poverty or a hardship. But in practical application of the concept, these conditions are hardly fulfilled, because every debtor may claim that his default is due to his financial inability to repay on the due date, and it is very difficult for a financial institution to hold an inquiry about the financial position of each client and to verify whether or not he was able to pay. What the banks normally do is that they presume that every client was able to pay unless he has been

declared as bankrupt or insolvent. It means that the concession allowed in the suggestion can be enjoyed only by the insolvent people. Obviously, insolvency is a rare phenomenon, and in this rare situation, even the interest-based banks cannot normally recover interest from the borrower. Therefore, the suggestion leaves no practical and meaningful difference between an interest based financing and an Islamic financing.

So far as the grace period is concerned, it is a minor concession which is sometimes given by conventional banks as well. Once again, in practical terms, there is no material difference between interest and the late payment charged as compensation.

It is argued in favour of charging compensation that the Holy Prophet صلى الله عليه وسلم has condemned the person who delays the payment of his dues without a valid cause. According to the well-known hadith he has said:

لیّ الواجد یحلّ عقوبته وعرضه

The well-off person who delays the payment of his debt, subjects himself to punishment and disgrace.[14]

The argument runs that the Holy Prophet صلى الله عليه وسلم has permitted it to inflict a punishment on such a person. The punishments may be of different kinds, including the imposition of a monetary penalty. But this argument overlooks the fact that even if it is assumed that imposing a fine or a monetary penalty is allowed in *Shari'ah*,[15] it is imposed by a court of law and is normally paid to the government. Nobody has allowed a situation where an aggrieved party imposes the fine on its own (and for its own benefit) without a judgment of a court competent to decide the matter.

Moreover, had it been a recognized punishment, it should have been imposed even if the investment account has earned no profit during that period, because the guilt of the defaulter is established and it has no nexus with the profit of the investment account of the bank.

In fact, the suggestion of compensation equal to the rate of profit of the investment account is based on the concept of opportunity cost of money. This concept is foreign to the principles of *Shari'ah*. Islam does not recognize opportunity cost of money, because after the elimination of interest from the economy, money has no definite return. It is always exposed to loss as well as it has the ability to earn a profit. And it is the risk of loss which makes it entitled to gain a return.

Another point is worthy of attention. The one who defaults in payment of debt is, at the most, like a thief or a usurper. But the study of the rules prescribed for theft and usurpation would show that a thief has been subjected to a very severe punishment of amputating his hand, but he was never asked to pay an additional amount to compensate the victim of theft. Similarly, if a person has usurped the money of another person, he

[14] Sahih al-Bukhari, hadith No. 2400, with Path al-Bari, v. 5, p. 62.

[15] Many classical jurists do not allow the imposition of fine (تعزیر بالمال) even by a court of law, however, some classical jurists, like Imam Ahmad and Abu Yousuf allow it and this is the preferred view according to most contemporary jurists.

may be punished by way of ta'zir, but no Muslim jurist has ever imposed on him a financial penalty to compensate the owner.

Imam al-Shafi is of the view that if someone usurps the land of another person, he will have to pay the rent of the land according to the market rate. But if he has usurped money, he will return the equal amount of money and not more.[16]

All these rules go a long way to prove that the opportunity cost of money is never recognized by the Islamic *Shari'ah*, because, as explained above, money has no definite return, nor any intrinsic utility.

On the basis of what is stated above, the idea of compensation to be charged from a defaulter is not approved by most of the contemporary scholars. The question was thoroughly discussed in the annual session of Islamic *Fiqh* Academy, Jeddah, and it was resolved that no such compensation is allowed in *Shari'ah*.[17]

All this discussion relates to the impermissibility of the proposed compensation in *Shari'ah*. Now it is to be noted that this proposal does not solve the problem of default at all. To the contrary, it may encourage the debtors to commit as much default as they wish. The reason is that, according to this suggestion, the defaulter is asked to pay compensation equal to the return earned by the depositors during the period of default. It is evident that the rate of return earned by the depositors is always less than the rate of profit paid by the customer in a *murabahah* transaction. Therefore, the customer will be paying after default, much less than he was paying before the default. Therefore, he would willingly accept to pay this amount and not pay the amount of price which he will invest in a more profitable activity. Suppose the rate of profit agreed in a *murabahah* transaction of six moths is 15 per cent p.a. and the rate of profit declared to the depositors is 10 per cent. p.a. It means that if the client withholds the price of *murabahah* after its maturity date and keeps it for another six months, he will have to pay the compensation at the rate of 10 per cent p.a. which is much less than the rate of original *murabahah* (i.e. 15 per cent). As such he will default and enjoy another facility for the next six months at a lesser rate.

This proposal, therefore, is not only against *Shari'ah*, but also deficient in meeting the problem of default.

5.7. An Alternative Suggestion

The question now arises as to how the banks and financial institutions may solve this problem. If nothing is charged from the defaulters, it may be a greater incentive for a dishonest person to default continuously. Here is the answer to this question:

We have already mentioned that the real solution to this problem is to develop a system where the defaulters are duly punished by depriving them from enjoying a

[16] Al-Shirazi, Al-Muhadhdhab 1:370.

[17] Resolution No. 53, Vth Annual Session, Jeddah, Journal No. 6, v. I, p. 447.

financial facility in future. However, as commented earlier, this may be only where the whole banking system is based on Islamic principles, or the Islamic banks are given due protection against defaulters. Therefore, up to a time when this goal is reached, we may need some other alternative.

For this purpose it was suggested that the client, when entering into a *murabahah* transaction, should undertake that in case he defaults in payment on the due date, he will pay a specified amount to a charitable fund maintained by the bank. It must be ensured that no part of this amount shall form part of the income of the bank. However, the bank may establish a charitable fund for this purpose and all amounts credited therein shall be exclusively used for purely charitable purpose approved by the *Shari'ah*. The bank may also advance interest-free loans to the needy persons from this charitable fund.

This proposal is based on a ruling given by some Maliki jurists who say that if a debtor is asked to pay an additional amount in case of default, it is not allowed by *Shari'ah*, because it amounts to charging interest. However, in order to assure the creditor of timely payment, the debtor may undertake to give some amount in charity in case of default. This is, in fact, a sort of *Yamin* (vow) which is a self-imposed penalty to keep oneself away from default. Normally, such 'vows' create a moral or religious obligation and are not enforceable through courts. However, some Maliki jurists allow to make it justiceable,[18] and there is nothing in the Holy Qur'an or in the Sunnah of the Holy Prophet صلى الله عليه وسلم which forbids making this 'vow' enforceable through courts of law. Therefore, in cases of genuine need, this view can be acted upon. But, while implementing this proposal, the following points must be kept in mind.

1. The proposal is meant only to pressurize the debtors on paying their dues on time and not to increase the income of the creditor/financier, nor to compensate him for his opportunity cost. Therefore, it must be ensured that no part of the penalty forms part of the income of the bank in any case, nor can it be used to pay taxes or to set-off any liability of the financier.
2. Since the amount of penalty is not deserved by the financier as his income, but it goes to charity, it may be any amount wilfully undertaken by the debtor. It can also be determined on per cent per annum basis. Therefore, it may serve as a real deterrent against deliberate default, unlike the former suggestion of compensation which, as explained earlier, may tend to encourage the defaults.
3. Since the penalty undertaken by the client is originally a self-undertaken vow, and not a penalty charged by the financier, the agreement should reflect this concept. Therefore, the proper wording of the penalty clause would be on the following pattern:

> "The client hereby undertakes that if he defaults in payment of any of his dues under this agreement, he shall pay to the charitable account/fund maintained by the Bank/Financier a sum calculated on the basis of ... per cent per annum for each day of default unless he establishes through the evidence satisfactory to the Bank/financier that his non-payment on the due date was caused due to poverty or some other factors beyond his control."

[18] Al-hattab, Tahrir-al-Kalam p. 176, Beirut 1404.

4. Being a vow of a charitable act, it was originally permissible for the client to give the stipulated amount to any charity of his own choice, but in order to ensure that he will pay, the charitable account or fund maintained by the financier/bank is specified in the proposed undertaking. This specific undertaking does not violate any principle of *Shari'ah*. However, it is necessary that the bank or the financial institution maintains a separate fund, or at least, a separate account for this purpose and the amounts credited to that account must be spent in well-defined charities known to the client/debtor.

This proposal has now been implemented successfully in a large number of Islamic financial institutions.

5.8. No Roll-Over in *Murabahah*

Another rule which must be remembered and fully complied with is that a *murabahah* transaction cannot be rolled over for a further period. In an interest-based financing, if a customer of the bank cannot pay on the due date for any reason, he may request the bank to extend the facility for another term. If the bank agrees, the facility is rolled over on the terms and conditions mutually agreed at that point of time, whereby the newly agreed rate of interest is applied to the new term. It actually means that another loan of the same amount is re-advanced to the borrower.

Some Islamic banks or financial institutions, who misunderstood the concept of *murabahah* and took it as merely a mode of financing analogous to an interest-based loan, started using the concept of roll-over to *murabahah* also. If the client requests them to extend the maturity date *of murabahah,* they roll it over and extend the period of payment on an additional mark-up charged from the client which practically means that another separate *murabahah* is booked on the same commodity. This practice is totally against the well-settled principles of *Shari'ah*.

It should be clearly understood that *murabahah* is not a loan. It is the sale of a commodity the price of which is deferred to a specific date. Once the commodity is sold, its ownership is passed on to the client. It is no more a property of the seller. What the seller can legitimately claim is the agreed price which has become a debt payable by the buyer. Therefore, there is no question of effecting another sale on the same commodity between the same parties. The roll-over in *murabahah* is nothing but interest, pure and simple, because it is an agreement to charge an additional amount on the debt created by the *murabahah* sale.

5.9. Rebate on Earlier Payment

Sometimes the debtor wants to pay earlier than the specified date. In this case he wants to earn a discount on the agreed deferred price. Is it permissible to allow him a rebate for his earlier payment? This question has been discussed by the classical jurists in detail. The issue is known in the Islamic legal literature as "ضع و تعجّل" (Give discount and

receive soon). Some earlier jurists have held this arrangement as permissible, but the majority of the Muslim jurists, including the four recognized schools of Islamic jurisprudence do not allow it, if the discount is held to be a condition for earlier payment.[19]

The view of those who allow this arrangement is based on a hadith in which Abdullah ibn 'Abbas رضى الله عنه is reported to have said that when the Jews belonging to the tribe of Banu Nadir were banished from Madinah (because of their conspiracies) some people came to the Holy Prophet صلى الله عليه وسلم and said, "You have ordered them to be expelled, but some people owe them some debts which have not yet matured." Thereupon the Holy Prophet صلى الله عليه وسلم said to them (i.e., the Jews who were the creditors):

صلى الله عليه وسلم

Give discount and receive (your debts) soon.[20]

The majority of Muslim jurists, however, do not accept this hadith as authentic. Even Imam al Baihaqi, who has reported this hadith in his book, has expressly admitted that this is a weak narration.

Even if the hadith is held to be authentic, the exile of Banu Nadir was in the second year after hijrah, when *riba* was not yet prohibited.

Moreover, al-Waqidi has mentioned that Banu Nadir used to advance usurious loans. Therefore, the arrangement allowed by the Holy Prophet صلى الله عليه وسلم was that the creditors forego the interest and the debtors pay the principal sooner. Al-Waqidi has narrated that Sallam b. Abi Huqaiq, a Jew of Banu Nadir, had advanced eighty dinars to Usaid ibn Hudayr رضى الله عنه payable after one year with an addition of 40 dinars. Thus, Usaid رضى الله عنه owed him 120 dinars after one year. After this arrangement, he paid the principal amount of 80 dinars and Sallam withdrew from the rest.[21]

For these reasons, the majority of jurists holds that if the earlier payment is conditioned with discount, it is not permissible. However, if this is not taken to be a condition for earlier payment, and the creditor gives a rebate voluntarily on his own, it is permissible.

The same view is taken by the Islamic *Fiqh* Academy in its annual session.[22]

It means that in a *murabahah* transaction effected by an Islamic bank or financial institution, no such *rebate* can be stipulated in the agreement, nor can the client claim it as his right. However, if the bank or a financial institution gives him a rebate on its own, it is not objectionable, especially where the client is a needy person. For example, if a

[19] Ibn Qudamah, Al-Mughni 4:174, 175. For full discussion, see my Arabic book بحوث فى قضايا فقهية معاصرة p. 25.

[20] Albaihaqi, Al-Sunan al-Kubra 6:28.

[21] Al-Waqidi, Almaghazi 1:374.

[22] Resolution No. 66, VIth session, journal No. 7, v.2, p. 217.

poor farmer has purchased a tractor or agricultural inputs on the basis of *murabahah,* the bank should give him a voluntary discount.

5.10. Calculation of Cost in *Murabahah*

It has already been mentioned that the transaction of *murabahah* contemplates the concept of cost plus sale, therefore, it can be effected only where the seller can ascertain the exact cost he has incurred in acquiring the commodity he wants to sell. If the exact cost cannot be ascertained, no *murabahah* can be possible. In this case, the sale must be effected on the basis of *musawamah* (i.e. sale without reference to cost).

This principle leads to another rule: the *murabahah* transaction should be based on the same currency in which the seller has purchased the commodity from the original supplier. If the seller has purchased it for Pakistani rupees, the onward sale to the ultimate purchaser should also be based on Pakistani rupees, and if the first purchase has occurred in U.S. dollars, the price *of murabahah* should be based on dollars as well, so that the exact cost may be ascertained.

However, in the case of international trade, it may be difficult to base both purchases on the same currency. If the commodity intended to be sold to the customer is imported from a foreign country, while the ultimate purchaser is in Pakistan, the price of the original sale has to be paid in a foreign currency and the price of the second sale will be determined in Pakistani Rupees.

This situation may be met with in two ways. Firstly, if the ultimate purchaser agrees and the laws of the country allow, the price of the second sale may also be determined in dollars.

Secondly, if the seller has purchased the commodity by converting Pakistani Rupees into dollars, the exact amount of Pak rupees paid by the seller to convert them into dollars can be taken as the cost price and the profit of *murabahah* can be added thereon.

In some cases, the bank purchases the commodity from abroad at a price payable after three months or in different instalments, and sells the commodity to his client before he pays the full price to the supplier. Since he pays the price in dollars, its equivalent in Pakistani Rupees is not known at the time when the commodity is sold to the client. Due to fluctuation in the price of dollars in Pak Rupees, the bank may have to pay more than it anticipated at the time of *murabahah* sale. For example, the rate of U.S. dollars at the time of *murabahah* was Rs. 40/- for one dollar. The price of *murabahah* was settled according to this rate, but when the bank paid the price to the supplier, the dollar rate increased to Rs. 41/-, meaning thereby that the cost to the bank increased by 2.5 per cent. In order to meet this situation, some financial institutions put a condition in the *murabahah* agreement that in case of such fluctuation in currency rates, the client shall bear the additional cost. According to the classical Muslim jurists, *murabahah* based on this condition is not valid because it leads to uncertainty of the price at the time of sale. Such uncertainty continues up to a date after three months when the buyer actually pays

the price to the supplier. Such uncertainty renders the transaction invalid. Therefore, there are following options open to the bank in this issue:

(a) The bank should purchase that commodity on the basis of letter of credit at sight and should pay the price to the supplier before effecting sale with the customer. In this case no question of fluctuation in currency rates will be involved. The *murabahah* price can be determined on the basis of the market rate of dollars on the date when the bank has paid the price to the supplier.

(b) The bank determines the *murabahah* price in US dollars rather than in Pak rupees, so that the deferred *murabahah* price is paid by the customer in dollars. In this case the bank will be entitled to receive dollars from the customer and the risk of the fluctuation in dollar's price will be borne by the purchaser.

(c) Instead of *murabahah*, the deal may be on the basis of musawamah (a sale without reference to the cost of the seller) and a price may be fixed to cover the anticipated fluctuation in the currency rates.

5.11. Subject-Matter of *Murabahah*

All commodities which may be subject matter of sale with profit can be the subject matter of *murabahah*, because it is a particular kind of sale. Therefore, the shares of a lawful company may be sold or purchased on *murabahah* basis, because according to the Islamic principles, the shares of a company represent the holder's proportionate ownership in the assets of the company. If the assets of a company can be sold with profit, its shares can also be sold by way of *murabahah*. But it goes without saying that the transaction must fulfil all the basic conditions, already discussed, for the validity of a *murabahah* transaction. Therefore, the seller must first acquire the possession of the shares with all their rights and obligations, then sell them to his client. A buy back arrangement or selling the shares without taking their possession is not allowed at all.

Conversely, no *murabahah* can be effected on things which cannot be the subject-matter of sale. For example *murabahah* is not possible in exchange of currencies, because it must be spontaneous or, if deferred, on the market rate prevalent on the date of the transaction.[23] Similarly, the commercial papers representing a debt receivable by the holder cannot be sold or purchased except at par value, and therefore no *murabahah* can be effected in respect of such papers. Similarly, any paper entitling the holder to receive a specified amount of money from the issuer cannot be negotiated. The only way of its sale is to transfer it for its face value. Therefore, they cannot be sold on *murabahah* basis.

[23] For detailed discussion on the subject, see my Arabic treatise "أحكام الأوراق النقدية"

5.12. Rescheduling of Payments in *Murabahah*

If the purchaser/client in *murabahah* financing is not able to pay according to the dates agreed upon in the *murabahah* agreement, he sometimes requests the seller/the bank for rescheduling the instalments. In conventional banks, the loans are normally rescheduled on the basis of additional interest. This is not possible in *murabahah* payments. If the instalments are rescheduled, no additional amount can be charged for rescheduling. The amount of the *murabahah* price will remain the same in the same currency.

Some Islamic banks proposed to reschedule the *murabahah* price in a hard currency different from the one in which the original sale took place. This was proposed to compensate the bank through appreciation of the value of the hard currency. Since this benefit was proposed to be drawn from rescheduling, it is not permissible. Rescheduling must always be on the basis of the same amount in the same currency. At the time of payment however, the purchaser may pay with the consent of the seller, in a different currency on the basis of the exchange rate of that day (i.e. the day of payment) and not the rate of the date of transaction.

5.13. Securitization of *Murabahah*

Murabahah is a transaction which cannot be securitized for creating a negotiable instrument to be sold and purchased in secondary market. The reason is obvious. If the purchaser/client in a *murabahah* transaction signs a paper to evidence his indebtedness towards the seller/ financier, the paper will represent a monetary debt receivable from him. In other words, it represents money payable by him. Therefore transfer of this paper to a third party will mean transfer of money. It has already been explained that where money is exchanged for money (in the same currency) the transfer must be at par value. It cannot be sold or purchased at a lower or a higher price. Therefore, the paper representing a monetary obligation arising out of a *murabahah* transaction cannot create a negotiable instrument. If the paper is transferred, it must be at par value. However, if there is a mixed portfolio consisting of a number of transactions like *musharakah,* leasing and *murabahah,* then this portfolio may issue negotiable certificates subject to certain conditions more fully discussed in the chapter of "Islamic Funds".

5.14. Some Basic Mistakes in *Murabahah* Financing

After explaining the concept of *murabahah* and its relevant issues, it will be pertinent to highlight some basic mistakes often committed by the financial institutions in the practical implementation of the concept.

1. The first and the most glaring mistake is to assume that *murabahah* is a universal instrument which can be used for every type of financing offered by conventional interest-based banks and NBFIs.[24] Under this false assumption, some financial institutions are found using *murabahah* for financing overhead expenses of a firm or company like paying salaries of their staff, paying the bills of electricity etc. and setting off their debts payable to other parties. This practice is totally unacceptable, because *murabahah* can be used only where a commodity is intended to be purchased by the customer. If funds are required for some other purpose, *murabahah* cannot work. In such cases, some other suitable modes of financing, like *musharakah*, leasing etc. can be used according to the nature of the requirement.

2. In some cases, the clients sign the *murabahah* documents merely to obtain funds. They never intend to employ these funds to purchase a specific commodity. They just want funds for unspecified purpose, but to satisfy the requirement of the formal documents, they name a fictitious commodity. After receiving money, they use it for whatever purpose they wish.

Obviously this is a fictitious deal, and the Islamic financiers must be very careful about it. It is their duty to make sure that the client really intends to purchase a commodity which may be subject to *murabahah*. This assurance must be obtained by the authorities sanctioning the facility to the customer. Then, all necessary steps must be taken to confirm that the transaction is genuine. For example:

(a) Instead of giving funds to the customer, the purchase price should be paid directly to the supplier.
(b) If it becomes necessary that the client is entrusted with funds to purchase the commodity on behalf of the financier, his purchase should be evidenced by invoices or similar other documents which he should present to the financier.
(c) Where either of the above two requirements is not possible to be fulfilled, the financing institution should arrange for physical inspection of the purchased commodities.

The Islamic financial institutions are, at any rate, under an obligation to make sure that *murabahah* is a real and genuine transaction of actual sale and is not being misused to camouflage an interest-based loan.

3. In some cases, sale of a commodity to a client is effected before the commodity is acquired from the supplier. This mistake is invariably committed in transactions where all the documents of *murabahah* are signed at one time without taking into account various stages of the *murabahah*. Some institutions have only one *murabahah* agreement which is signed at the time of disbursement of money, or in some cases, at the time of approving the facility. This is totally against the basic principles of *murabahah*. It has already been explained in this chapter that the *murabahah* arrangement practiced by the banks is a package of different contracts which come into play one after another at their

[24] Non-bank Financial Institutions.

respective stages. These stages have been fully highlighted earlier while discussing the concept of '*Murabahah* Financing'. Without observing this basic feature of *murabahah* financing, the whole transaction turns into an interest-bearing loan. Merely changing the nomenclature does not make it lawful in the eyes of *Shari'ah*.

The representatives of the *Shari'ah* Boards of the Islamic banks, when they check the transactions of the bank with regard to their compliance with *Shari'ah*, must make sure that all these stages have been really observed, and every transaction is effected on its due time.

4. International commodity transactions are often resorted to for liquidity management. Some Islamic banks feel that these transactions, being asset-based, can easily be entered into on a *murabahah* basis, and they enter the field ignoring the fact that the commodity operations as in vogue in the international markets, do not conform to the principles of *Shari'ah*. In many cases, they are fictitious transactions where no delivery takes place. The parties end up paying differences. In some cases, there are real commodities but they are subjected to forward sales or short sales which are not allowed in *Shari'ah*. Even if the transactions are restricted to spot sales, they should be formulated on the basis of Islamic principles of *murabahah* by fulfilling all the necessary conditions already mentioned in this book.

5. It is observed in some financial institutions that they effect *murabahah* on commodities already purchased by their clients from a third party. This is again a practice never warranted by the *Shari'ah*. Once the commodity is purchased by the client himself, it cannot be purchased again from the same supplier. If it is purchased by the bank from the client himself and is sold to him, it is a buy-back technique which is not allowed in *Shari'ah*, especially in *murabahah*. In fact, if the client has already purchased a commodity, and he approaches the bank for funds, he either wants to set-off his liability towards his supplier, or he wants to use the funds for some other purpose. In both cases an Islamic bank cannot finance him on the basis of *murabahah*. *Murabahah* can be effected only on commodities not yet purchased by the client.

6. CONCLUSIONS

From the foregoing discussion on different aspects of *murabahah* financing, the following conclusions may be summarized as the basic points to remember:

1. *Murabahah* is not a mode of financing in its origin. It is a simple sale on cost-plus basis. However, after adding the concept of deferred payment, it has been devised to be used as a mode of financing only in cases where the client intends to purchase a commodity. Therefore, it should neither be taken as an ideal Islamic mode of financing, nor a universal instrument for all sorts of financing. It should be taken as a transitory step towards the ideal Islamic system of financing based on *musharakah* or *mudarabah*. Otherwise its use should be restricted to areas where *musharakah* or *mudarabah* cannot work.

2. While approving a *murabahah* facility, the sanctioning authority must make sure that the client really intends to purchase commodities which may be subject matter of *murabahah*. It should never be taken as merely a paper work having no genuine basis.
3. No *murabahah* can be effected for overhead expenses, paying the bills or settling the debts of the client, nor can it be effected for purchase of currencies.
4. It is the foremost condition for the validity of *murabahah* that the commodity comes in the ownership and physical or constructive possession of the financier before he sells it to the customer on *murabahah* basis. There should be a time in which the risk of the commodity is borne by the financier. Without having its ownership or assuming the risk of the commodity, though for a short while, the transaction is not acceptable to *Shari'ah* and the profit accruing therefrom is not halal.
5. The best way to effect *murabahah* is that the financier himself purchases the commodity directly from the supplier and after taking its delivery sells it to the client on *murabahah* basis. Making the client agent to purchase on behalf of the financier renders the arrangement dubious. For this very reason some *Shari'ah* Boards have forbidden this technique, except in cases where direct purchase is not possible at all. Therefore, the agency concept should be avoided as far as possible.
6. If in cases of genuine need, the financier appoints the client his agent to purchase the commodity on his behalf, his different capacities (i.e. as agent and as ultimate purchaser) should be clearly distinguished. As an agent, he is a trustee, and unless he commits negligence or fraud, he is not liable to any loss so far as the commodity is in his possession as agent of the financier. After he purchases the commodity in his capacity as agent, he must inform the financier that, in fulfilling his obligation as his agent, he has taken delivery of the purchased commodity and now he extends his offer to purchase it from him. When, in response to this offer, the financier conveys his acceptance to this offer, the sale will be deemed to be complete, and the risk of the property will be passed on to the client as purchaser. At this point, he will become a debtor and the consequences of indebtedness will follow. These are the necessary requirements of *murabahah* financing which can never be dispensed with. While describing the concept of "*Murabahah* as a mode of financing" we have already identified five stages of *murabahah* under agency agreement. Each and every step out of these five is necessary in its own right and neglecting any one of them renders the whole arrangement unacceptable.

It should be noted with care that *murabahah* is a border-line transaction and a slight departure from the prescribed procedure makes it step in the prohibited area of interest-based financing. Therefore this transaction must be carried out with due diligence and no requirement of *Shari'ah* should be taken lightly.

7. Two different prices for cash and credit sales are allowed on condition that either of the two options is specifically elected by the customer. Once the price is fixed, it can neither be increased because of late payment, nor decreased on earlier payment.
8. In order to assure that the purchaser will pay the price on time, he may undertake that in case of default, he will pay a certain amount to the charitable fund maintained by the financing institution. This amount may be based on per cent per annum concept, but it

must invariably be spent for purely charitable purposes and should in no case form part of the income of the institution.

9. In the case of earlier payment, no rebate can be claimed by the client. However, the institution may at it own option, forego some part of the price without making it a pre-condition in the agreement.

CHAPTER 3

Ijarah

1. INTRODUCTION

Ijarah is a term of Islamic *Fiqh.* Lexically, it means 'to give something on rent'. In Islamic jurisprudence, the term *ijarah* is used for two different situations. In the first place, it means 'to employ the services of a person on wages given to him as a consideration for his hired services.' The employer is called *musta'jir* while the employee is called *ajir.*

Therefore, if A has employed B in his office as a manager or as a clerk on a monthly salary, A is *musta'jir,* and B is an *ajir.* Similarly, if A has hired the services of a porter to carry his baggage to the airport, A is a *musta'jir* while the porter is an *ajir,* and in both cases the transaction between the parties is termed as *ijarah.* This type of *ijarah* includes every transaction where the services of a person are hired by someone else. He may be a doctor, a lawyer, a teacher, a labourer or any other person who can render some valuable services. Each one of them may be called an *ajir* according to the terminology of Islamic law, and the person who hires their services is called a *musta'jir,* while the wages paid to the *ajir* are called their *ujrah.*

The second type of *ijarah* relates to the usufructs of assets and properties, and not to the services of human beings. *Ijarah* in this sense means 'to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him.' In this case, the term *ijarah* is analogous to the English term 'leasing'. Here the lessor is called *mu'jir,* the lessee is called *musta'jir* and the rent payable to the lessor is called *ujrah.*

Both these kinds of *ijarah* are thoroughly discussed in the literature of Islamic jurisprudence and each one of them has its own set of rules. But for the purpose of the present book, the second type of *ijarah* is more relevant, because it is generally used as a form of investment, and as a mode of financing also.

The rules of *ijarah,* in the sense of leasing, are very much analogous to the rules of sale, because in both cases something is transferred to another person for a valuable consideration. The only difference between *ijarah* and sale is that in the latter case the corpus of the property is transferred to the purchaser, while in the case of *ijarah,* the corpus of the property remains in the ownership of the transferor, but only its usufruct i.e. the right to use it, is transferred to the lessee.

Therefore, it can easily be seen that *ijarah* is not a mode of financing in its origin. It is a normal business activity like sale. However, due to certain reasons, and in particular, due to some tax concessions it may carry, this transaction is being used in the Western countries for the purpose of financing also. Instead of giving a simple interest-bearing

loan, some financial institutions started leasing some types of equipment to their customers. While fixing the rent of these equipments, they calculate the total cost they have incurred in the purchase of these assets and add the stipulated interest they could have claimed on such an amount during the lease period. The aggregate amount so calculated is divided on the total months of the lease period, and the monthly rent is fixed on that basis.

The question whether or not the transaction of leasing can be used as a mode of financing in *Shari'ah* depends on the terms and conditions of the contract.

As mentioned earlier, leasing is a normal business transaction and not a mode of financing. Therefore, the lease transaction is always governed by the rules of *Shari'ah* prescribed for *ijarah*. Let us, therefore, discuss the basic rules governing the lease transactions, as enumerated in the Islamic *Fiqh*. After the study of these rules, we will be able to understand under what conditions the *ijarah* may be used for the purpose of financing.

Although the principles of *ijarah* are so numerous that a separate volume is required for their full discussion, we will attempt in this chapter to summarize those basic principles only which are necessary for the proper understanding of the nature of the transaction and are generally needed in the context of modern economic practice. These principles are recorded here in the form of brief notes, so that the readers may use them for quick reference.

2. BASIC RULES OF LEASING

1. Leasing is a contract whereby the owner of a property transfers its usufruct to another person for an agreed period, at an agreed consideration.
2. The subject of lease must have a valuable use. Therefore, things having no usufruct at all cannot be leased.
3. It is necessary for a valid contract of lease that the corpus of the leased property remains in the ownership of the seller, and only its usufruct is transferred to the lessee. Thus, anything which cannot be used without consuming cannot be leased out. Therefore, the lease cannot be effected in respect of money, eatables, fuel and ammunition etc. because their use is not possible unless they are consumed. If anything of this nature is leased out, it will be deemed to be a loan and all the rules concerning the transaction of loan shall accordingly apply. Any rent charged on this invalid lease shall be an interest charged on a loan.
4. As the corpus of the leased property remains in the ownership of the lessor, all the liabilities emerging from the ownership shall be borne by the lessor, but the liabilities referable to the use of the property shall be borne by the lessee.
Example: A has leased his house to B. The taxes referable to the property shall be borne by A, while the water tax, electricity bills and all expenses referable to the use of the house shall be borne by B, the lessee.
5. The period of lease must be determined in clear terms.

6. The lessee cannot use the leased asset for any purpose other than the purpose specified in the lease agreement. If no such purpose is specified in the agreement, the lessee can use it for whatever purpose it is used in the normal course. However if he wishes to use it for an unusual purpose, he cannot do so unless the lessor allows him in express terms.
7. The lessee is liable to indemnify the lessor against any harm to the leased asset caused by any misuse or negligence on the part of the lessee.
8. The leased asset shall remain in the risk of the lessor throughout the lease period in the sense that any harm or loss caused by the factors beyond the control of the lessee shall be borne by the lessor.
9. A property jointly owned by two or more persons can be leased out, and the rental shall be distributed between all the joint owners according to the proportion of their respective shares in the property.
10. A joint owner of a property can lease his proportionate share to his co-sharer only, and not to any other person.[1]
11. It is necessary for a valid lease that the leased asset is fully identified by the parties.
Example: A said to B. "I lease you one of my two shops." B agreed. The lease is void, unless the leased shop is clearly determined and identified.

3. DETERMINATION OF RENTAL

12. The rental must be determined at the time of contract for the whole period of lease.
It is permissible that different amounts of rent are fixed for different phases during the lease period, provided that the amount of rent for each phase is specifically agreed upon at the time of effecting a lease. If the rent for a subsequent phase of the lease period has not been determined or has been left at the option of the lessor, the lease is not valid.
Example 1: A leases his house to B for a total period of 5 years. The rent for the first year is fixed as Rs. 2000/- per month and it is agreed that the rent of every subsequent year shall be 10 per cent more than the previous one. The lease is valid.
Example 2: In the above example, A puts a condition in the agreement that the rent of Rs. 2000/- per month is fixed for the first year only. The rent for the subsequent years shall be fixed each year at the option of the lessor. The lease is void, because the rent is uncertain.

The determination of rental on the basis of the aggregate cost incurred in the purchase of the asset by the lessor, as normally done in financial leases, is not against the rules of *Shari'ah*, if both parties agree to it, provided that all other conditions of a valid lease prescribed by the *Shari'ah* are fully adhered to.
13. The lessor cannot increase the rent unilaterally, and any agreement to this effect is void.

[1] See Ibn 'Abidin, Radd-al-Muhtar v. 6, p. 47–48

14. The rent or any part thereof may be payable in advance before the delivery of the asset to the lessee, but the amount so collected by the lessor shall remain with him as 'on account' payment and shall be adjusted towards the rent after its being due.
15. The lease period shall commence from the date on which the leased asset has been delivered to the lessee, no matter whether the lessee has started using it or not.
16. If the leased asset has totally lost the function for which it was leased, and no repair is possible, the lease shall terminate on the day on which such loss has been caused. However, if the loss is caused by the misuse or by the negligence of the lessee, he will be liable to compensate the lessor for the depreciated value of the asset, as it was immediately before the loss.

4. LEASE AS A MODE OF FINANCING

Like *murabahah*, lease is not originally a mode of financing. It is simply a transaction meant to transfer the usufruct of a property from one person to another for an agreed period against an agreed consideration. However, certain financial institutions have adopted leasing as a mode of financing instead of long term lending on the basis of interest. This kind of lease is generally known as the 'financial lease' as distinguished from the 'operating lease' and many basic features of actual leasing transaction have been dispensed with therein.

When interest-free financial institutions were established in the near past, they found that leasing is a recognized mode of finance throughout the world. On the other hand, they realized that leasing is a lawful transaction according to *Shari'ah* and it can be used as an interest-free mode of financing. Therefore, leasing has been adopted by the Islamic financial institutions, but very few of them paid attention to the fact that the 'financial lease' has a number of characteristics more similar to interest than to the actual lease transaction. That is why they started using the same model agreements of leasing as were in vogue among the conventional financial institutions without any modification, while a number of their provisions were not in conformity with *Shari'ah*.

As mentioned earlier, leasing is not a mode of financing in its origin. However, the transaction may be used for financing, subject to certain conditions. It is not sufficient for this purpose to substitute the name of 'interest' with the name of 'rent' and replace the name of 'mortgage' with the name of 'leased asset'. There must be a substantial difference between leasing and an interest-bearing loan. That will be possible only by following all the Islamic rules of leasing, some of which have been mentioned in the first part of this chapter.

To be more specific, some basic differences between the contemporary financial leasing and the actual leasing allowed by the *Shari'ah* are indicated below.

4.1. The Commencement of Lease

1. Unlike the contract of sale, the agreement of *ijarah* can be effected for a future date.[2] Thus, while a forward sale is not allowed in *Shari'ah*, an *ijarah* for a future date is allowed, on the condition that the rent will be payable only after the leased asset is delivered to the lessee.

In most cases of the 'financial lease' the lessor i.e. the financial institution purchases the asset through the lessee himself. The lessee purchases the asset on behalf of the lessor who pays its price to the supplier, either directly or through the lessee. In some lease agreements, the lease commences on the very day on which the price is paid by the lessor, irrespective of whether the lessee has effected payment to the supplier and taken delivery of the asset or not. It may mean that the lessee's liability for the rent starts before the lessee takes delivery of the asset. This is not allowed in *Shari'ah*, because it amounts to charging rent on the money given to the customer which is nothing but interest, pure and simple.

The correct way, according to *Shari'ah*, is that the rent be charged after the lessee has taken delivery of the asset, and not from the day the price has been paid. If the supplier has delayed the delivery after receiving the full price, the lessee should not be liable for the rent of the period of delay.

4.2. Different Relationships of the Parties

2. It should be clearly understood that when the lessee himself has been entrusted with the purchase of the asset intended to be leased, there are two separate relationships between the institution and the client which come into operation one after the other. In the first instance, the client is an agent of the institution to purchase the asset on the latter's behalf. At this stage, the relation between the parties is nothing more than the relation of a principal and his agent. The relation of lessor and lessee has not yet come into operation.

The second stage begins from the date when the client takes delivery from the supplier. At this stage, the relation of lessor and lessee comes to play its role.

These two capacities of the parties should not be mixed up or confused with each other. During the first stage, the client cannot be held liable for the obligations of a lessee. In this period, he is responsible to carry out the functions of an agent only. But when the asset is delivered to him, he is liable to discharge his obligations as a lessee.

However, there is a point of difference between *murabahah* and leasing. In *murabahah*, as mentioned earlier, actual sale should take place after the client takes delivery from the supplier, and the previous agreement of *murabahah* is not enough for effecting the actual sale. Therefore, after taking possession of the asset as an agent, he is

[2] See Radd-al-Muhtar v. 4, p. 64

bound to give intimation to the institution, and make an offer for the purchase from him. The sale takes place after the institution accepts the offer.

The procedure in leasing is different, and a little shorter. Here the parties need not effect the lease contract after taking delivery. If the institution, while appointing the client its agent, has agreed to lease the asset with effect from the date of delivery, the lease will automatically start on that date without any additional procedure.

There are two reasons for this difference between *murabahah* and leasing:

Firstly, it is a necessary condition for a valid sale that it should be effected instantly. Thus, a sale attributed to a future date is invalid in *Shari'ah*. But leasing can be attributed to a future date. Therefore, the previous agreement is not sufficient in the case of *murabahah*, while it is quite enough in the case of leasing.

Secondly, the basic principle of *Shari'ah* is that one cannot claim a profit or a fee for a property the risk of which was never borne by him.

Applying this principle to *murabahah*, the seller cannot claim a profit over a property which never remained under his risk for a moment. Therefore, if the previous agreement is held to be sufficient for effecting a sale between the client and the institution, the asset shall be transferred to the client simultaneously when he takes its possession, and the asset shall not come into the risk of the seller even for a moment. That is why the simultaneous transfer is not possible in *murabahah*, and there should be a fresh offer and acceptance after the delivery.

In leasing, however, the asset remains under the risk and ownership of the lessor throughout the leasing period, because the ownership has not been transferred. Therefore, if the lease period begins right from the time when the client has taken delivery, it does not violate the principle mentioned above.

4.3. Expenses Consequent to Ownership

3. As the lessor is the owner of the asset, and he has purchased it from the supplier through his agent, he is liable to pay all the expenses incurred in the process of its purchase and its import to the country of the lessor. Consequently, he is liable to pay the freight and the customs duty etc. He can, of course, include all these expenses in his cost and can take them into consideration while fixing the rentals, but as a matter of principle, he is liable to bear all these expenses as the owner of the asset. Any agreement to the contrary, as is found in the traditional financial leases, is not in conformity with *Shari'ah*.

4.4. Liability of the Parties in Cases of Loss to the Asset

4. As mentioned in the basic principles of leasing, the lessee is responsible for any loss caused to the asset by his misuse or negligence. He can also be made liable to the wear and tear which normally occurs during its use. But he cannot be made liable to a loss caused by the factors beyond his control. The agreements of the traditional 'financial

lease' generally do not differentiate between the two situations. In a lease based on the Islamic principles, both the situations should be dealt with separately.

4.5. Variable Rentals in Long-Term Leases

5. In the long term lease agreements it is mostly not in the benefit of the lessor to fix one amount of rent for the whole period of lease, because the market conditions change from time to time.

In this case the lessor has two options:

(a) He can contract lease with a condition that the rent shall be increased according to a specified proportion (e.g. 5 per cent) after a specified period (like one year).

(b) He can contract lease for a shorter period after which the parties can renew the lease at new terms and by mutual consent, with full liberty to each one of them to refuse the renewal, in which case the lessee is bound to vacate the leased property and return it to the lessor.

These two options are available to the lessor according to the classical rules of Islamic *Fiqh*. However, some contemporary scholars have allowed, in long-term leases, to tie up the rental amount with a variable benchmark which is so well-known and well-defined that it does not leave room for any dispute. For example, it is permissible according to them to provide in the lease contract that in case of any increase in the taxes imposed by the government on the lessor, the rent will be increased to the extent of same amount. Similarly it is allowed by them that the annual increase in the rent is tied up with the rate of inflation. Therefore if there is an increase of 5 per cent in the rate of inflation, it will result in an increase of 5 per cent in the rent as well.

Based on the same principle, some Islamic banks use the rate of interest as a benchmark to determine the rental amounts. They want to earn the same profit through leasing as is earned by the conventional banks through advancing loans on the basis of interest. Therefore, they want to tie up the rentals with the rate of interest and instead of fixing a definite amount of rental, they calculate the cost of purchasing the lease assets and want to earn through rentals an amount equal to the rate of interest. Therefore, the agreement provides that the rental will be equal to the rate of interest or to the rate of interest plus something. Since the rate of interest is variable, it cannot be determined for the whole lease period. Therefore, these contracts use the interest rate of a particular country (like LIBOR) as a benchmark for determining the periodical increase in the rent.

This arrangement has been criticized on two grounds:

The first objection raised against it is that, by subjecting the rental payments to the rate of interest, the transaction is rendered akin to an interest based financing. This objection can be overcome by saying that, as fully discussed in the case of *murabahah*, the rate of interest is used as a benchmark only. So far as other requirements of *Shari'ah* for a valid lease are properly fulfilled, the contract may use any benchmark for determining the amount of rental. The basic difference between an interest-based financing and a valid lease does not lie in the amount to be paid to the financier or the lessor. The basic

difference is that in the case of lease, the lessor assumes the full risk of the corpus of the leased asset. If the asset is destroyed during the lease period, the lessor will suffer the loss. Similarly, if the leased asset looses its usufruct without any misuse or negligence on the part of the lessee, the lessor cannot claim the rent, while in the case of an interest-based financing, the financier is entitled to receive interest, even if the debtor did not at all benefit from the money borrowed. So far as this basic difference is maintained, (i.e. the lessor assumes the risk of the leased asset) the transaction cannot be categorised as an interest-bearing transaction, even though the amount of rent claimed from the lessee is equal to the rate of interest.

It is thus clear that the use of the rate of interest merely as a benchmark does not render the contract invalid as an interest-based transaction. It is, however, advisable at all times to avoid using the interest rate even as a benchmark, so that an Islamic transaction is totally distinguished from an un-Islamic one, having no resemblance to interest whatsoever.

The second objection to this arrangement is that the variations of the rate of interest being unknown, the rental tied up with the rate of interest will imply *jahalah* and *gharar* which is not permissible in *Shari'ah*. It is one of the basic requirements of *Shari'ah* that the consideration in every contract must be known to the parties when they enter into it. The consideration in a transaction of lease is the rent charged from the lessee, and therefore it must be known to each party right at the beginning of the contract of lease. If we tie up the rental with the future rate of interest, which is unknown, the amount of rent will remain unknown as well. This is the *jahalah* or *gharar* which renders the transaction invalid.

Responding to this objection, one may say that the *jahalah* has been prohibited for two reasons: One reason is that it may lead to a dispute between the parties. This reason is not applicable here, because both parties have agreed with mutual consent upon a well defined benchmark that will serve as a criterion for determining the rent, and whatever amount is determined, based on this benchmark, will be acceptable to both parties. Therefore, there is no question of any dispute between them.

The second reason for the prohibition of *jahalah* is that it renders the parties susceptible to an unforeseen loss. It is possible that the rate of interest, in a particular period, zooms up to an unexpected level in which case the lessee will suffer. It is equally possible that the rate of interest zooms down to an unexpected level, in which case the lessor may suffer. In order to meet the risks involved in such possibilities, it is suggested by some contemporary scholars that the relation between rent and the rate of interest is subjected to a limit or ceiling. For example, it may be provided in the base contract that the rental amount after a given period, will be changed according to the change in the rate of interest, but it will in no case be higher than 15 per cent or lower than 5 per cent of the previous monthly rent. It will mean that if the increase in the rate of interest is more than 15 per cent the rent will be increased only up to 15 per cent. Conversely, if the decrease in the rate of interest is more than 5 per cent the rent will not be decreased to more than 5 per cent.

In our opinion, this is the moderate view which takes care of all the aspects involved in the issue.

4.6. Penalty for Late Payment of Rent

In some agreements of financial leases, a penalty is imposed on the lessee in case he delays the payment of rent after the due date. This penalty, if meant to add to the income of the lessor, is not warranted by the *Shari'ah*. The reason is that the rent after it becomes due, is a debt payable by the lessee, and is subject to all the rules prescribed for a debt. A monetary charge from a debtor for his late payment is exactly the *riba* prohibited by the Holy Qur'an. Therefore, the lessor cannot charge an additional amount in case the lessee delays payment of the rent.

However, in order to avoid the adverse consequences resulting from the misuse of this prohibition, another alternative may be resorted to. The lessee may be asked to undertake that, if he fails to pay rent on its due date, he will pay a certain amount to a charity. For this purpose the financier/lessor may maintain a charity fund where such amounts may be credited and disbursed for charitable purposes, including advancing interest-free loans to needy persons. The amount payable for charitable purposes by the lessee may vary according to the period of default and may be calculated on a per cent, per annum basis . The agreement of the lease may contain the following clause for this purpose:

"The Lessee hereby undertakes that, if he fails to pay rent on its due date, he shall pay an amount calculated at ... per cent per annum to the charity fund maintained by the Lessor which will be used by the Lessor exclusively for charitable purposes approved by the *Shari'ah* and shall in no case form part of the income of the Lessor."

This arrangement, though it does not compensate the lessor for his opportunity cost of the period of default, may yet serve as a strong incentive to the lessee to pay the rent on time.

The justification for such an undertaking of the lessee, and inability of any penalty or compensation claimed by the lessor for his own benefit is discussed in full in the chapter on *murabahah* (above) which may be consulted for details.

4.7. Termination of Lease

6. If the lessee contravenes any term of the agreement, the lessor has a right to terminate the lease contract unilaterally. However, if there is no contravention on the part of the lessee, the lease cannot be terminated without mutual consent. In some agreements of the 'financial lease' it has been noticed that the lessor has been given an unrestricted power to terminate the lease unilaterally whenever he wishes, according to his sole judgment. This is again contrary to the principles of *Shari'ah*.

7. In some agreements of the 'financial lease' a condition has been found to the effect that in case of the termination of the lease, even at the option of the lessor, the rent of the remaining lease period shall be paid by the lessee.

This condition is obviously against *Shari'ah* and the principles of equity and justice. The basic reason for inserting such conditions in the agreement of lease is that the main concept behind the agreement is to give an interest-bearing loan under the ostensible cover of lease. That is why every effort is made to avoid the logical consequences of the lease contract.

Naturally, such a condition cannot be acceptable to *Shari'ah*. The logical consequence of the termination of lease is that the asset should be taken back by the lessor. The lessee should be asked to pay the rent as due up to the date of termination. If the termination has been effected due to the misuse or negligence on the part of the lessee, he can also be asked to compensate the lessor for the loss caused by such misuse or negligence. But he cannot be compelled to pay the rent of the remaining period.

4.8. Insurance of the Assets

8. If the leased property is insured under the Islamic mode of *takaful*, it should be at the expense of the lessor and not at the expense of the lessee, as is generally provided in the agreements of the current financial leases.

4.9. The Residual Value of the Leased Asset

9. Another important feature of the modern financial leases is that after the expiry of the lease period, the corpus of the leased asset is normally transferred to the lessee. As the lessor already recovers his cost along with an additional profit thereon, which is normally equal to the amount of interest which could have been earned on a loan of that amount advanced for that period, the lessor has no further interest in the leased asset. On the other hand, the lessee wants to retain the asset after the expiry of the leased period.

For these reasons, the leased asset is generally transferred to the lessee at the end of the lease, either free of any charge or at a nominal token price. In order to ensure that the asset will be transferred to the lessee, sometimes the lease contract has an express clause to this effect. Sometimes this condition is not mentioned in the contract expressly; however, it is understood between the parties that the title of the asset will be passed on to the lessee at the end of the lease term.

This condition, whether it is express or implied, is not in accordance with the principles of *Shari'ah*. It is a well settled rule of Islamic jurisprudence that one transaction cannot be tied up with another transaction so as to make the former a pre-condition for the other. Here the transfer of the asset at the end has been made a necessary condition for the transaction of lease which is not allowed in *Shari'ah*.

The original position in *Shari'ah* is that the asset shall be the sole property of the lessor, and after the expiry of the lease period, the lessor shall be at liberty to take the asset back, or to renew the lease or to lease it out to another party, or sell it to the lessee or to any other person. The lessee cannot force him to sell it to him at a nominal price, nor can such a condition be imposed on the lessor in the lease agreement.

But after the lease period expires, and the lessor wants to give the asset to the lessee as a gift or to sell it to him, he can do so by his free will.

However, some contemporary scholars, keeping in view the needs of the Islamic financial institutions have come up with an alternative. They say that the agreement of ljarah itself should not contain a condition of gift or sale at the end of the lease period. However, the lessor may enter into a unilateral promise to sell the leased asset to the lessee at the end of the lease period. This promise will be binding on the lessor only. The principle, according to them, is that a unilateral promise to enter into a contract at a future date is allowed whereby the promisor is bound to fulfil the promise, but the promisee is not bound to enter into that contract . It means that he has an option to purchase which he may or may not exercise. However, if he wants to exercise his option to purchase, the promisor cannot refuse it because he is bound by his promise. Therefore, these scholars suggest that the lessor, after entering into the lease agreement, can sign a separate unilateral promise whereby he undertakes that if the lessee has paid all the amounts of rentals and wants to purchase the asset at a specified mutually acceptable price, he will sell the leased asset to him for that price.

Once this promise is signed by the lessor, he is bound to fulfil it and the lessee may exercise his option to purchase at the end of the period, if he has fully paid the amounts of rent according to the agreement of lease.

Similarly, it is also allowed by these scholars that, instead of sale, the lessor signs a separate promise to gift the leased asset to the lessee at the end of the lease period, subject to his payment of all amounts of rent.

This arrangement is called *ijarah wa iqtina*. It has been allowed by a large number of contemporary scholars and is widely acted upon by the Islamic banks and financial institutions. The validity of this arrangement is subject to two basic conditions:

Firstly, the agreement of *ijarah* itself should not be subjected to signing this promise of sale or gift but the promise should be recorded in a separate document.

Secondly, the promise should be unilateral and binding on the promisor only. It should not be a bilateral promise binding on both parties because in this case it will be a fully-fledged contract effected to a future date which is not allowed in the case of sale or gift.

5. SUB-LEASE

10. If the leased asset is used differently by different users, the lessee cannot sub-lease the leased asset except with the express permission of the lessor. If the lessor permits the lessee for subleasing, he may sublease it. If the rent claimed from the sub-lessee is equal to or less than the rent payable to the owner/original lessor, all the recognized schools of

Islamic jurisprudence are unanimous on the permissibility of the sub-lease. However, opinions are different where the rent charged from the sub-lessee is higher than the rent payable to the owner. Imam al-Shafi'i and some other scholars allow it and hold that the sub-lessor may enjoy the surplus received from the sub-lessee. This is the preferred view in the Hanbali school as well. On the other hand. Imam Abu Hanifah is of the view that the surplus received from the sub-lessee in this case is not permissible for the sub-lessor to keep and he will have to give that surplus in charity. However, if the sub-lessor has developed the leased property by adding something to it or has rented it in a currency different from the currency in which he himself pays rent to the owner/the original lessor, he can claim a higher rent from his sub-lessee and can enjoy the surplus.[3]

Although the view of Imam Abu Hanifah is more cautious which should be acted upon to the best possible extent, in cases of need the view of Shafi'i and Hanbali schools may be followed because there is no express prohibition in the Holy Qur'an or in the Sunnah against the surplus claimed from the lessee. Ibn Qudamah has argued for the permissibility of surplus on forceful grounds.

6. ASSIGNING OF THE LEASE

11. The lessor can sell the leased property to a third party whereby the relation of lessor and lessee shall be established between the new owner and the lessee. However, the assigning of the lease itself (without assigning the ownership in the leased asset) for a monetary consideration is not permissible.

The difference between the two situations is that in the latter case the ownership of the asset is not transferred to the assignee, but he becomes entitled to receive the rent of the asset only. This kind of assignment is allowed in *Shari'ah* only where no monetary consideration is charged from the assignee for this assignment, for example, a lessor can assign his right to claim rent from the lessee to his son, or to his friend in the form of a gift. Similarly, he can assign this right to any one of his creditors to set off his debt out of the rentals received by him. But if the lessor wants to sell this right for a fixed price, it is not permissible, because in this case the money (the amount of rentals) is sold for money which is a transaction subject to the principle of equality. Otherwise it will be tantamount to a riba transaction, hence prohibited.

7. SECURITIZATION OF *IJARAH*

The arrangement of *ijarah* has a good potential of securitization which may help create a secondary market for the financiers on the basis of *ijarah*. Since the lessor in *ijarah* owns the leased assets, he can sell the asset, in whole or in part, to a third party who may

[3] See Ibn Qudamah. Almughni v. 5, p. 475 Riyad, 1981, and Ibn 'Abidin, Radd-al-Muhtar v. 5, p. 20.

purchase it and may replace the seller in the rights and obligations of the lessor with regard to the purchased part of the asset.[4]

Therefore, if the lessor, after entering into *ijarah*, wishes to recover his cost of purchase of the asset with a profit thereon, he can sell the leased asset wholly or partly either to one party or to a number of individuals. In the latter case, the purchase of a proportion of the asset by each individual may be evidenced by a certificate which may be called *ijarah* certificate. This certificate will represent the holder's proportionate ownership in the leased asset and he will assume the rights and obligations of the owner/lessor to that extent. Since the asset is already leased to the lessee, lease will continue with the new owners and each one of the holders of this certificate will have the right to enjoy a part of the rent according to his proportion of ownership in the asset. Similarly, he will also assume the obligations of the lessor to the extent of his ownership. Therefore, in the case of total destruction of the asset, he will suffer the loss to the extent of his ownership. These certificates, being an evidence of proportionate ownership in a tangible asset, can be negotiated and traded in freely in the market and can serve as an instrument easily convertible into cash. Thus they may help in solving the problems of liquidity management faced by the Islamic banks and financial institutions.

It should be remembered, however, that the certificate must represent ownership of an undivided part of the asset with all its rights and obligations. Misunderstanding this basic concept, some quarters tried to issue *ijarah* certificates representing the holder's right to claim certain amount of the rental only without assigning to him any kind of ownership in the asset. It means that the holder of such a certificate has no relation with the leased asset at all. His only right is to share the rentals received from the lessee. This type of securitization is not allowed in *Shari'ah*. As explained earlier in this chapter, the rent after being due is a debt payable by the lessee. The debt or any security representing debt only is not a negotiable instrument in *Shari'ah*, because trading in such an instrument amounts to trade in money or in monetary obligation which is not allowed, except on the basis of equality, and if the equality of value is observed while trading in such instruments, the very purpose of securitization is defeated. Therefore, this type of *ijarah* certificates cannot serve the purpose of creating a secondary market.

It is, therefore, necessary that the *ijarah* certificates are designed to represent real ownership of the leased assets, and not only a right to receive rent.

8. HEAD-LEASE

Another concept developed in the modern leasing business is that of 'head-leasing'. In this arrangement a lessee subleases the property to a number of sub-lessees. Then, he

[4] Some jurists are of the opinion that this sale will not take effect until the lease period is over. However, Imam Abu Yusuf and other jurists are of the view that the sale is valid, the purchaser will replace the seller and Ijarah may continue. See Radd-al-Muhtar by Ibn 'Abidin v. 4, p. 57.

invites others to participate in his business by making them share the rentals received by his sub-lessees. For making them participate in receiving rentals, he charges a specified amount from them. This arrangement is not in accordance with the principles of *Shari'ah*. The reason is obvious. The lessee does not own the property. He is entitled to benefit from its usufruct only. That usufruct he has passed on to his sub-lessees by contracting a sublease with them. Now he does not own anything, neither the corpus of the property, nor its usufruct. What he has is the right to receive rent only. Therefore, he assigns a part of this right to other persons. It is already explained in detail that this right cannot be traded in, because it amounts to selling a receivable debt at a discount which is one of the forms of *riba* prohibited by the Holy Qur'an and Sunnah. Therefore, this concept is not acceptable.

These are some basic features of the financial lease which are not in conformity with the dictates of *Shari'ah*. While using the lease as an Islamic mode of finance, these shortcomings must be avoided.

The list of the possible shortcomings in the lease agreement is not restricted to what has been mentioned above, but only the basic errors found in different agreements have been pointed out, and the basic principles of Islamic leasing have been summarized. An Islamic lease agreement must conform to all of them.

CHAPTER 4

Salam and *Istina'*

1. INTRODUCTION

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.

1.1. 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 on the spot.

Here the price is cash, but the supply of the purchased goods is deferred. The buyer is called *rabb-ussalam*, the seller is *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 for these terms.

Salam was allowed by the Holy Prophet صلى الله عليه وسلم subject to certain conditions. The basic purpose of this sale was to meet the needs of the small farmers who needed money to grow their crops and to feed their family up to 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 usurers 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:

1.2. 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 صلى الله عليه وسلم. Moreover, the basic wisdom behind the permissibility of *salam* is to fulfil 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.[1]
2. *Salam* can be effected 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 precious stone is normally different from another either in its quality or in its size or weight and their exact specification is not generally possible.
3. *Salam* cannot be effected 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.[2]
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

[1] Ibn Qudamah, Almughni v. 4, p. 328.
[2] See Ibn Qudamah, Almughni v. 4, p. 325, Riyad, 1981.

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 effected in respect of things which must be delivered on the 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 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 صلى الله عليه وسلم. The most famous *hadith* in this context is the one in which the Holy Prophet صلى الله عليه وسلم said:

من أسلف فى شيئى فليسلف في كيل معلوم، ووزن معلوم إلى أجل معلوم

Whoever wishes to enter into a contract of *salam,* he must effect the *salam* according to a specified measure and a specified weight and a specified date of delivery.[3]

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

1. It is necessary, according to the Hanafischool, that the commodity (for which *salam* is effected) remains available in the market right from the day of contract up to the date of delivery. Therefore, if a commodity is not available in the market at the time of the contract, *salam* cannot be effected in respect of that commodity, even though it is expected that it will be available in the markets at the date of delivery.[4]

However, the other three schools of *Fiqh* (i.e. *Shafi'i, 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.[5]

This view can be adopted in the present circumstances.[6]

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

[3] This *hadith* is reported by all the six famous books *of hadith* (see Ibnul-humam, Fath-ul-Qadir v. 6, p. 205

[4] Al-Kasani, Bada'i'-us-sana'i' v. 5, p. 211.

[5] Ibn Qudamah, Almughni v. 4, p. 326.

[6] Thanawi, AshrafAli; Imdad-ul-Fatawa v. 3, pp. 21, 106.

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.[7]

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.[8]

This view is, however, opposed by some other jurists, like Imam Shafi'i and some Hanafi jurists also.[9] They say that the Holy Prophet صلى الله عليه وسلم 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 صلى الله عليه وسلم 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.[10]

2. *SALAM* AS A MODE OF FINANCING

It is evident from the foregoing discussion that *salam* was allowed by *Shari'ah* to fulfil 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 on the 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

[7] Ihn Qudamah. Almughni. v. 4, p. 323.
[8] Dardir. al-Sharh-us-Saghir v. 3, p. 275 and al-Khurashi v. 3, p. 20.
[9] Ibn-ul-Humam, Fath-ul-Qadeer v. 6, p. 219.
[10] Ashraf Ali Thanawi, Imdad-ul-Fatawa v. 3, pp. 21, 106.

be in the form of a guarantee or in the form of mortgage or hypothecation.[11] 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/the 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 those 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 benefiting 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, on 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

[11] *Ibid.*

after taking delivery from him, it cannot be prearranged at the time of original sale. Therefore, this proposal is not acceptable at all.

2.1. 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 have to be observed:

1. In an arrangement of parallel *salam*, the bank enters into 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 1,000 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 1,000 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 1,000 bags of wheat to C. He can seek whatever recourse he has against B, but he cannot rid himself of his liability to deliver wheat to C.

Similarly, if B has delivered defective goods which do not conform to 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 a '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.

3. *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.[12] However after the manufacturer has started the work, the contract cannot be cancelled unilaterally.

3.1. 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 effected 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 effected, 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.[13]

3.2. 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 specified fee paid to him.[14]

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-urru'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'*.

[12] Ibn Abidin, Radd-ul-Muhtar v.5, p. 223.

[13] *Op. cit.*, p. 225

[14] Khalid al-Atasi, Sharh-ul-Majallah v. 2, p. 403.

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.[15]

3.3. 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 to pay the price.[16]

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 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/- if the tailor finishes the clothes within one day and Rs. 80/- if he finishes them within two days.[17]

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.

4. *ISTISNA'* AS A MODE OF FINANCING

Istisna' can be used for providing the facility of financing in certain transactions, 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

[15] See Majallah sec. 392 and the Introduction.

[16] See Ibn 'Abidin, Radd-ul-Muhtar v. 5, p. 225. وإن للاستعجال كإن تفرغه غدا كان صحيحا

[17] See Ibn Abidin, Radd-ul-Muhtar v. 3, p. 311.

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 *on* 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 to any time according to the agreement of the parties[18]), therefore, the time of payment may be fixed in whatever manner they wish. The payment may also be in instalments.

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 instalments 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 instalments, 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 instalment 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 through 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.

[18] Atasi, Sharh-ul-Majallah, v. 2, p. 406.

CHAPTER 5

Islamic Investment Funds

1. INTRODUCTION

The term 'Islamic Investment Fund' in this chapter means a joint pool wherein the investors contribute their surplus money for the purpose of its investment to earn *halal* profits in strict conformity with the precepts of Islamic *Shari'ah*. The subscribers of the fund may receive a document certifying their subscription and entitling them to the pro-rata profits actually earned by the fund. These documents may be called 'certificates', 'units', 'shares' or may be given any other name, but their validity in terms of *Shari'ah* will always be subject to two basic conditions.

Firstly, instead of a fixed return tied up with their face value, they must carry a *pro rata* profit actually earned by the fund. Therefore, neither the principal nor a rate of profit (tied up with the principal) can be guaranteed. The subscribers must enter into the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered by the fund. If the fund earns huge profits, the return on their subscription will increase to that proportion. However, in case the fund suffers loss, they will have to share it also, unless the loss is caused by negligence or mismanagement, in which case the management, and not the fund, will be liable to compensate it.

Secondly, the amounts so pooled together must be invested in a business acceptable to *Shari'ah*. It means that not only the channels of investment, but also the terms agreed with the clients must conform to Islamic principles.

Keeping these basic requisites in view, Islamic investment funds may accommodate a variety of modes of investment which are discussed briefly in the following paragraphs.

2. EQUITY FUND

In an equity fund the amounts are invested in the shares of joint stock companies. The profits are mainly derived through capital gains by purchasing shares and selling them when their prices are increased. Profits are also earned through dividends distributed by the relevant companies.

It is obvious that if the main business of a company is not lawful in terms of *Shari'ah*, it is not allowed for an Islamic fund to purchase, hold or sell its shares, because it will entail the direct involvement of the share holder in that prohibited business.

Similarly the contemporary *Shari'ah* experts are almost unanimous on the point that if all the transactions of a company are in full conformity with *Shari'ah*, which includes that the company neither borrows money on interest nor keeps its surplus in an interest-

bearing account, its shares can be purchased, held and sold. But evidently, such companies are very rare in the contemporary stock markets. Almost all the companies quoted in the present stock markets are in some way involved in an activity which violates the injunctions of *Shari'ah*. Even if the main business of a company is *halal*, its borrowings are based on interest. On the other hand, they keep their surplus money in an interest bearing account or purchase interest-bearing bonds or securities.

The case of such companies has been a matter of debate between the *Shari'ah* experts in the present century. A group of the *Shari'ah* experts is of the view that it is not allowed for a Muslim to deal in the shares of such a company, even if its main business is halal. Their basic argument is that every shareholder of a company is a *sharik* (partner) of the company, and every *sharik*, according to Islamic jurisprudence, is an agent for the other partners in the matters of the joint business. Therefore, the mere purchase of a share of a company embodies an authorization from the shareholder to the company to carry on its business in whatever manner the management deems fit. If it is known to the shareholder that the company is involved in an un-Islamic transaction, and he still holds the shares in that company, it means that he has authorized the management to proceed with that un-Islamic transaction. In this case, he will not only be responsible for giving his consent to an un-Islamic transaction, but that transaction will also be rightfully attributed to himself, because the management of the company is working under his tacit authorization.

Moreover, when a company is financed on the basis of interest, its funds employed in the business are impure. Similarly, when the company receives interest on its deposits an impure element is necessarily included in its income which will be distributed to the share-holders through dividends.

However, a large number of present-day scholars do not endorse this view. They argue that a joint stock company is basically different from a simple partnership. In partnership, all policy decisions are taken through a consensus of all the partners, and each one of them has a veto power with regard to the policy of the business. Therefore, all the actions of a partnership are rightfully attributed to each partner. Conversely, policy decisions in a joint stock company are made by the majority. Being composed of a large number of shareholders, a company cannot give a veto power to each shareholder. The opinions of individual shareholders can be overruled by a majority decision. Therefore, each and every action taken by the company cannot be attributed to every shareholder in his individual capacity. If a share-holder raises an objection against a particular transaction in an Annual General Meeting, but his objection is overruled by the majority, it will not be fair to conclude that he has given his consent to that transaction in his individual capacity, especially when he intends to refrain from the income resulting from that transaction.

Therefore, if a company is engaged in a *halal* business, but also keeps its surplus money in an interest-bearing account, wherefrom a small incidental income of interest is received, it does not render all the business of the company unlawful. Now, if a person acquires the shares of such a company with clear intention that he will oppose this incidental transaction also, and will not use that proportion of the dividend for his own

benefit, how can it be said that he has approved the transaction of interest and how can that transaction be attributed to him?

The other aspect of the dealings of such a company is that it sometimes borrows money from financial institutions. These borrowings are mostly based on interest. Here again the same principle is relevant. If a shareholder is not personally agreeable to such borrowings, but has been overruled by the majority, these borrowing transactions cannot be attributed to him.

Moreover, even though according to the principles of Islamic jurisprudence, borrowing on interest is a grave and sinful act, for which the borrower is responsible in the Hereafter; but, this sinful act does not render the whole business of the borrower as haram or impermissible. The borrowed amount being recognized as owned by the borrower, anything purchased in exchange for that money is not unlawful. Therefore, the responsibility of committing a sinful act of borrowing on interest rests with the person who wilfully indulged in a transaction of interest, but this fact does not render the whole business of a company unlawful.

2.1. Conditions for Investment in Shares

In the light of the foregoing discussion, dealing in equity shares can be acceptable in *Shari'ah* subject to the following conditions:

1. The main business of the company is not violative of *Shari'ah*. Therefore, it is not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance companies, or the companies involved in some other business not approved by the *Shari'ah*, such as companies manufacturing, selling or offering liquors, pork, *haram* meat, or involved in gambling, night club activities, pornography etc.
2. If the main business of the companies is *halal*, like automobiles, textile, etc. but they deposit their surplus amounts in an interest-bearing account or borrow money on interest, the share holder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general meeting of the company.
3. If some income from interest-bearing accounts is included in the revenue of the company, the proportion of such income in the dividend paid to the shareholder must be given in charity, and must not be retained by him. For example, if 5 per cent of the whole income of a company has come out of interest-bearing deposits, 5 per cent of the dividend must be given in charity.
4. The shares of a company are negotiable only if the company owns some non-liquid assets. If all the assets of a company are in liquid form, i.e. in the form of money they cannot be purchased or sold except at par value, because in this case the share represents money only and the money cannot be traded in except at par.

What should be the exact proportion of non-liquid assets of a company for warranting the negotiability of its shares? Contemporary scholars have different views about this question. Some scholars are of the view that the ratio of non-liquid assets must be 51 per

cent in the least. They argue that if such assets are less than 50 per cent, then most of the assets are in liquid form, and therefore, all its assets should be treated as liquid on the basis of the juristic principle:

للأكثر حكم الكل

The majority deserves to be treated as the whole of a thing.

Some other scholars have opined that even if the non-liquid assets of a company are 33 per cent, its shares can be treated as negotiable.

The third view is based on the *Hanafi* jurisprudence. The principle of the *hanafi* school is that whenever an asset is a combination of liquid and non-liquid assets, it can be negotiable irrespective of the proportion of its liquid part. However, this principle is subject to two conditions.

Firstly, the non-liquid part of the combination must not be of an inconsequential quantity. It means that it should be in a considerable proportion.

Secondly, the price of the combination should be more than the value of the liquid amount contained therein. For example, if a share of $100 represents $75, plus some fixed assets, the price of the share must be more than $75. In this case, if the price of the share is fixed as $105, it will mean that $75 are in exchange of $75 owned by the share and the balance of $30 dollars is in exchange of the fixed assets. Conversely, if the price of that share is fixed as $70, it will not be allowed, because the $75 owned by the share are in this case against an amount which is less than $75. This kind of exchange falls within the definition of *'riba'* and is not allowed. Similarly, if the price of the share in the above example is fixed as $75, it will not be permissible because if we presume that $75 of the price are against $75 owned by the share, no part of the price can be attributed to the fixed assets owned by the share. Therefore, some *part* of the price ($75) must be presumed to be in exchange for the fixed assets of the share. In this case, the remaining amount will not be adequate for being the price of $75. For this reason the transaction will not be valid. However, in practical terms, this is merely a theoretical possibility, because it is difficult to imagine a situation where the price of a share goes lower than its liquid assets.

Subject to these conditions, the purchase and sale of shares is permissible in *Shari'ah*. An Islamic Equity Fund can be established on this basis. The subscribers to the Fund will be treated in *Shari'ah* as partners *inter se*. All the subscription amounts will form a joint pool and will be invested in purchasing the shares of different companies. The profits can accrue either through dividends distributed by the relevant companies or through the appreciation in the prices of the shares. In the first case i.e. where the profits are earned through dividends, a certain proportion of the dividend, which corresponds to the proportion of interest earned by the company, must be given in charity. The contemporary Islamic Funds have termed this process as 'purification'.

Shari'ah scholars have different views about whether this 'purification' is necessary where the profits are made through capital gains (i.e. by purchasing shares at a lower price and selling them at a higher price). Some scholars are of the view that even in the case of capital gains, the process of 'purification' is necessary, because the market price

of the share may reflect an element of interest included in the assets of the company. The other view is that no purification is required if the share is sold, even if it results in a capital gain. The reason is that no specific amount of the price can be allocated for the interest received by the company. It is obvious that if all the above requirements of the *halal* shares are observed, then most of the assets of the company are *halal*, and a very small proportion of its assets may have been created by the income of interest. This small proportion is not only unknown, but also ignorable as compared to the bulk of the assets of the company. Therefore, the price of the share, in fact, is against the bulk of the assets, and not against such a small proportion of income through interest. The whole price of the share therefore, may be taken as the price of the *halal* assets only.

Although this second view is not without force, yet the first view is more precautious and far from doubts. Particularly, it is more equitable in an open-ended equity fund, because if the purification is not carried out on the appreciation and a person redeems his unit of the Fund at a time when no dividend is received by it, no amount of purification will be deducted from its price, even though the price of the unit may have increased due to the appreciation in the prices of the shares held by the fund. Conversely, when a person redeems his unit after some dividends have been received in the fund and the amount of purification has been deducted therefrom, reducing the net asset value per unit, he will get a lesser price as compared to the first person.

On the contrary, if purification is carried out both on dividends and on capital gains, all the unit-holders will be treated at par with regard to the deduction of the amounts of purification. Therefore, it is not only free from doubts but also more equitable for all the unit holders to carry out purification in the capital gains also. This purification may be carried out on the basis of an average percentage of the interest earned by the companies included in the portfolio.

The management of the fund may be carried out in two alternative ways. The managers of the Fund may act as *mudaribs* for the subscribers. In this case a certain percentage of the annual profit accrued to the Fund may be determined as the reward of the management, meaning thereby that the management will get its share only if the fund has earned some profit. If there is no profit in the fund, the management will deserve nothing. The share of the management will increase with the increase of profits.

The second option for the management is to act as an agent for the subscribers. In this case, the management may be given a pre-agreed fee for its services. This fee may be fixed in lump sum or as a monthly or annual remuneration. According to the contemporary *Shari'ah* scholars, the fee can also be based on a percentage of the net asset value of the fund. For example, it may be agreed that the management will get 2 per cent or 3 per cent of the net asset value of the fund[1] at the end of every financial year.

However, it is necessary in *Shari'ah* to determine any one of the aforesaid methods before launching the fund. The practical way for this would be to disclose in the

[1] This way may be justified on the analogy of *simsar* (broker) for whom the fee based on percentage is allowed.

prospectus of the fund the basis on which the fees of the management will be paid. It is generally presumed that whoever subscribes to the fund agrees with the terms mentioned in the prospectus. Therefore, the manner of paying the management will be taken as agreed upon by all the subscribers.

3. *IJARAH* FUND

Another type of Islamic Fund may be an *ijarah* fund. *Ijarah* means leasing, the detailed rules of which have already been discussed in the third chapter of this book. In this fund the subscription amounts are used to purchase assets like real estate, motor vehicles or other equipments for the purpose of leasing them out to their ultimate users. The ownership of these assets remains with the Fund and the rentals are charged from the users. These rentals are the source of income for the fund which is distributed pro rata to the subscribers. Each subscriber is given a certificate to evidence his proportionate ownership in the leased assets and to ensure his entitlement to the pro rata share in the income. These certificates may preferably be called *sukuk* – a term recognized in the traditional Islamic jurisprudence. Since these *sukuk* represent the pro rata ownership of their holders in the tangible assets of the fund, and not the liquid amounts or debts, they are fully negotiable and can be sold and purchased in the secondary market. Anyone who purchases these *sukuk* replaces the sellers in the pro rata ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him. The price of these *sukuk* will be determined on the basis of market forces, and are normally based on their profitability.

However, it should be kept in mind that the contracts of leasing must conform to the principles of *Shari'ah* which substantially differ from the terms and conditions used in the agreements of conventional financial leases. The points of difference are explained in detail in the third chapter of this book. However, some basic principles are summarized here:

1. The leased assets must have some usufruct, and the rental must be charged only from that point of time when the usufruct is handed over to the lessee.
2. The leased assets must be of a nature that their *halal* (permissible) use is possible.
3. The lessor must undertake all the responsibilities consequent to the ownership of the assets.
4. The rental must be fixed and known to the parties right at the beginning of the contract.

In this type of fund the management should act as an agent of the subscribers and should be paid a fee for its services. The management fee may be a fixed amount or a proportion of the rentals received. Most of the Muslim jurists are of the view that such a fund cannot be created on the basis of *mudarabah*, because *mudarabah*, according to them, is restricted to the sale of commodities and does not extend to the business of services and

leases. However, in the *Hanbali* school, *mudarabah* can be effected in services and leases also. This view has been preferred by a number of contemporary scholars.

4. COMMODITY FUND

Another possible type of Islamic Funds may be a commodity fund. In a fund of this type the subscription amounts are used in purchasing different commodities for the purpose of resale. The profits generated by the sales are the income of the fund which is distributed *pro rata* among the subscribers.

In order to make this fund acceptable to *Shari'ah*, it is necessary that all the rules governing the transactions of sale are fully complied with. For example:

1. The commodity must be owned by the seller at the time of sale, because short sales in which a person sells a commodity before he owns it are not allowed in *Shari'ah*.
2. Forward sales are not allowed except in the case of *salam* and *istisna'* (For their full details the previous chapter of this book may be consulted).
3. The commodities must be *halal*. Therefore, it is not allowed to deal in wines, pork or other prohibited materials.
4. The seller must have physical or constructive possession over the commodity he wants to sell. (Constructive possession includes any act by which the risk of the commodity is passed on to the purchaser.)
5. The price of the commodity must be fixed and known to the parties. Any price which is uncertain or is tied to an uncertain event renders the sale invalid.

In view of the above and similar other conditions, more fully described in the second chapter of this book, it may easily be understood that the transactions prevalent in the contemporary commodity markets, specially in the futures commodity markets do not comply with these conditions. Therefore, an Islamic Commodity Fund cannot enter into such transactions. However, if there are genuine commodity transactions observing all the requirements of *Shari'ah*, including the above conditions, a commodity fund may well be established. The units of such a fund can also be traded in with the condition that the portfolio owns some commodities at all times.

5. *MURABAHAH* FUND

Murabahah is a specific kind of sale where the commodities are sold on a cost-plus basis. This kind of sale has been adopted by the contemporary Islamic banks and financial institutions as a mode of financing. They purchase the commodity for the benefit of their clients, then sell it to them on the basis of deferred payment at an agreed margin of profit added to the cost. If a fund is created to undertake this kind of sale, it should be a closed-end fund and its units cannot be negotiable in a secondary market. The reason is that in the case of *murabahah*, as undertaken by the present financial institutions, the

commodities are sold to the clients immediately after their purchase from the original supplier, while the price being on deferred payment basis becomes a debt payable by the client. Therefore, the portfolio of *murabahah* does not own any tangible assets. It comprises either cash or the receivable debts, Therefore, the units of the fund represent either the money or the receivable debts, and both these things are not negotiable, as explained earlier. If they are exchanged for money, it must be at par value.

6. *BAI'-AL-DAIN*

Here comes the question whether or not *bai'-al-dain* is allowed in *Shari'ah*. *Dain* means 'debt' and *bai'* means sale. *Bai'-al-dain*, therefore, connotes the sale of debt. If a person has a debt receivable from a person and he wants to sell it at a discount, as normally happens in the bills of exchange, it is termed in *Shari'ah* as *bai'-al-dain*. The traditional Muslim jurists (*fuqaha'*) are unanimous on the point that *bai'al-dain* with discount is not allowed in *Shari'ah*. The overwhelming majority of the contemporary Muslim scholars are of the same view. However, some scholars of Malaysia have allowed this kind of sale. They normally refer to the ruling of the *Shafi'ite* school wherein it is held that the sale of debt is allowed, but they did not pay attention to the fact that the *Shafi'ite* jurists have allowed it only in a case where a debt is sold at its par value.

In fact, the prohibition of *bai'-al-dain* is a logical consequence of the prohibition of *riba* or interest. A debt receivable in monetary terms corresponds to money, and every transaction where money is exchanged for the same denomination of money, the price must be at par value. Any increase or decrease from one side is tantamount to *riba* and can never be allowed in *Shari'ah*.

Some scholars argue that the permissibility of *bai'al-dain* is restricted to a case where the debt is created through the sale of a commodity. In this case, they say, the debt represents the sold commodity and its sale may be taken as the sale of a commodity. The argument, however, is devoid of force. For, once the commodity is sold, its ownership is passed on to the purchaser and it is no longer owned by the seller. What the seller owns is nothing other than money. Therefore if he sells the debt, it is no more than the sale of money and it cannot be termed by any stretch of imagination as the sale of the commodity.

That is why this view has not been accepted by the overwhelming majority of the contemporary scholars. The Islamic *Fiqh* Academy of Jeddah, which is the largest representative body of the *Shari'ah* scholars and has the representation of all the Muslim countries, including Malaysia, has approved the prohibition of *bai'-al-dain* unanimously without a single dissent.

7. MIXED FUND

Another type of Islamic Fund may be of a nature where the subscription amounts are employed in different types of investments, like equities, leasing, commodities etc. This may be called a Mixed Islamic Fund. In this case if the tangible assets of the Fund are more than 51 per cent while the liquidity and debts are less than 50 per cent, the units of the fund may be negotiable. However, if the proportion of liquidity and debts exceeds 50 per cent, its units cannot be traded according to the majority of the contemporary scholars. In this case the fund must be a closed-end fund.

CHAPTER 6

The Principles of Limited Liability

1. INTRODUCTION

The concept of limited liability has now become an inseparable ingredient of the large scale enterprises of trade and industry throughout the modern world, including the Muslim countries. The present chapter aims to explain this concept and evaluate it from the *Shari'ah* point of view in order to know whether or not this principle is acceptable in a pure Islamic economy.

Limited liability in the modern economic and legal terminology is a condition under which a partner or a shareholder of a business secures himself from bearing a loss greater than the amount he has invested in a company or partnership with limited liability. If the business incurs a loss, the maximum a shareholder can suffer, is that he may lose his entire original investment. But the loss cannot extend to his personal assets, and if the assets of the company are not sufficient to discharge all its liabilities, the creditors cannot claim the remaining part of their receivables from the personal assets of the shareholders.

Although the concept of limited liability was, in some countries, applied to partnership also, yet, it was most commonly applied to companies and corporate bodies. Perhaps it will be more true to say that the concept of limited liability originally emerged with the establishment of corporate bodies and joint stock companies. The basic purpose of the introduction of this principle was to attract the maximum number of investors to the large-scale joint ventures and to assure them that their personal fortunes will not be at stake, if they wish to invest their savings in such a joint enterprise. In the practice of modern trade, the concept proved itself to be a vital force to mobilize large amounts of capital from a wide range of investors.

No doubt, the concept of limited liability is beneficial to the shareholders of a company. But, at the same time, it may be injurious to its creditors. If the liabilities of a limited company exceed its assets, the company becomes insolvent and is consequently liquidated, the creditors may lose a considerable amount of their claims, because they can only receive the liquidated value of the assets of the company, and have no recourse to its shareholders for the rest of their claims. Even the directors of the company who may be responsible for such an unfortunate situation cannot be held responsible for satisfying the claims of the creditors. It is this aspect of the concept of limited liability which requires consideration and research from the *Shari'ah* viewpoint.

Although the concept of limited liability in the context of the modern commercial practice is a new concept and finds no express mention as such in the original sources of Islamic *Fiqh*, yet the *Shari'ah* viewpoint about it can be sought in the principles laid

down by the Holy Qur'an, the Sunnah of the Holy Prophet صلى الله عليه وسلم and Islamic jurisprudence. This exercise requires some sort of *ijtihad* carried out by the persons qualified for it. This *ijtihad* should preferably be undertaken by *Shari'ah* scholars at a collective level, yet, as a pre-requisite, there should be some individual efforts which may serve as a basis for the collective exercise.

As a humble student of *Shari'ah*, the author has been considering the issue for a long time, and what is going to be presented in this article should not be treated as a final verdict on this subject, nor an absolute opinion on the point. It is the outcome of an initial thinking on the subject, and the purpose of this article is to provide a foundation for further research.

The question of limited liability, it can be said, is closely related to the concept of juridical personality of the modern corporate bodies. According to this concept, a joint-stock company in itself enjoys the status of a separate entity as distinguished from the individual entities of its shareholders. The separate entity as a fictive person has legal personality and may thus sue and be sued, may make contracts, may hold property in its name, and has the legal status of a natural person in all its transactions entered into in the capacity of a juridical person.

The basic question, it is believed, is whether the concept of a juridical person' is acceptable in *Shari'ah* or not. Once the concept of 'juridical person' is accepted and it is admitted that, despite its fictive nature, a juridical person can be treated as a natural person in respect of the legal consequences of the transactions made in its name, we will have to accept the concept of limited liability which will follow as a logical result of the former concept. The reason is obvious. If a real person i.e. a human being, dies insolvent, his creditors have no claim except to the extent of the assets he has left behind. If his liabilities exceed his assets, the creditors will certainly suffer, no remedy being left for them after the death of the indebted person.

Now, if we accept that a company, in its capacity of a juridical person, has the rights and obligations similar to those of a natural person, the same principle will apply to an insolvent company. A company, after becoming insolvent, is bound to be liquidated: and the liquidation of a company corresponds to the death of a person, because a company after its liquidation, cannot exist any more. If the creditors of a real person can suffer, when he dies insolvent, the creditors of a juridical person may suffer too, when its legal life comes to an end by its liquidation.

Therefore, the basic question is whether or not the concept of juridical person' is acceptable to *Shari'ah*.

Although the idea of a juridical person, as envisaged by the modern economic and legal systems has not been dealt with in the Islamic *Fiqh*, yet there are certain precedents wherefrom the basic concept of a juridical person may be derived by inference.

1.1. *Waqf*

The first precedent is that of a *waqf*. The *waqf* is a legal and religious institution wherein a person dedicates some of his properties for a religious or a charitable purpose. The properties, after being declared as *waqf*, no longer remain in the ownership of the donor. The beneficiaries of a *waqf* can benefit from the corpus or the proceeds of the dedicated property, but they are not its owners. Its ownership vests in Allah Almighty alone.

It seems that Muslim jurists have treated the *waqf* as a separate legal entity and have ascribed to it some characteristics similar to those of a natural person. This will be clear from two rulings given by the *fuqaha'* (Muslim jurists) in respect of *waqf*.

Firstly, if a property is purchased with the income of a *waqf*, the purchased property cannot become a part of the *waqf* automatically. Rather, the jurists say, the property so purchased shall be treated as a property owned by the *waqf*.[1] It clearly means that a *waqf*, like a natural person, can own a property.

Secondly, the jurists have clearly mentioned that the money given to a mosque as a donation does not form part of the *waqf*, but it comes in the ownership of the mosque.[2]

Here again the mosque is accepted to be an owner of money. This principle has been expressly mentioned by some jurists of the *Maliki* school also. They have stated that a mosque is capable of being the owner of something. This capability of the mosque, according to them, is constructive, while the capability enjoyed by a human being is physical.[3]

Another renowned *Maliki* jurist, namely, Ahmad AlDardir, validates a bequest made in favour of a mosque, and gives the reason that a mosque can own properties. Not only this, he extends the principle to an inn and a bridge also, provided that they are *waqf*.

It is clear from these examples that the Muslim jurists have accepted that a *waqf* can own properties. Obviously, a *waqf* is not a human being, yet they have treated it as a human being in the matter of ownership. Once its ownership is established, it will logically follow that it can sell and purchase, may become a debtor and a creditor and can sue and be sued, and thus all the characteristics of a juridical person can be attributed to it.

1.2. *Baitul-Mal*

Another example of 'juridical person' found in our classic literature of *Fiqh* is that of the *baitul-mal* (the exchequer of an Islamic state). Being public property, all the citizens of an Islamic state have some beneficial right in the *baitul-mal*, yet, nobody can claim to be

[1] Al-Fatawa al-Hindiyyah, *Waqf*, Ch. 5, v. 2, p. 417.
[2] *Ibid.* v. 3, p. 240, see also I'laussunan v. 13, p. 198.
[3] See al-Khurashi on Khalil v. 7, p. 80.

its owner. Still, the *baitul-mal* has some rights and obligations. Imam Al-Sarakhsi, the well-known *Hanafi* jurist, says in his work *Al-Mabsut*:

> "The Baitul-mal has some rights and obligations which may possibly be undetermined."[4]

At another place the same author says:

> "If the head of an Islamic state needs money to give salaries to his army, but he finds no money in the Kharaj department of the Baitul-mal (wherefrom the salaries are generally given) he can give salaries from the *sadaqah* (*Zakah*) department, but the amount so taken from the *sadaqah* department shall be deemed to be a debt on the *Kharaj* department".[5]

It follows from this that not only the *baitul-mal*, but also the different departments therein can borrow and advance loans to each other. The liability of these loans does not lie on the head of state, but on the concerned department of *baitul-mal*. It means that each department of *baitul-mal* is a separate entity and in that capacity it can advance and borrow money, may be treated a debtor or a creditor, and thus can sue and be sued in the same manner as a juridical person does. It means that the *fuqaha* of Islam have accepted the concept of juridical person in respect of *baitul-mal*.

1.3. Joint Stock

Another example very much close to the concept of 'juridical person' in a joint stock company is found in the *Fiqh* of Imam *Shafi'i*. According to a settled principle of *Shafi'i* School, if more than one person run their business in partnership, where their assets are mixed with each other, the *zakah* will be levied on each of them individually, but it will be payable on their joint-stock as a whole, so much so that even if one of them does not own the amount of the *nisab*, but the combined value of the total assets exceeds the prescribed limit of the *nisab*, *zakah* will be payable on the whole joint-stock including the share of the former, and thus the person whose share is less than the *nisab* shall also contribute to the levy in proportion to his ownership in the total assets, whereas he was not subject to the levy of *zakah*, had it been levied on each person in his individual capacity.

The same principle, which is called the principle of *khultah-al-shuyu* is more forcefully applied to the levy of *zakah* on the livestock. Consequently, a person sometimes has to pay more *zakah* than he was liable to in his individual capacity, and sometimes he has to pay less than that.

That is why the Holy Prophet صلى الله عليه وسلم has said:

لا يجمع بين متفرق و لا يفرق بين مجتمع مخافة الصدقة

[4] Al-Mabsut by Sarakhsi v. 14, p. 33.
[5] *Op. cit.* v. 3, p. 18.

'The separate assets should not be joined together nor the joint assets should be separated in order to reduce the amount of Zakah levied on them.'

This principle of *khultah-al-shuyu* which is also accepted to some extent by the *Maliki* and *Hanbali* schools with some variance in details, has a basic concept of a juridical person underlying it. It is not the individual, according to this principle, who is liable to *zakah*. It is the joint-stock which has been made subject to the levy. It means that the joint-stock has been treated a separate entity, and the obligation of *zakah* has been diverted towards this entity which is very close to the concept of a juridical person, though it is not exactly the same.

1.4. Inheritance under Debt

The fourth example is the property left by a deceased person whose liabilities exceed the value of all the property left by him. For the purpose of brevity we can refer to it as 'inheritance under debt'.

According to the jurists, this property is neither owned by the deceased, because he is no more alive, nor is it owned by his heirs, for the debts on the deceased have a preferential right over the property as compared to the rights of the heirs. It is not even owned by the creditors, because the settlement has not yet taken place. They have their claims over it, but it is not their property unless it is actually divided between them. Being property of nobody, it has its own existence and it can be termed a legal entity. The heirs of the deceased or his nominated executor will look after the property as managers, but they are not the owners. If the process of the settlement of debt requires some expenses, the same will be met by the property itself.

Looked at from this angle, this 'inheritance under debt' has its own entity which may sell and purchase, becomes debtor and creditor, and has the characteristics very much similar to those of a juridical person.' Not only this, the liability of this juridical person' is certainly limited to its existing assets. If the assets do not suffice to settle all the debts, there is no remedy left with its creditors to sue anybody, including the heirs of the deceased, for the rest of their claims.

These are some instances where the Muslim jurists have affirmed a legal entity, similar to that of a juridical person. These examples would show that the concept of juridical person' is not totally foreign to the Islamic jurisprudence, and if the juridical entity of a joint-stock company is accepted on the basis of these precedents, no serious objection is likely to be raised against it.

As mentioned earlier, the question of limited liability of a company is closely related to the concept of a juridical person. If a juridical person can be treated as a natural person in its rights and obligations, then, every person is liable only to the limit of the assets he owns, and in case he dies insolvent, no other person can bear the burden of his remaining liabilities, however closely related to him he may be. On this analogy the limited liability of a joint-stock company may be justified.

1.5. The Limited Liability of the Master of a Slave

Here I should like to cite another example with advantage, which is the closest example to the limited liability of a joint-stock company. The example relates to a period of our past history when slavery was in vogue, and slaves were treated as the property of their masters and were freely traded in. Although the institution of slavery with reference to our age is something past and closed, yet the legal principles laid down by our jurists while dealing with various questions pertaining to the trade of slaves are still beneficial to a student of Islamic jurisprudence, and we can avail of those principles while seeking solutions to our modern problems and in this respect this example seems to be the most relevant to the question at issue. The slaves in those days were of two kinds. The first kind was of those who were not permitted by their masters to enter into any commercial transaction. A slave of this kind was called *qinn.* But there was another kind of slave who were allowed by their masters to trade. A slave of this kind was called العبد المأذون. The initial capital for the purpose of trade was given to such a slave by his master, but he was free to enter into all commercial transactions. The capital invested by him totally belonged to his master. The income would also vest in him, and whatever the slave earned would go to the master as his exclusive property. If in the course of trade, the slave incurred debts, the same would be set off by the cash and the stock present in the hands of the slave. But if the amount of such cash and stock would not be sufficient to set off the debts, the creditors had a right to sell the slave and settle their claims out of his price. However, if their claims would not be satisfied even after selling the slave, and the slave would die in that state of indebtedness, the creditors could not approach his master for the rest of their claims.

Here, the master was actually the owner of the whole business, the slave being merely an intermediary tool to carry out the business transactions. The slave owned nothing from the business. Still, the liability of the master was limited to the capital he invested including the value of the slave. After the death of the slave, the creditors could not have a claim over the personal assets of the master.

This is the nearest example found in the Islamic *Fiqh* which is very much similar to the limited liability of the shareholders of a company, which can be justified on the same analogy.

On the basis of these five precedents, it seems that the concepts of a juridical person and that of limited liability do not contravene any injunction of Islam. But at the same time, it should be emphasized, that the concept of 'limited liability' should not be allowed to work for cheating people and escaping the natural liabilities consequent to a profitable trade. So, the concept could be restricted to the public companies only who issue their shares to the general public and the number of whose shareholders is so large that each one of them cannot be held responsible for the day-to-day affairs of the business and for the debts exceeding the assets.

As for the private companies or the partnerships, the concept of limited liability should not be applied to them, because, practically, each one of their shareholders and partners

can easily acquire knowledge of the day-to-day affairs of the business and should be held responsible for all its liabilities.

There may be an exception for the sleeping partners or the shareholders of a private company who do not take part in the business practically and their liability may be limited as per agreement between the partners.

If the sleeping partners have a limited liability under this agreement, it means, in terms of Islamic jurisprudence, that they have not allowed the working partners to incur debts exceeding the value of the assets of the business. In this case, if the debts of the business exceed the specified limit, it will be the sole responsibility of the working partners who have gone beyond the limit.

The upshot of the foregoing discussion is that the concept of limited liability can be justified, from the *Shari'ah* viewpoint, in the public joint-stock companies and those corporate bodies only who issue their shares to general public. The concept may also be applied to the sleeping partners of a firm and to the shareholders of a private company who take no active part in the business management. But the liability of the active partners in a partnership and active shareholders of a private company should always be unlimited.

7

The Performance of The Islamic Banks – A Realistic Evaluation

Islamic banking has become today an undeniable reality. The number of Islamic banks and the financial institutions is ever increasing. New Islamic Banks with huge amount of capital are being established. Conventional banks are opening Islamic windows or Islamic subsidiaries for the operations of Islamic banking. Even the non-Muslim financial institutions are entering the field and trying to compete each other to attract as many Muslim customers as they can. It seems that the size of Islamic banking will be multiplied during the next decade and the operations of Islamic banks are expected to cover a large area of financial transactions of the world. But before the Islamic financial institutions expand their business, they should evaluate their performance during the last two decades, because every new system has to learn from the experience of the past to revise its activities and to analyse its deficiencies in a realistic manner. Unless we analyse our merits and demerits we cannot expect to advance towards our total success. It is in this perspective that we should seek to analyse the operations of Islamic banks and financial institutions in the light of *Shari'ah* and to highlight what they have achieved and what they have missed.

Once, during a press conference in Malaysia, the author was asked a question about the contribution of the Islamic Banks in promoting the Islamic economy. My reply to the question was apparently contradictory, I said 'they have contributed a lot and they have contributed nothing'. In the present chapter an attempt has been made to elaborate upon this reply.

When it was said that they have contributed a lot, what was meant is that it was a remarkable achievement of the Islamic banks that they have made a great breakthrough in the present banking system by establishing Islamic financial institutions meant to follow *Shari'ah*. It was a cherished dream of the Muslim Ummah to have an interest-free economy, but the concept of Islamic banking was merely a theory discussed in research papers, having no practical example. It was the Islamic banks and financial institutions which translated the theory into practice and presented a living and practical example for the theoretical concept in an environment where it was claimed that no financial institution can work without interest. It was indeed a courageous step on the part of the Islamic banks to come forward with a firm resolution that all their transactions will conform to *Shari'ah* and all their activities will be free from all transactions involving interest.

Another major contribution of the Islamic banks is that, being under the supervision of their respective *Shari'ah* Boards, they have presented a wide spectrum of questions relating to modern business to the *Shari'ah* scholars, thus providing them with an opportunity not only to understand the contemporary practice of business and trade but

also to evaluate it in the light of *Shari'ah* and to find out other alternatives which may be acceptable according to the Islamic principles.

It must be understood that when we claim that Islam has a satisfactory solution for every problem emerging in any situation in all times to come, we do not mean that the Holy Quran or the Sunnah of the Holy Prophet (SW) or the rulings of the Islamic scholars provide a specific answer to each and every minute detail of our socio-economic life. What we mean is that the Holy Quran and the Sunnah of the Holy Prophet صلى الله عليه وسلم have laid down broad principles in the light of which the scholars of every time have deduced specific answers to the new situation arising in their age. Therefore, in order to reach a definite answer about a new situation the scholars of *Shari'ah* have to play a very important role. They have to analyse every new question in the light of the principles laid down by the Holy Quran and Sunnah as well as in the light of the standards set by the earlier jurists, enumerated in the books of Islamic jurisprudence. This exercise is called *Istinbat* or *Ijtihad.* It is this exercise which has enriched the Islamic jurisprudence with a wealth of knowledge and wisdom for which no parallel is found in any other religion. In a society where the *Shari'ah* is implemented in its full sway, the ongoing process of *Istinbat* keeps injecting new ideas, concepts and rulings into the heritage of Islamic jurisprudence which makes it easier to find out specific answer to almost every situation in the books of Islamic jurisprudence. But during the past few centuries, the political decline of the Muslims stopped this process to a considerable extent. Most of the Islamic countries were captured by non-Muslim rulers who, by enforcing with power the secular system of government, deprived the socio-economic life of the guidance provided by the *Shari'ah*, and the Islamic teachings were restricted to a limited sphere of worship, religious education and in some countries to the matters of marriage, divorce and inheritance only. So far as the political and economic activities are concerned, the governance of *Shari'ah* was totally rejected.

Since the evolution of any legal system depends on its practical application, the evolution of Islamic law with regard to business and trade was hindered by this situation. Almost all the transactions in the market, being based on secular concepts, were seldom brought to the *Shari'ah* scholars for their scrutiny in the light of *Shari'ah*. It is true that even in these days some practising Muslims brought some practical questions before the *Shari'ah* scholars for which the scholars have been giving their rulings in the forms of *fatwas* of which a substantial collection is still available. However, all these *fatwas* related mostly to the individual problems of the relevant persons and addressed their individual needs.

It is a major contribution of the Islamic banks that, because of their entry into the field of large-scale business, the wheel of evolution of Islamic legal system has re-started. Most of the Islamic banks are working under the supervision of their *Shari'ah* Boards. They bring their day-to-day problems before the *Shari'ah* scholars who examine them in the light of Islamic rules and principles and give specific rulings about them. This procedure not only makes *Shari'ah* scholars more familiar with the new market situation, but also through their exercise of *istinbat*, contributes to the evolution of Islamic jurisprudence. Thus, if a practice is held to be un-Islamic by the *Shari'ah* scholars, a

suitable alternative is also sought by the joint efforts of the *Shari'ah* scholars and the management of the Islamic banks. The resolutions of the *Shari'ah* Boards have by now produced dozens of volumes – a contribution which can never be underrated.

Another major contribution of the Islamic banks is that they have now asserted themselves in the international market, and Islamic banking as distinguished from conventional banking is being gradually recognized throughout the world. This is how I explain my comment that they have contributed a lot.

On the other hand, there are a number of deficiencies in the working of the present Islamic banks which should be analysed with all seriousness.

First of all, the concept of Islamic banking was based on an economic philosophy underlying the rules and principles of *Shari'ah*. In the context of interest-free banking, this philosophy aimed at establishing distributive justice free from all sorts of exploitation. As I have explained in a number of articles, the instrument of interest has a constant tendency in favour of the rich and against the interests of the common people. The rich industrialists, by borrowing huge amounts from the bank, utilize the money of the depositors in their huge profitable projects. After they earn profits, they do not let the depositors share these profits except to the extent of a meagre rate of interest, and this is also taken back by them by adding it to the cost of their products. Therefore, looked at from macro level, they pay nothing to the depositors. While in the extreme cases of losses which lead to their bankruptcy and the consequent bankruptcy of the bank itself, the whole loss is suffered by the depositors. This is how interest creates inequity and imbalance in the distribution of wealth.

Contrary to this is the case of Islamic financing. The ideal instrument of financing according to *Shari'ah* is *musharakah* where the profits and losses both are shared by both the parties according to equitable proportion. *Musharakah* provides better opportunities for the depositors to share actual profits earned by the business which in normal cases may be much higher than the rate of interest. Since the profits cannot be determined unless the relevant commodities are completely sold, the profits paid to the depositors cannot be added to the cost of production, therefore, unlike the interest-based system, the amount paid to the depositors cannot be claimed back through increase in the prices.

This philosophy cannot be translated into reality unless the use of *musharakah* is expanded by the Islamic banks. It is true that there are practical problems in using the *musharakah* as a mode of financing, especially in the present atmosphere where the Islamic banks are working in isolation, and mostly without the support of their respective governments. The fact, however, remains that the Islamic banks should have advanced towards *musharakah* in gradual phases and should have increased the size of *musharakah* financing. Unfortunately, the Islamic banks have overlooked this basic requirement of Islamic banking and there are no visible efforts to progress towards this transaction even in a gradual manner, even on a selective basis. This situation has resulted in a number of adverse factors:

Firstly, the basic philosophy of Islamic banking seems to be totally neglected. Secondly, by ignoring the instrument of *musharakah*, the Islamic banks are forced to use the instrument of *murabahah* and *ijarah* and these too, within the framework of the

conventional benchmarks like LIBOR etc. where the net result is not materially different from the interest-based transactions. Nevertheless, I do not subscribe to the view of those people who do not find any difference between the transactions of conventional banks and *murabahah* and *ijarah* and who blame the instruments of *murabahah* and *ijarah* for perpetuating the same business with a different name, because if *murabahah* and *ijarah* are implemented with their necessary conditions, they have many points of difference which distinguish them from interest-based transactions. However, one cannot deny that these two transactions are not originally modes of financing in *Shari'ah*. The *Shari'ah* scholars have allowed their use for financing purposes only in those spheres where *musharakah* cannot work and that too with certain conditions. This allowance should not be taken as a permanent rule for all sorts of transactions and the entire operations of Islamic Banks should not revolve around it.

Thirdly, when people realize that the income generated from these transactions undertaken by Islamic banks is akin to the transactions of conventional banks, they become sceptical towards the functioning of Islamic banks.

Fourthly, if all the transactions of Islamic banks are based on the above devices, it becomes very difficult to argue for the case of Islamic banking before the masses, especially before the non-muslims who feel that it is nothing but a matter of twisting of documents only.

It is observed in a number of Islamic banks that even *murabahah* and *ijarah* are not effected according to the procedure required by the *Shari'ah*. The basic concept of *murabahah* was that the bank should purchase the commodity and then sell it to the customer on deferred payment basis at a margin of profit. From the *Shari'ah* point of view it is necessary that the commodity should come into the ownership and at least in the constructive possession of the bank before it is sold to the customer. The bank should bear the risk of the commodity during the period it is owned and possessed by the bank. It has been observed that many Islamic banks and financial institutions commit a number of mistakes with regard to this transaction.

Some financial institutions have presumed that *murabahah* is the substitute for interest, for all practical purposes. Therefore, they contract a *murabahah* even when the client wants funds for his overhead expenses like paying salaries or bills for the goods and services already consumed. Obviously *murabahah* cannot be effected in this case because no commodity is being purchased by the bank.

In some cases, the client purchases the commodity on his own prior to any agreement with the Islamic Bank and a *murabahah* is effected on a buy-back basis. This is again contrary to the Islamic principles because the buy-back arrangement is unanimously held as prohibited in *Shari'ah*.

In some cases, the client himself is made an agent for the bank to purchase a commodity and to sell it to himself immediately after acquiring the commodity. This is not in accordance with the basic conditions of the permissibility of *murabahah*. If the client himself is made an agent to purchase the commodity, his capacity as an agent must be distinguished from his capacity as a buyer which means that after purchasing a commodity on behalf of the bank, he must inform the bank that he has effected the

purchase on its behalf and then the commodity should be sold to him by the bank through a proper offer and acceptance which may be effected through the exchange of telexes, faxes or e-mails.

As explained earlier, *murabahah* is a kind of sale and it is an established principle of *Shari'ah* that the price must be determined at the time of sale. This price can neither be increased nor reduced unilaterally, once it is fixed by the parties. It is observed that some financial institutions increase the price of *murabahah* in the case of late payment which is not allowed in *Shari'ah*. Some financial institutions roll-over the *murabahah* in the case of default by the client. Obviously, this practice is not warranted by *Shari'ah* because once the commodity is sold to the customer, it cannot be the subject matter of another sale to the same customer.

In transactions of *ijarah* also, some requirements of *Shari'ah* are often overlooked. It is a prerequisite for a valid *Ijarah* that the lessor bears the risks related to the ownership of the leased asset and that the usufruct of the leased asset must be made available to the lessee for which he pays rent. It is observed in a number of *Ijarah* agreements that these rules are violated. Even in the case of destruction of the asset due to force majeure, the lessee is required to keep paying the rent which means that the lessor neither assumes the liability for his ownership nor offers any usufruct to the lessee. This type of *ijarah* is against the basic principles of *Shari'ah*.

The Islamic banking is based on principles different from those followed in conventional banking system. It is therefore logical that the results of their operations are not necessarily the same in terms of profitability. An Islamic bank may earn more in some cases and may earn less in some others. If our target is always to match the conventional banks in terms of profits, we can hardly develop our own products based on pure Islamic principles. Unless the sponsors of the bank as well as its management and its clientele realize this fact and are ready to accept different – but not necessarily adverse - results, the Islamic banks will keep using artificial devices and a true Islamic system will not come into being.

According to the Islamic principles, business transactions can never be separated from the moral objectives of the society. Therefore, Islamic banks were supposed to adopt new financing policies and to explore new channels of investments which may encourage development and support the small scale traders to lift up their economic level. A very few Islamic banks and financial institutions have paid attention to this aspect. Unlike the conventional financial institutions who strive for nothing but making enormous profits, the Islamic banks should have taken the fulfilment of the needs of the society as one of their major objectives and should have given preference to the products which may help the common people to raise their standard of living. They should have invented new schemes for house-financing, vehicle-financing and rehabilitation-financing for the small traders. This area still awaits attention of the Islamic banks.

The case of Islamic banking cannot be advanced unless a strong system of inter-bank transactions based on Islamic principles is developed. The lack of such a system forces the Islamic banks to turn to the conventional banks for their short term needs of liquidity which the conventional banks do not provide without either an open or camouflaged

interest. The creation of an inter-bank relationship based on Islamic principles should no longer be deemed difficult. The number of Islamic financial institutions today has reached around two hundred. They can create a fund with a mixture of *murabahah* and *ijarah* instruments, the units of which can be used even for overnight transactions. If they develop such a fund, it may solve a number of problems.

Lastly, the Islamic banks should develop their own culture. Obviously, Islam is not restricted to the banking transactions. It is a set of rules and principles governing the whole human life. Therefore, for being 'Islamic' it is not sufficient to design the transactions on Islamic principles. It is also necessary that the outlook of the institution and its staff reflects the Islamic identity, quite distinguished from the conventional institution. This requires a major change in the general attitude of the institution and its management. Islamic obligations of worship as well as the ethical norms must be prominent in the whole atmosphere of an institution which claims to be Islamic. This is an area in which some Islamic institutions in the Middle East have made progress. However, it should be a distinguishing feature of all the Islamic banks and financial institutions throughout the world. The guidance of *Shari'ah* Boards should be sought in this area also.

The purpose of this discussion, as clarified at the outset, is by no means to discourage the Islamic Banks or to find faults with them. The only purpose is to persuade them to evaluate their own performance from the *Shari'ah* point of view and to adopt a realistic approach while designing their procedures and determining their policies.

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