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3. Islamic Banking in non-Muslim countries
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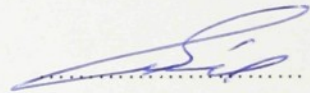


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## Annotation

The Diploma Work is oriented to the especially of Islamic banking. The aim of the study is to explain the basic pillars controlling all processes of financial saving and investment to be in harmony with qur'an ideas.

The essential framework is given by Shari'ah comprising, the main principles and rules for financial transactions as well as the conditions under which they are to be provided. Respects are given for problems in implementing the profit and loose sharing scheme, for Islamic banks in non-Muslim countries, differences, similarities, and comparisons with the conventional banking in developed countries. Some points of view and criteria's in these connections are discussed.

In conclusion challenges and goals facing Islamic banking are drawn.

Práce je zaměřená na zvláštnosti Islámského bankovníctví cílem studie je vysvětlit základní pilíře řídící procesy finančních úspor a investice, aby byly v souladu s ideami Koránu.

Podstata systému je dána "Shariah" obsahující hlavní principy a pravidla pro finanční transakce, jakož i podmínky, na jejichž základě mají být prováděny. Pozornost je směřována k problémům při zavedení modelů podílení se na ziscích a ztrátách islámských bank v nemuslimských zemích, rozdílům, podobnostem a porovnáním s konvenčními bankami ve vyspělých zemích. Jsou diskutovány některé názory a kriteria v těchto souvislostech.

V závěru jsou načrtnuty výzvy a cíle stojící před islámským bankovníctvím.



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## A. Introduction:

For millions of Muslims, banks are institutions to be avoided. Islam is a religion, which keeps Believers from the teller's window. Their Islamic beliefs prevent them from dealings that involve usury or interest (Riba). Yet Muslims need banking services as much as anyone and for many purposes: to finance new business ventures, to buy a house, to buy a car, to facilitate capital investment, to undertake trading activities, and to offer a safe place for savings. Muslims are not averse to legitimate profit as Islam encourages people to use money in Islamically legitimate ventures, not just to keep their funds idle.

However, in this fast moving world, more than 1400 years after the Prophet Mohamed, can Muslims find room for the principles of their religion? The answer comes with the fact that a global network of Islamic banks, investment houses and other financial institutions has started to take shape based on the principles of Islamic finance laid down in the Qur'an and the Prophet's traditions 14 centuries ago. Islamic banking, based on the Qur'anic prohibition of charging interest, has moved from a theoretical concept to embrace more than 100 banks operating in 40 countries with multi-billion dollar deposits world-wide. Islamic banking is widely regarded as the fastest growing sector in the Middle Eastern financial services market. Exploding onto the financial scene barely thirty years ago, an estimated USD 70 billion worth of funds are now managed according to Shari'ah. Deposit assets held by Islamic banks were approximately USD5 billion in 1985 but grew over \$80USD billion in 2000.<sup>1</sup>

The Qur'an forbids the charging of Riba or interest on money lent. It is important to understand certain principles of Islam that underpin Islamic finance. The Shari'ah consists of the Qur'anic commands as laid down in the Holy Qur'an and the words and deeds of the Prophet Muhammad . The Shari'ah disallows Riba and there is now a general consensus among Muslim economists that Riba is not restricted to usury but encompasses interest as well. The Qur'an is clear about the prohibition of

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<sup>1</sup> Siddiqi, A: Anthology of Islamic banking. 2000 (47)



Riba, which is sometimes defined as excessive interest. "O You who believe! Fear Allah and give up that remains of your demand for usury, if you are indeed believers." (Qur'an). Muslim scholars have accepted the word Riba to mean any fixed or guaranteed interest payment on cash advances or on deposits. Several Qur'anic passages expressly admonish the faithful to shun interest.

### **The Sources of The Shari'a**

The primary source of the Shari'a is the Quran, the literal word of God. The Quran deals with a full range of issues ranging from the establishment of the creed to defining the absolute moral standards and codes of permissible and impermissible behavior. It delineates the articles of worship, and lays down the framework of a comprehensive legal system relating to family law, economic rules, penal code, social conduct, treaties, ethics of war and peace, pattern of government (the Shura is considered the Islamic forerunner of democracy), human rights, relations with other nations and other religions, inheritance, (Zakat) taxation, etc., so that it is true to say that there is hardly an affair of life that lacks some reference in the Quran. Yet the ultimate and final rules in the Quran pertain only to the issues of Creed (Aqeeda) and Worship (Ibadat), whereas the third area of law and other human interaction (Moamalat) is, with a limited number of exceptions, covered with general and flexible guidelines. The constants of the Shari'a in Moamalat are therefore limited, which allowed the science of Jurisprudence (derivation of rulings) to arise and flourish, accommodating various schools of thought and amassing over the centuries a wealth of opinions that suited various places and times and proved that the Shari'a is neither static nor exhaustible.

The second source of the Shari'a is the Sunna (Tradition) of prophet Mohammad in what he ordered, forbade, did or acknowledged in his capacity as prophet. The Sunna sometimes explains the Quran, illustrates it, details some generalities and complements it in some areas.<sup>2</sup>

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<sup>2</sup> Siddiqi, A: Anthology of Islamic banking. 2000,(51)



The third source of the Shari'a operates when an issue is not specifically settled by the Quran or the Sunna. Analogy is resorted to through a process of deductive reasoning that equates a new issue with one already decided by the Quran and/or Sunna. "Ijtihad" is the term indicating the utilization of available evidence (religious, scientific, statistical, social) to think out the best course to be taken provided it does not conflict with the Quran or Sunna or the goals of the Shari'a. The Shari'a therefore is not a rigid set of rules to be copied and applied any time any place, and allows for human ingenuity to address changeable situations by progressive legislation. During the evolution of the science of Jurisprudence certain juridical rules were established to enable derivation of new rulings. Examples of these are "Necessities overrule prohibitions" For example, pig meat is unlawful to eat, but if it is the only food available for a traveler lost in the desert, it becomes permissible as long as necessary. Other rules include "The choice of the lesser of two evils if both cannot be avoided", "Public interest to take priority over private interest", "Harm is to be removed" etc. The overall rule, given no conflict with the Quran and Sunna, is "Wherever welfare goes, there goes the statue of God."

## **B. Islamic Financial tools:**

### **B.1. Commercial tools:**

#### **B.1.1. Murabahah**

Murabahah, a term in Islamic Fiqh, refers to a particular kind of sale. In a Murabahah transaction, a seller agrees with his buyer to provide a specific commodity with a certain amount of profit added to the initial cost. The basic component 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 the form of a fixed lump sum or based on a percentage.

Payment in Murabahah may either be done on the spot or at a future date as agreed by the parties. Murabahah does not necessarily imply the concept of deferred payment.

The term "Murabahah", therefore, simply meant is a sale. However, Islamic banks and financial institutions now use Murabahah as a mode of financing. The validity of such transactions, however, depends on some conditions, which should be duly observed to make them acceptable in Shari'ah<sup>3</sup>.

In order to understand these conditions correctly, one should appreciate that Murabahah is a sale that has its own implications, and that all the basic ingredients of a valid sale should be present in Murabahah.

- Murabahah is a particular kind of sale where the seller expressly tells the buyer how much cost he has incurred and how much profit he is going to charge in addition to that cost.
- 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.

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<sup>3</sup> Khan, A: Islamic Economic and finance. 1995 (65)



- All expenses incurred by the seller in acquiring the commodity e.g. freight, customs 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 staff, the rent of premises etc. cannot be included in the cost of an individual transaction. The profit claimed over the cost should take cover these expenses.
- 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 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:** Person A purchased a pair of shoes for USD 100. He wants to sell it on Murabahah with a 10% mark-up. The exact cost is known. The Murabahah sale is valid.

**Example 2:** Person A purchased a ready-made suit with a pair of shoes in a single transaction, for lump sums price of USD 500. He can sell the suit and the shoes on Murabahah. He cannot however, 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.<sup>4</sup>

#### **B.1.1.2.Murabahah as a mode of financing**

According to Islamic Shari'ah, the ideal mode of financing is Mudharabah or Musharakah. However, within the existing economic framework, there are certain practical difficulties in using Mudharabah and Musharakah in some areas of financing. Therefore, contemporary Shari'ah experts have allowed, subject to certain conditions, the use of the Murabahah on deferred payment basis, as a mode of financing.

There are some essential points, which must be fully understood in this respect:

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<sup>4</sup> Khan, A: Islamic Economic and Finance. 1995 (68)



- It is essential to remember that, originally, Murabahah was not a mode of financing. Currently it is only a device to escape from "interest" and not an ideal instrument for carrying out the real economic objectives of Islam. Therefore, this Murabahah should only be used as a transitory step taken in the process of the Islamisation of the economy, and its use should be restricted to cases where Mudharabah or Musharakah are not feasible.
- A Murabahah transaction does not come into existence by merely replacing the word "interest" with the words "profit" or "mark-up". Shari'ah scholars have only allowed Murabahah as a mode of financing subject to stringent conditions. Unless these conditions are fully observed, Murabahah is not permissible. Essentially, 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.<sup>5</sup>
- 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.
- Being a sale, Murabahah should fulfil all the conditions necessary for a valid sale. Which are in the further text.
- Murabahah can only be used as a mode of financing when the client needs funds to actually purchase some commodities. For example, if the client wants funds to purchase raw material for his factory, the Bank can sell him the raw material on the basis of Murabahah. If however, the funds are required for other purposes, e.g. paying the price for commodities already purchased, electricity bills or staff salaries, Murabahah cannot be effected because Murabahah requires a real sale of commodities, and not merely advancing a loan.
- The financier must own the commodity before it is sold to the client.
- The commodity must come into the possession of the financier, whether physical or constructive, in order that he bears the risk, even if for a short period.



- According to Shari'ah principles, the best method for Murabahah is that the financier purchases the commodity and keeps it in his possession, or purchases the commodity through a third person appointed as an agent, before it is sold onto the customer. However, in exceptional cases, where direct purchase from the supplier is not possible, the financier can appoint the customer as an agent to buy the commodity on his behalf. In this case the client purchases the commodity on behalf of the financier and takes possession as such. Thereafter, the commodity is purchased from the financier at a deferred price. The client's possession over the commodity in the first instance is in the capacity of an agent of the financier. In this capacity the client is only a trustee, while the ownership vests in the financier and the risk of the commodity is also borne as a logical consequence of the ownership. But when the client purchases the commodity from the financier, the ownership, as well as the risk, is transferred to the client.

- 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. Taking into consideration the aforementioned principles, a financial institution can use Murabahah as a mode of financing by adopting the following procedure:

- a) The institution may ask the client to furnish a security for the prompt payment of the deferred price. They may also ask the client to sign a promissory note or a bill of exchange, but only after the actual sale takes place, i.e. at the final stage mentioned. The objective is that a debtor in favor of his creditor signs the promissory note, but the relation of debtor and creditor between the institution and the client begins only at the final stage, whereupon the actual sale takes place between them.

- b) If the buyer defaults in paying at the due date, the price cannot be increased. However, if an agreement has been undertaken to pay an amount for a charitable purpose, as mentioned in paragraph 7 of the rules of Bai' Mu'ajjal, the buyer shall be liable to pay the amount undertaken. However the amount recovered from the buyer

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<sup>5</sup> Siddiqi, A: Anthology of Islamic Banking. 2000 (74)



shall not form part of the income of the financier, who is bound to spend it for a charitable purpose on behalf of the buyer.<sup>6</sup>

### **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 stipulated many rules governing the contract of sale, whilst Muslim jurists have written a large number of books, to elaborate on them. The following is a summary of only those rules, which are more relevant to the transactions of Murabahah, as carried out by financial institutions:

- The subject of sale must exist at the time of sale. Something, 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.<sup>7</sup>

**Example:** The sale of an unborn calf. The sale is void.

- The subject of sale must be in the ownership of the seller at the time of sale. What the seller does not own, cannot be sold. If something is sold before acquiring its ownership, the sale is void.

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

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

**Example 1:** A has purchased a car from B, who has not yet delivered it to A or to his agent. A cannot sell the car to C. If he sells it before collecting it from B, the sale is void.

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<sup>6</sup> Khan, A: Islamic Economics and Finance.2000 (95)



**Explanation 1:** Essentially a person cannot sell a commodity unless:

- i. It has come into existence;
- ii. The seller owns it;
- iii. It is in the physical or constructive possession of the seller.

**Explanation 2:** There exists a great 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 them.

The actual sale will have to be effected after the commodity comes into the possession of the seller. This will require a separate offer and acceptance, and unless the sale is affected in this manner, it will not be valid.<sup>8</sup>

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<sup>7</sup> Siddiqi, A: Anthology of Islamic Banking. 2000 (89)

### B.1.2. Ijarah (leasing)

"Ijarah" is a term of Islamic Fiqh. Literally, it means 'to give something on rent'. In Islamic jurisprudence, the term 'Ijarah' is used for two different situations. Firstly 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 'Mustajir' while the employee is called 'Ajir'.

This form of Ijarah includes every transaction where someone else hires the services of a person. It may be a doctor, a lawyer, a teacher, a laborer 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 'Mustajir'.

**For example** if A has employed B in his office as a manager or as a clerk on a monthly salary, A is Mustajir 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 Mustajir while the porter is an Ajir, and in both cases the transaction between the parties is termed as Ijarah.

The second type of Ijarah relates to the usufructs of assets and properties, and not to the services of human beings. 'Ijarah' in this situation means "to transfer the usufruct of a particular property to another person in exchange for rent claimed. In this case, the term 'Ijarah' is equivalent to the English term 'leasing'. The lessor is called 'Mujir', the lessee is called 'Mustajir' and the rent payable to the lessor is called 'Ujrah'.

This type of Ijarah is generally used as a form of investment, and also as a mode of financing.<sup>9</sup>

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 difference between Ijarah and a sale is that in the latter

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<sup>8</sup> Khan, A: Islamic Economic and Finance. 1995 (117)

<sup>9</sup> Khan, A: Islamic economic and Finance. 1995 (144)



case the majority of the property is transferred to the purchaser. 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.<sup>10</sup> However, due to certain reasons, and in particular, due to some tax concessions it may carry, this transaction is also being used in the Western countries for the purpose of financing.

Instead of giving a simple interest-bearing loan, some financial institutions started leasing some equipment to their customers. While fixing the rent of this equipment, they calculate the total cost they have incurred in the purchase of these assets and add the agreed profit margin. The aggregate amount so calculated is divided on the total months of the lease period, and the monthly rent is fixed on that basis.

### **Basic rules of leasing:**

- Leasing is a contract whereby the owner of something transfers its usufruct to another person for an agreed period, at an agreed consideration.
- The subject of lease must have a valuable use. Subjects with no usufruct at all cannot be leased.
- It is necessary for a valid lease contract that the corpus of the leased property remains in the ownership of the subject, and only its usufruct is transferred to the lessee. Anything, which cannot be used without consuming, cannot be leased out. Therefore, the lease cannot be effected in respect of money, consumables, 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 as a loan and all rules concerning the loan transaction shall apply accordingly. Any rent that is charged on an invalid lease shall be considered interest that is charged on a loan.
- 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.

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<sup>10</sup>Khan, A: Islamic Economic and Finance. 1995 (152)

**For 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.

- The period of lease must be clearly defined.
- The leased asset cannot be used 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 for which it would normally be used.
- The lessee is liable to compensate the lessor for any damage to the asset caused by any misuse or negligence on the part of the lessee.
- The leased asset shall remain in the risk of the lessor throughout the lease period. Any harm or loss caused by factors beyond the control of the lessee shall be borne by the lessor.
- A property jointly owned by two or more persons can be leased out. The rental shall be distributed between all the joint owners according to the proportion of their respective shares in the property.
- A joint owner of a property can lease a proportionate share to a co-sharer only, and not to any other person.
- It is necessary for a valid lease that the leased asset is fully identified by the parties.<sup>11</sup>

For 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.

### Determination of Rental

Rental must be determined at the time of contract for the whole period of lease. It is permissible to fix different amounts of rent for different phases during the lease



period. However this is dependent upon the rent for each phase is specifically agreed upon at the time of affecting 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.<sup>12</sup>

Example 1: A leases his house to B for a total period of 5 years. The rent for the first year is fixed as USD2000/- per month and it is agreed that the rent of every subsequent year shall be 10% more than the previous one. The lease is valid.<sup>13</sup>

Example 2: A now puts a condition in the agreement that the rent of USD2000/- 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.<sup>14</sup>

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 permissible according to the rules of Shari'ah. This is only applicable if both parties agree and all other conditions of a valid lease prescribed by the Shari'ah are fully adhered to.

The lessor cannot increase the rent unilaterally, and any agreement to this effect is void. The rent or any part thereof may be paid in advance before commencement of the lease. However, the amount collected by the lessor shall remain as 'on account' payment and shall be adjusted towards the rent after it is due.

The lease period shall commence from the date on which the leased asset has been delivered to the lessee. If the leased asset no longer is functional for the what it was leased out as, the lease shall be 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, then liability for compensation for the depreciated value of the asset falls onto the lessee.

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<sup>11</sup> Khan, A: Islamic Economic and Finance. 1995 (163)

<sup>12</sup> Zafar, A: Islamic Banking and it's Operations. 1999(85)

<sup>13</sup> Zafar, A: (86)

<sup>14</sup> Zafar, A: (86)



### **B.1.2.1. Leasing as a mode of Financing**

In the same context as Murabahah, leasing was not originally a mode of financing. It is simply a transaction 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 form of leasing is referred to as a 'financial lease' distinguished from the 'operating lease'. Many basic features of an actual leasing transaction have been dispensed with therein.

When interest-free financial institutions were established, leasing was found to be a recognized mode of finance throughout the world. It was also determined that leasing is a lawful transaction according to Shari'ah and can be used as an interest-free mode of financing.

Despite leasing being adopted by many Islamic financial institutions, few institutions have paid attention to the fact that a 'financial lease' has a number of characteristics more similar to interest than to an actual lease transaction. Furthermore the usage of model agreements of leasing, similar to those within conventional financial institutions does not conform to Shari'ah principles.

Although leasing was not originally a mode of financing, it may be used as an action for financing, subject to certain conditions. However, it is not sufficient to simply substitute the name of 'interest' by the name of 'rent' and replace the name of 'mortgage' by the name of 'leased asset'. A substantial difference between leasing and an interest-bearing loan must clearly exist.

#### Different relationship between the parties

Two separate relationships are created, when the lessee has been entrusted with purchase of the leased asset. In the first instance, the client is an agent of the institution employed to purchase the asset on latter's behalf. At this stage, the



relationship between the parties is simply of a principal and an agent. The relationship of lessor and lessee has not yet come into operation. The second relationship begins when the client takes delivery from the supplier. At this point, the relationship of lessor and lessee is created.

In the case of the first relationship, the client cannot be held liable for the obligations of a lessee. However, in the case of the second relationship, when the asset is delivered the client is liable to discharge any obligations as a lessee.<sup>15</sup>

### **Differences between Murabahah and Leasing:**

There are certain differences between Murabahah and leasing. In the case of Murabahah an actual sale must take place after the client takes delivery from the supplier, and any previous agreement of Murabahah is not enough for affecting the actual sale. After taking possession of the asset as an agent, the client is bound to give intimation to the institution, and make an offer for the purchase. The sale only takes place after the institution accepts the offer.

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

There are two principle reasons as to why this difference between Murabahah and leasing exists: Firstly, it is a necessary condition for a valid sale to be effected instantly. According to the principles of Shari'ah a sale attributed to a future date is invalid. However, leasing can be attributed to a future date. Thus a previous agreement is not sufficient in the case of Murabahah, which in the case of leasing it is. 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 them.

Applying this principle to Murabahah, a seller cannot claim a profit over a property, which was never a financial risk for him. Therefore, if the previous agreement is held

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<sup>15</sup> Zafar, A: Islamic Banking and it's Operations. 1999 (93)

to be sufficient for effecting a sale between the client and the institution, the asset shall be transferred to the client simultaneously when possession is taken, and the asset shall not come into the risk of the seller. This highlights why simultaneous transfer is not possible in Murabahah, creating a need for 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 as the ownership has not been transferred. If the lease period began from when the client has taken delivery, it does not violate the principle mentioned above.<sup>16</sup>

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<sup>16</sup> Zafar, A: Islamic Banking and it's Operations. 1999 (97)



### **B.1.3.Salam**

Salam refers to a sale whereby the seller undertakes to supply specific goods to a buyer at a future date in exchange of an advanced price.

Although the cost is paid in cash known as "rasul-ul-mal", the supply of the purchased commodity "muslam fih" is deferred. The buyer is known as "rabb-us-salam", the seller as "muslam ilaih"

Salam during the time of the Prophet Mohamed was permitted under specific conditions. Originally the purpose of a salam sale was to meet the needs of small farmers who needed money to grow their crops and feed their family until the time of harvest. With the prohibition of riba they were not able to take out loans, as they were usurious. In order to overcome this, farmers were permitted to sell agricultural products in advance.<sup>17</sup> Similarly, the traders of Arabia used to import and export goods from their homeland. Money was needed in order to undertake this form of business. As they were prohibited from borrowing usurious loans, a salam sale permitted the sale of their goods in advance. After receiving their cash price, they could easily undertake the aforesaid business.

The benefits of a salam to the seller were of receiving cash in advance, whilst for the buyer the benefits were a lower cost of purchase.

The permissibility of salam therefore, is an exception to the general rule that prohibits advance sales. Salam however, can only be carried out under the following stringent conditions:

#### **(Conditions of Salam)**

- For the validity of salam the buyer must pay the price in full to the seller at the time of affecting the sale. This is necessary as 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 Prophet Mohamed.<sup>18</sup> The basic wisdom behind the permissibility of

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<sup>17</sup> Iqbal, A: Islam and the Theory of Interest. 1999 (173)

<sup>18</sup> (174)

salam is to fulfill the instant needs of the seller. If the price is not paid in full, the basic purpose of the transaction will be defeated. All Muslim jurists are unanimous that full payment of the price is essential in salam.

- Salam can be affected in commodities where only the quality and quantity can be specified exactly. Where quality or quantity cannot be determined by specification sale by salam is not permissible. For example, precious stones cannot be sold on the basis of salam, as every piece of precious stone is normally different from the other, either in its quality or in its size or weight and exact specification is not generally possible.

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

- It is necessary that the quality of the commodity (intended to be purchased through salam) be fully specified leaving no ambiguity that may lead to dispute.

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

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

- Salam cannot be affected in respect of things that 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.



- All the Muslim jurists are unanimous that salam will not be valid unless all these conditions are fully observed.<sup>19</sup>

### **Salam in a modern economy**

Salam was initially allowed as a form of financing for small farmers and traders. In contemporary economics, banks and financial institutions may use salam as a mode of financing. However, whenever discussing Islamic modes of financing, it should always be highlighted that the concept of financial institutions dealing only in money is a concept foreign to Islamic Shari'ah. If institutions wish to earn a halal profit, they must be willing to deal in commodities, as according to Shari'ah, no profit is allowed only on advancing loans. The establishment of an Islamic economy requires a basic change in approach and in the outlook of financial institutions.

#### **B.1.4.Istisna**

'Istisna is a form 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 with material from the manufacturer, the transaction of istisna comes into existence. However, 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 is fully settled between them.

The contract of Istisna creates a moral obligation on the manufacturer to manufacture the goods. However, before production is started, it is possible for either party to cancel the contract. Prior notice to the other party must however, be given. If the manufacturer has started the work, the contract cannot be cancelled unilaterally.

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<sup>19</sup> Iqbal, A: Islame and the Theory of Interest. 1999 (176)

## **Difference between Istisna and Salam**

The main points of difference between istisna and salam are summarized below:

- The subject of istisna is always a commodity, which needs manufacturing, while salam can be affected on any thing, whether it needs manufacturing, or not.
- It is necessary for salam that the price is paid in full in advance, while it is not necessary in istisna.
- The contract of salam, once affected, cannot be cancelled unilaterally, whereas the contract of istisna can be cancelled before the manufacturer starts the work.
- The time of delivery is an essential part of salam while it is not necessary in istisna that the time of delivery is fixed.<sup>20</sup>

### **B.1.4.1. Istisna as a mode of financing**

- One of the main uses of istisna as financing is the house-purchasing sector. If a client has his or her own land and seeks financing for the construction of a house, the financier may undertake the 'contract 'to construct the house on the basis of istisna. If the client has no land and wishes to purchase also land, the financier may undertake to provide him a constructed house on a specified piece of land.
- Since it is not necessary to istisna that the cost is paid in advance, or the time of delivery, the time of payment may therefore be fixed in whatever manner they wish. The payment can also be made in installments.
- It also is not necessary for the financier to personally construct the house. A parallel contract of istisna with a third party can be established, or the hire of a contractor (other than the client). In both cases, the cost should be calculated and fixed onto the price of istisna with the client. The payment of installments by the client may start, in this case, right from the day when the contract of istisna is signed

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<sup>20</sup> Iqbal, A: Islam and Theory of Interest 1999(180)



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 installments, 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 client pays the last installment.

- The financier 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 own cost as necessary for bringing it in terms with the contract.
- Istisna may also be used for project financing. For example - if a client wishes to install an air-conditioning plant in their 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 can 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.<sup>21</sup>

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<sup>21</sup> Khan, A: Islamic Economics and Finance. 1995 (185)

## C. Investment and saving tools:

### C.1.MUDHARABAH

**Mudharib:** Working Partner (brings effort).

**Ra's al-Mal:** Investment (brings capital).

**Rab al-Mal:** Investor.

**Wakeel:** Agent.

**Ameen:** Trustee.

**Kafil:** Guarantor.

**Mudharib:** Working partner (Manager).

**Hiba:** Gift.

Definition:

Mudharabah refers to a partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called "Rab al-mal" whilst the management and work is an exclusive responsibility of the other, who is called "Mudharib" and the profits generated are shared in a predetermined ratio.

Types of Mudharabah

There are two types of Mudharabah namely:<sup>22</sup>

- **Al-Mudharabah A-Moqayyadah:** Rab al-mal (investor) may specify a particular business or a particular place for the Mudharib, in which case the money shall be invested in that particular business or place. This is called Al-Mudharaba Al-Muqayyadah (restricted Mudharabah).
- **Al-Mudaraba AluMutlaqah:** Rab al-mal gives full freedom to Mudharib to undertake whatever business he deemed fit, this is called Al-Mudharaba Al-Mutlaqah (unrestricted Mudharabah). However Mudharib cannot, without the consent of Rab al-mal, lend money to anyone. Mudharib is authorized to carry out

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<sup>22</sup> Khan, A: 1995 (186)



any action that is normally done in the course of business. Nonetheless if the Mudharib wants to carry out something not in the normal routine of the work, it cannot be done so without expressed permission from the Rab al-mal.

The Mudharib is also not authorized to

- a). Keep another Mudharib or a partner.
- b). Mix his own investment in that particular Mudharabah without the consent of Rab al-mal.

Rab al-mal can contract Mudharabah 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 Mudharib and the capital of the Mudharabah shall be utilized by both of them jointly, and the share of the Mudharib.

#### **Difference between Musharakah and Mudharabah:**

##### **Musharakah**

- All partners invest.
- All partners participate in the management of the business and can work for it.
- All partners share the loss to the extent of the ratio of their investment.
- The liability of the partners is normally unlimited. If the liabilities of business exceed its assets and the business goes into liquidation, all the exceeding liabilities shall be borne pro rata by all partners. However if the partners agree 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.
- As soon as the partners pool their capital in a business, all according to the proportion of their respective investment jointly owns all the assets. All partners benefit from the appreciation in the value of the assets even if profit has not accrued through sales.

## **Investment**

In Mudharabah, Rab al-mal provides the investment and the Mudharib provides the management. However the Rab al-mal retains the authority to:

- oversee the Mudharib's activities.
- work with Mudharib if the Mudharib consents.

## **Mudharabah Expenses:**

The investor shares profit from the Mudharabah with the Mudharib on an agreed rate. Expenses such as meals, clothing, conveyance and medical care are not, however, borne by the Mudharabah.

The Mudharabah must pay all expenses, which are incidental to the Mudharabah's function like wages of employees/workers or commission in buying/selling. However all expenses will be included in the costs of commodities which Mudharib is selling, for example, if he is selling ready made garments then the stitching, dyeing, washing expenses etc. can be included by the Mudharib in the total cost of the garments.

If the Mudharib manages the Mudharabah within his city, no expenses will be allowed, only a share of profits. Similarly, if an employee is kept, the employee will not be allowed any expenses, just a salary.

If the Mudharabah agreement becomes void (Fasid) due to any reason, the Mudharib's status will be like an employee, meaning:<sup>23</sup>

- Whether he is traveling or doing business in his city, will not be entitled to any expense such as meals, conveyance, clothing, medicine etc.
- He will not be sharing any profit and will just get Ujrat-e-Misl (ordinary pay) for his job.



### **C.1.2.Distribution of Profit & Loss:**

It is necessary for the validity of Mudharabah that the parties agree 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 mutual consent. They can share the profit in equal proportions and they can also allocate different proportions for Rab al-mal and Mudharib.

The Mudharib & Rab al-mal cannot allocate a lump sum amount of profit to any party nor can they determine the share of any party at a specific rate tied up with the capital. However they can agree that 40% of the actual profit shall go to the Mudharib and 60% to the Rab al-mal or vice versa. It is also possible that different proportions are agreed in different situations.

**For example**, the Rab al-mal can say to Mudharib: "If you trade in wheat, you will get 50% of the profit and if you trade in flour, you will have 33% of the profit".

Apart from the agreed proportion of the profit, the Mudharib cannot claim any periodical salary or a fee or remuneration for the work carried out for the Mudharabah. All schools of Islamic Fiqh are unanimous on this point.<sup>24</sup>

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<sup>23</sup> Khan, A: Islamic Economics and Finance. 1995 (188)

<sup>24</sup>Khan (196)

### C.1.1.Roles of the Mudharib

**Ameen (Trustee):** To look after the investment responsibly, except in case of natural calamities.

**Shareek (Partner):** Sharing in any profit.

**Zamin (Liable):** To provide for the loss suffered by the Mudharabah due to any act on his part.

**Ajeer (Employee):** When the Mudharabah becomes void (Fasid) due to any reason, the Mudharib is entitled to only the salary, Ujrat-e-Misl.

In case there is a loss, the Mudharib will not even receive the Ujrat-e-Misl.

### C.2.MUSHARAKAH

'The literal translation of the word 'Musharakah' is to 'share' or 'sharing'. In the context of business and trade Musharakah refers to a joint enterprise in which all partners share the profit or loss of the joint venture. It is an ideal alternative to 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 any type. Since Islam has prohibited interest, this instrument cannot be used for providing funds of any kind.<sup>25</sup>

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 any profit. Islam has termed interest as an unjust instrument of financing as 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 only a small proportion of

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<sup>25</sup> Khan, A:1995 (190)



the profit leaving the rest for the debtor. In this way, the rate of interest is the main cause for imbalances in the system of distribution, which has a constant tendency to favor the rich and work against the interests of the poor.

Conversely, 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 wishes to share profits. If it is to assist the debtor, he should resist from claiming any excess on the principal of the loan, as the aim is to assist. However, if he wants to have a share in the profits of his debtor, it is necessary that he should also share the 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 for the financier. Musharakah has a tendency to favor the common people rather than just the rich. This is the basic philosophy, explaining why Islam has suggested Musharakah as an alternative to interest based financing.

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#### 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 more limited than the term "Shirkah", which is more commonly used in the Islamic jurisprudence. For the purpose of clarity in the basic concepts "Shirkah" means "Sharing" and in the terminology of Islamic Fiqh, it has been divided into two kinds:

**Shirkat-ul-milk:** means joint ownership of two or more persons in a particular property. This kind of "Shirkah" comes into operation at the option of the parties. For example, if two or more persons purchase a piece of equipment, it will be owned jointly by both of them and the relationship between them with regard to that property is called "Shirkat-ul-milk." Here, the relationship comes into existence at their own option, as they themselves elect to purchase the equipment jointly. However there are cases where this kind of "Shirkah" comes into operation 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.<sup>26</sup>

**Shirkat-ul-aqd:** means, "a partnership effected by a mutual contract" and a "joint commercial enterprise." Shirkat-ul-aqd is further divided into three kinds:

- Shirkat-ul-amwal where all the partners invest some capital into a commercial enterprise.
- Shirkat-ul-Amal where all the partners jointly undertake to render some services for their customers, and the fee they charge is distributed among them according to an agreed ratio.<sup>27</sup>

**For example,** if two persons agree to undertake tailoring services for their customers on the condition that the wages earned will go to a joint pool. This will then be distributed between them irrespective of the size of work partners have actually done. This partnership will be a Shirkat-ul-amal which is also called Shirkat-ut-taqabbul or Shirkat-us-sanai or Shirkat-ul-abdan.

- The third kind of Shirkat-ul-aqd is Shirkat-ul-wujooh. Here the partners have no investment at all. All they do is that they purchase the 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, whilst the term "Musharakah" is not found in the books of Fiqh. The term 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" e.g. the Shirkat-ul-amwal.<sup>28</sup>

### **C.2.1.The basic rules of Musharakah:**

Musharakah or Shirkat-ul-amwal is a relationship established by the parties through a mutual contract. Therefore all the necessary ingredients of a valid contract must be

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<sup>26</sup> Siddiqi, A: Anthology of Islamic Banking, 2000 (132)

<sup>27</sup> (132)

<sup>28</sup> (133)

present. There are also certain components, which are peculiar to the contract of "Musharakah".

#### **C.2.1.1. Distribution of Profit:**

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.

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 amount for anyone of the partners, or any rate of profit tied up with his investment.

**For example** 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. Similarly, if it is agreed between them that A will get 15% 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 amount or a certain percentage of the investment has been agreed for anyone 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. Thereby any amount so drawn by any partner shall be treated as 'on account payment' and will be adjusted to the actual profit deserved at the end of the term. If no profit is actually earned or is less than anticipated, the amount drawn by the partner shall have to be returned.

#### **Ratio of Profit:**

Muslim jurists differ in opinion on whether it is necessary for the ratio of profit of each partner to conform to the ratio of capital invested. In the view of Imam Malik and



Imam Shafi, it is necessary for the validity of Musharakah that each partner gets the profit exactly in the proportion of the investment.<sup>29</sup>

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 with their free consent.<sup>30</sup>

The third view is presented by Imam Abu Hanifah. 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 the share of profit cannot be more than the ratio of the investment.<sup>31</sup>

### **C.2.1.2.Sharing of loss**

In the case of loss, Muslim jurists are unanimous that each partner shall suffer the loss according to the ratio of his investment. Therefore, if a partner has invested 40% of the capital, he must suffer 40% of the loss. There is a complete consensus of jurists on this principle.

Therefore, according to Imam Shafii, the ratio of the share of a partner in the profit and loss must conform to the ratio of investment. According to Imam Abu Hanifah and Imam Ahmad, the loss must be divided between partners in exact accordance with the ratio of capital invested by each one of them. It is this principle that has been mentioned in the famous maxim:<sup>32</sup>

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

### **C.2.1.3.The Nature of the Capital**

Many Muslim jurists are of the opinion that the capital invested by each partner must be in liquid form. Musharakah can only be based on money, and not on commodities. However, there are different views in this respect.

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<sup>29</sup>Khan, A: Islamic Economics and Finance.1995(207)

<sup>30</sup>(207)

<sup>31</sup>(208)

<sup>32</sup>(208)

- Imam Malik is of the view that the liquidity of capital is not a condition for the validity of Musharakah. 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. Some Hanbali jurists also adopt this view.

- 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:<sup>33</sup>

a) That the commodities of each partner are always distinguishable from the commodities of the other.

**For example:** if A has contributed one motorcar to the business, and B has come with another motorcar, each one of the two cars is the exclusive property of its original owner. Now, if the car of A is sold, its sale-proceeds should go to A. B has no right to claim a share in its price. Therefore, as the property of each partner is distinguished from the property of the other.

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.

b) 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 invested, leaving nothing for the other partner. Conversely, if the value of those commodities decreases, there is a possibility that one partner secures

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<sup>33</sup> Khan, A: Islamic Economic and Finance. 1995 (212)



some part of the original price of the commodity of the other partner in addition to his own investment.

- Imam al-Shafii is of the view that the commodities are of two kinds.<sup>34</sup>

In short, if a partner wants to participate in a Musharakah by contributing some commodities to it, it can be done so according to Imam Malik without any restriction. The share in the Musharakah shall be determined on the basis of the current market value of the commodities, prevalent at the date of the commencement of Musharakah.

According to Imam al-Shafii, 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, mixing the commodities of each partner together can do this. If the commodities are Dhawat-ul-qeemah, then, they cannot form part of the share capital.

In conclusion 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.

### **C.2.2.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. In this case the sleeping partner shall be entitled to the profit only to the extent of investment, and the ratio of profit allocated should not exceed the ratio of his investment.

If all partners agree to work for the joint venture, each one of them shall be treated as the agent of the other in all matters of the business. Any work carried out by one of them in the normal course of business shall be deemed to be authorized by all the partners.

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<sup>34</sup> Khan, A: Islamic Economics and Finance.1995 (214)



## **Termination of Musharakah**

Musharakah is deemed to be terminated in anyone of the following events:<sup>35</sup>

- 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. 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 a dispute arises between the partners in this matter i.e one partner seeks liquidation whilst the other wants partition or distribution of the non-liquid assets themselves, the latter shall be preferred. 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 to liquidate. 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.
- If anyone of the partners dies during the Musharakah, the contract of Musharakah with the deceased stands terminated. 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.
- If anyone of the partners becomes insane or otherwise becomes incapable of effecting commercial transactions, the Musharakah stands terminated.

### **C.2.3.Termination of Musharakah without closing the business**

If one of the partners wants termination of the Musharakah, while the other partner or partners prefer to continue with the business, this can be achieved by mutual agreement. The partners who wish to continue the business may purchase the share of the partner who wants to terminate his partnership, as the termination of Musharakah with one partner does not imply its termination between the other partners.



However, the price of the share of the leaving partner must be determined by mutual consent, 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 the contract of the Musharakah, on a condition that the liquidation or separation of the business shall not be effected unless the majority of them wants to do so. 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 to liquidate or separate the assets.

Although Islamic Fiqh appears to be silent to this question, it appears there is no bar from the Shari'ah point of view if the partners agree to such a condition right at the beginning of the Musharakah. Some Hanbali jurists expressly permit this.

This condition may be justified, especially in the modern situation as that the nature of business, requires continuity for its success, and the liquidation or separation at the instance of a single partner may cause irreparable damage to the other partners. This view appears to be supported by the general principle laid down by the Prophet in his famous Hadith:

"All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful."<sup>35</sup>

Financial instrument for project finance in the Middle-East have been largely dominated by Murabahah and Ijarah as shown in the table below.

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<sup>35</sup> Khan, A: Islamic Economics and Finance. 1995 (219)

<sup>36</sup> Siddiqi, A: Anthology of Islamic Banking. 2000 (59)

Selected Project Finance, Deals and Transaction in the Muslim World.

COUNTRY	AMOUNT	PROJECT	MODE OF FINANCE
Bahrain	USD\$30m	Purchasing construction material for Pakistan's Lahore-Islamabad Highway	Syndicated Murabahah
Kuwait	USD\$30m	Purchasing of capital equipment for the production of medium density fibreboard	<i>Ijarah</i> (lease finance)
Malaysia	RM1billion	Finance Tenaga Nasional's current expenditure	Bai-bithaman ajil-bay al-Dayn (debt trading)
Bahrain	USD\$70m	Water& power Development Authority Sydicated Murabahah	Syndicated Murabahah
Egypt	USD\$11.2m	Alexandria Naional Iron& steel Company	<i>Ijarah</i> (lease finance)
Pakistan	USD\$2.05m	Equity capital investment in Al-Meezan Investment Bank	Musharakah

Source: Islamic Banker, various issues<sup>37</sup>

<sup>37</sup> International Journal of Islamic Financial Services, 2 Jul-Sep 1999



### **C.3.Banking:**

#### **C.3.1.Alwadiyah**

Under an Islamic scheme of Savings and Current account, you can enjoy interest free safekeeping services of your money, as well as a share of any profit that the bank makes on your behalf. The bank uses an Islamic banking principle that is known as "Al Wadiah Yad Dhamanah" or guaranteed custody. This scheme ensures that Islamic financial institutions can acquire deposits under Islamic banking principles. The core of this arrangement is that the bank has authority to use your deposits under a guarantee to return it when you need it. Periodically, you will receive a share of the profits earned by the bank when it utilizes your money to invest in its business ventures. The portion of profit shared is the absolute discretion of the bank. This reward is an alternative to interest that you would have received from a conventional bank.

#### **The application process of a savings and current account: <sup>38</sup>**

1. This product is not confined to Muslim owned companies. Non-Muslim organizations and corporations may also apply.
2. Directors and shareholders may need to complete an application form from the bank that offers this product.
3. A minimum amount of deposit may be required by the bank to initiate your savings or current accounts.
4. You will be given an account book and if available, an ATM card (upon request).
5. You will also receive a cheque book if you are applying for the current account.
6. The bank may offer other services such as direct credit payments to staff

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<sup>38</sup> Zafar, A: Islamic Banking and it's Operations. 1999 (164)

salaries, direct debit payment for your monthly utility bills, and credit card payments.

7. The bank may charge a small processing fee if you wish to close either account.

The main problem, both for the banks and for the customers, seems to be in the area of financing. Bank lending is still practiced but that is limited to either no cost loans (mainly consumer loans) including overdrafts, or loans with service charges only. Both these types of loans bring no income to the banks and therefore naturally they are not so keen to engage in this activity much. That leaves us with investment financing and trade financing. Islamic banks are expected to engage in these activities only on a profit and loss sharing (PLS) basis. This is where the banks' main income is to come from and this is also from where the investment account holders are expected to derive their profits. And the latter is supposed to be the incentive for people to deposit their money with the Islamic banks. And it is precisely in this PLS scheme that the main problems of the Islamic banks lay. Therefore we will look at this system more carefully in the following section.



#### D. Problems in implementing the PROFIT AND LOSS SHARING scheme

Several writers have attempted to show, with varying degrees of success, that Islamic Banking based on the concept of profit and loss sharing (PLS) is theoretically superior to conventional banking from different angles. See, for example. However from the practical point of view things do not seem that rosy. In the over half-a-decade of full-scale experience in implementing the PLS scheme the problems have begun to show up. In the following paragraphs I will try to set down some of the major difficulties.

##### D.1. Financing

There are four main areas where the Islamic banks find it difficult to finance under the PLS scheme: a) participating in long-term low-yield projects, b) financing the small businessman, c) granting non-participating loans to running businesses, and d) financing government borrowing. Let us examine them in turn.

##### Long-term projects

Table shows the term structure of investment by 20 Islamic Banks. It is clear that less than 10 percent of the total assets go into medium- and long-term investment. Admittedly, the banks are unable or unwilling to participate in long-term projects. This is a very unsatisfactory situation.

<i>Term Structure of Investment by 20 Islamic Banks,</i>		
<b>Type of Investment</b>	<b>Amount</b>	<b>% of Total</b>
Short-term	4,909.8	68.4
Social lending	64.2	0.9
Real-estate investment	1,498.2	20.9
Medium- and long-term investment	707.7	9.8

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Source: International Association of Islamic Banks, Bahrain.InUSD.

The main reason of course is the need to participate in the enterprise on a PLS basis which involves time consuming complicated assessment procedures and negotiations, requiring expertise and experience. The banks do not seem to have developed the latter and they seem to be averse to the former. There are no commonly accepted criteria for project evaluation based on PLS partnerships. Each single case has to be treated separately with utmost care and each has to be assessed and negotiated on its own merits. Other obvious reasons are: a) such investments tie up capital for very long periods, unlike in conventional banking where the capital is recovered in regular installments almost right from the beginning,<sup>39</sup> and the uncertainty and risk are that much higher, b) the longer the maturity of the project the longer it takes to realize the returns and the banks therefore cannot pay a return to their depositors as quick as the conventional banks can. Thus it is no wonder that the banks are averse to such investments.

### Small businesses

Small-scale businesses form a major part of a country's productive sector. Besides, they form a greater number of the bank's clientele. Yet it seems difficult to provide them with the necessary financing under the PLS scheme, even though there is excess liquidity in the banks. The observation of Iqbal is revealing:

Given the comprehensive criteria to be followed in granting loans and monitoring their use by banks, small-scale enterprises have, in general encountered greater difficulties in obtaining financing than their large-scale counterparts in the Islamic Republic of Iran. This has been particularly relevant for the construction and service sectors, which have large share in the gross domestic product (GDP). The service sector is made up of many small producers for whom the banking sector has not been able to provide sufficient financing. Many of these small producers, who traditionally were able to obtain interest-based credit facilities on the basis of collateral, are now finding it difficult to raise funds for their operations.

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<sup>39</sup> Iqbal, A: *Islam and the Theory of Interest*. 1999 (220)



who traditionally were able to obtain interest-based credit facilities on the basis of collateral, are now finding it difficult to raise funds for their operations.

### Running businesses

Running businesses frequently need short-term capital as well as working capital and ready cash for miscellaneous on-the-spot purchases and sundry expenses. This is the daily reality in the business world. Very little thought seems to have been given to this important aspect of the business world's requirement. The PLS scheme is not geared to cater to this need. Even if there is complete trust and exchange of information between the bank and the business it is nearly impossible or prohibitively costly to estimate the contribution of such short-term financing on the return of a given business. Neither is the much-used mark-up system suitable in this case. It looks unlikely to be able to arrive at general rules to cover all the different situations.

Added to this is the delay involved in authorizing emergency loans. One staff member of the Bank of Industry and Mines of Iran has commented:<sup>40</sup>

Often the clients need to have quick access to fresh funds for the immediate needs to prevent possible delays in the project's implementation schedule. According to the set regulations, it is not possible to bridge-finance such requirements and any grant of financial assistance must be made on the basis of the project's appraisal to determine type and terms and conditions of the scheme of financing.

The enormity of the damage or hindrance caused by the inability to provide financing to this sector will become clear if we realise that running businesses and enterprises are the mainstay of the country's very economic survival.

### Government borrowing

In all countries the Government accounts for a major component of the demand for credit - both short-term and long-term. Unlike business loans these borrowings are not always for investment purposes, nor for investment in productive enterprises. Even when invested in productive enterprises they are generally of a longer-term

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<sup>40</sup> Zafar: Islamic Banking and its operation. 1999 (198)



type and of low yield. This latter only multiplies the difficulties in estimating a rate of return on these loans if they are granted under the PLS scheme.

## D.2. Legislation

Existing banking laws do not permit banks to engage directly in business enterprises using depositors' funds. But this is the basic asset acquiring method of Islamic banks. Therefore new legislation and/or government authorization are necessary to establish such banks. In Iran a comprehensive legislation was passed to establish Islamic banks. In Pakistan the Central Bank was authorized to take the necessary steps. In other countries either the banks found ways of using existing regulations or were given special accommodation. In all cases government intervention or active support was necessary to establish Islamic banks working under the PLS scheme. In spite of this, there is still need for further auxiliary legislation in order to fully realize the goals of Islamic banking.

For example, in Pakistan the new law has been introduced without fundamental changes in the existing laws governing contracts, mortgages, and pledges. Similarly no law has been introduced to define modes of participatory financing that are *Musharakah*. It is presumed that whenever there is a conflict between the Islamic banking framework and the existing law, the latter will prevail. In essence, therefore, the relationship between the bank and the client that of creditor and debtor is left unchanged as specified by the existing law. The existing banking law was developed to protect mainly the credit transactions; its application to other modes of financing results in the treatment of those modes as credit transactions also. Banks doubt whether some contracts, though consist the Islamic banking framework, would be acceptable in the courts

In Iran, although the law establishing interest-free banking is comprehensive, the lack of proper definitions of property rights may have constrained bank lending. Thus far there has been no precise legislative and legal expression of what is viewed as "lawful and conditional" private property rights. This may also have militated against investment lending in agricultural and industrial sectors and thus encouraged increased concentration of assets in short-term trade financing instruments.



Iran and Pakistan are countries committed to ridding their economies of *riba* and have made immense strides in towards achieving it. Yet there are many legal difficulties still to be solved as we have seen above. In other Muslim countries the authorities actively or passively participate in the establishment of Islamic banks on account of their religious persuasion. Such thing is not the case in non-Muslim countries. Here establishing Islamic banks involves conformation to the existing laws of the concerned country which generally are not conducive to PLS type of financing in the banking sector. We will see some of these problems below.

Dr Hasanuz-Zaman, lists the traditional tasks of the bank and then questions its ability to take on the additional functions it is called upon to perform under the PLS scheme:<sup>41</sup>

It is due to historical reasons that banks have evolved purely as financial institutions. They are suited to attract money, keep it in safe custody, lend it under safety, invest it profitably and enjoy the capacity to create the means of payment. A bank has to maintain a balance between income, liquidity and flexibility. While allocating its funds it has to be meticulously sensitive about the capital position and rate of profitability of various types of loans, stability of deposit, economic conditions, influence of monetary and fiscal policy, ability and experience of bank's personnel and credit needs of the area. So far these banks thrive on a fixed rate of return a portion of which is passed on by them to the depositor. Thus the entire effort of a bank is directed towards money management and it is not geared to act as an entrepreneur, trader, industrialist, contractor or caterer.

The question arises: with all these limitations can a bank claim any competence in trading or entrepreneurship which is necessary for *musharakah* or *mudarba* contract, or can it act as an owner of a large variety of heavy machinery, transport vehicles or real estate to take the position of a lessor or, can it act as a stockiest to buy and resell the entire stock of imports and exports that are needed by genuine traders?

Then he raises the even more serious question:<sup>42</sup>

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<sup>41</sup> International Journal of Islamic Financial Services 1999

<sup>42</sup> International Journal of Islamic Financial Services. 1999



In case the bank is historically and practically not competent to do all these jobs its claim to share a portion of profits as a working partner, trader or lessor becomes questionable.

Traditional banks do perform a certain amount of project evaluation when granting large medium- and long-term loans. But doing such detailed evaluation as would be required to embark on a PLS scheme, such as determining the rates of return and their time schedule, is beyond the scope of conventional banks. So is the detailed accounting and monitoring necessary to determine the actual performance.

Under Islamic banking these exercises are not limited to relatively few large loans but need to be carried out on nearly all the advances made by the bank. Yet, widely acceptable and reliable techniques are yet to be devised. This is confounded by the fact that no consensus has yet been reached on the principles. Both the unprecedented nature of the task as well as the huge amount of work that need be done and the trained and experienced personnel needed to carry them out seems a daunting prospect.

#### **D.3. Re-training of staff**

It was seen in the previous section, the bank staff will have to acquire many new skills and learn new procedures to operate the Islamic banking system. This is a time consuming process, which is aggravated by two other factors. One, the sheer number of persons that need to be re-trained and, two, the additional staff that need to be recruited and trained to carry out the increased work.

Principles are still to be laid down and techniques and procedures evolved to carry them out. It is only after the satisfactory achievement of these that proper training can begin. This delay and the resulting confusion appears to be among the main reasons for the banks to stick to modes of financing that are close to the familiar interest-based modes.



### C.1.5 Other disincentives

Among the other disincentives from the borrower's point of view are the need to disclose his accounts to the bank if he were to borrow on the PLS basis, and the fear that eventually the tax authorities will become wise to the extent of his business and the profits. Several writers have lashed out at the lack of business ethics among the business community, but that is a fact of life at least for the foreseeable future. There is a paucity of survey or case studies of clients to see their reaction to current modes of financing. As such we are not aware of further disincentives that might be there.

### D.4. Accounts

When a business is financed under the PLS scheme it is necessary that the actual profit/loss made using that money has to be calculated. Though no satisfactory methods have yet been devised, the first requirement for any such activity is to have the necessary accounts. On the borrowers' side there are two difficulties: one, many small-time businessmen do not keep any accounts, leave alone proper accounts. The time and money costs will cut into his profits. Larger businesses do not like to disclose their real accounts to anybody. On the banks' side the effort and expense involved in checking the accounts of many small accounts is prohibitive and will again cut into their own share of the profits. Thus both sides would prefer to avoid having to calculate the actually realised profit/loss.<sup>43</sup>

Additionally the reluctance of small producers to submit their operations to bank audits and the perceived enormous cost of auditing and monitoring relative to the small size of the potential credits makes banks unwilling to extend credit on the basis of new modes of financing to these small producers. These reduced lending to small producers may also explain the existence of excess liquidity in the banking system.

### D.5. Tax

The bank is a big business and it has to declare its profit and loss and is legally required to present an audited account of its operations. Once the bank's accounts



are known it doesn't take much for the tax collectors to figure out the share of the business men financed by the bank under the PLS scheme. Thus it's no surprise that businesses are not too very happy about the situation. The fact that suggestions have been made to use the banks to collect taxes due has not helped the matter either.

#### D.6 Excess liquidity

Presence of excess liquidity is reported in nearly all-Islamic banks. This is not due to reduced demand for credit but due to the inability of the banks to find clients willing to be funded under the new modes of financing. Here we have a situation where there is money available on the one hand and there is need for it on the other but the new rules stand in the way of bringing them together! This is a very strange situation -- especially in the developing Muslim countries where money is at a premium even for ordinary economic activities, left alone development efforts. Removal of *riba* was expected to ease such difficulties, not to aggravate the already existing ones!

#### C.1.7 Uneasy questions of morality

The practices in use by the Islamic banks have evoked questions of morality. Do the practices adopted to avoid interest really do their job or is it simply a change of name? It suffices to quote a few authors.

*The Economist* writes:<sup>44</sup>

Muslim theoreticians and bankers have between them devised ingenious ways of coping with the interest problem. One is *murabaha*. The Koran says you cannot borrow USD100m from the bank for a year, at 5% interest, to buy the new machinery your factory needs? Fine. You get the bank to buy the machinery for you -- cost, USD100m -- and then you buy the stuff from the bank, paying it USD105m a year from now. The difference is that the extra USD 5m is not interest on loan, which the Koran (perhaps) forbids, but your thanks to the bank for the risk it takes of losing money while it is the owner of the machinery: this is honest trading, okay with the

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<sup>43</sup> Iqbal, A: *Islamic and the Theory of Interest*. 1999 (241)



Koran. Since with modern communications the bank's ownership may last about half a second, its risk is not great, but the transaction is pure. It is not surprising that *some Muslims uneasily sniff logic-chopping here.*

Siddiqi says:<sup>45</sup>

Two of the modes of financing prescribed by the State Bank, namely financing through the purchase of client's property with a buy-back agreement and sale of goods to clients on a mark-up, involved the least risk and were closest to the old interest-based operations. Hence the banks confined their operations mostly to these modes, particularly the former, after changing the simple buy-back agreement (prescribed by the State Bank) to buy-back agreement with a mark-up, as otherwise there was no incentive for them to extend any finances. The banks also reduced their mark-up-based financing, whether through the purchase of client's property or through the sale of goods to clients, to mere paper work, instead of actual buying of goods (property), taking their possession and then selling (back) to the client. As a result, there was no difference between the mark-up as practiced by the banks and the conventional interest rate, and hence it was judged repugnant to Islam in the recent decision of the Federal Shari'ah court.

As banks are essentially financial institutions and not trading houses, requiring them to undertake trading in the form of buy-back arrangements and sale on mark-up amounts to imposing on them a function for which they are not well equipped. Therefore, *banks in Pakistan made such modifications in the prescribed modes that defeated the very purpose of interest-free financing.* Furthermore, as these two minimum-risk modes of financing were kept open to banks, they never tried to

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<sup>44</sup> The Economist, 1994

<sup>45</sup> Siddiqi (195)

devise innovative and imaginative modes of financing within the framework of musharakah and mudarba.

Khan says:<sup>46</sup>

*Murabaha* (cost-plus financing) and *bai' mu'ajjal* (sale with deferred payment) are permitted in the Shari'ah under certain conditions. Technical financial mediation but a kind of business participation. The Shari'ah assumes that the financier actually buys the goods and then sells them to the client. Unfortunately, the current practice of "buy-back on mark-up" is not in keeping with the conditions on which *murabaha* or *bai' mu'ajjal* are permitted. What is being done is *a fictitious deal which ensures a predetermined profit to the bank without actually dealing in goods or sharing any real risk. This is against the letter and spirit of Shari'ah injunctions.*

Many techniques those the interest-free banks are practicing are not either in full conformity with the spirit of Shari'ah or practicable in the case of large banks or the entire banking system. Moreover, *they have failed to do away with undesirable aspects of interest. Thus, they have retained what an Islamic bank should eliminate.*

#### E. Islamic banking in non-Muslim countries

The modern commercial banking system in nearly all countries of the world is mainly evolved from and modeled on the practices in Europe, especially that in the United Kingdom. The philosophical roots of this system revolve around the basic principles of capital certainty for depositors and certainty as to the rate of return on deposits. In order to enforce these principles for the sake of the depositors and to ensure the smooth functioning of the banking system Central Banks have been vested with powers of supervision and control. All banks have to submit to the Central Bank rules. Islamic banks, which wish to operate in non-Muslim countries, have some difficulties in complying with these rules.

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<sup>46</sup> Khan, A: 1995 (226)



## Certainty of capital and return

While the conventional banks guarantee the capital and rate of return, the Islamic banking system, working on the principle of profit and loss sharing, cannot, by definition, guarantee any fixed rate of return on deposits. Many Islamic banks do not guarantee the capital either, because if there is a loss it has to be deducted from the capital. Thus the basic difference lies in the very roots of the two systems. Consequently countries working under conventional laws are unable to grant permission to institutions which wish to operate under the PLS scheme to functions as commercial banks. Two official comments, one from the UK and the other from the USA suffice to illustrate this.

Sir Leigh Pemberton, the former Governor of the Bank of England, told the Arab Bankers' Association in London that:<sup>47</sup>

- It is important not to risk misleading and confusing the general public by allowing two essentially different banking systems to operate in parallel;
- A central feature of the banking system of the United Kingdom as enshrined in the legal framework is capital certainty for depositors. It is the most important feature which distinguished the banking sector from the other segments of the financial system;
- Islamic banking is a perfectly acceptable mode of financing but it does not fall within the definition of what constitutes banking in the UK;
- The Bank of England is not legally able to authorize under the Banking Act, an institution which does not take deposits as defined under that Act;
- The Islamic facilities might be provided within other areas of the financial system without using a banking name.

In the United States, Mr Charles Schotte, the US Treasury Department specialist in regulatory issues has remarked: <sup>48</sup>

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<sup>47</sup> [www.alrajhbank.com/news](http://www.alrajhbank.com/news)

<sup>48</sup> [www.alrajhibank.com/news](http://www.alrajhibank.com/news)

There has never been an application for an Islamic establishment to set up either as a bank or as anything else. So there is no precedent to guide us. Any institution that wishes to use the word 'bank' in its title has to guarantee at least a zero rate of interest -- and even that might contravene Islamic laws.



## F. Differences and Similarities with the conventional banking system

Characteristics	Paradigm Version of Islamic Banking	Conventional Banking
Nominal value guarantee of:		
Demand deposits	Yes	Yes
Investment deposits	No	Yes
Equity-based system where Capital is at risk	Yes	No
Rate of return on deposits	Uncertain, not guaranteed	Certain and guaranteed
Mechanism to regulate final Returns on deposits	Depending on banks' performance/profits from investment.	Irrespective of banks' performance/profits from investment.
PLS principle is applied	Yes	No
Use of Islamic modes of Financing:		
PLS and non-PLS modes	Yes	N/A
Use of discretion by banks with regard to collateral	Possible for reducing moral hazard in PLS modes Yes in non-PLS modes	Yes always
Banks' pooling of depositors' funds to provide depositors with professional Investment management.	Yes	No

Source: IMF<sup>49</sup> March 1998/Islamic banking; Issues in prudential regulations and supervision.

<sup>49</sup> Luca Errico and Mitra Farahbaksh: Requirements to be fuelled when conventional banks set up Islamic Banks, 'windows' or 'Islamic funds'

## G. Supervision and control

Besides these, there are other concerns as well. One is the Central Bank supervision and control. This mainly relates to liquidity requirements and adequacy of capital. These in turn depend on an assessment of the value of assets of the Islamic banks. A financial advisor has this to say: (alrajhibank.com)

It is evident then that even if there is a desire to accommodate the Islamic system, the new procedures that need be developed and the modifications that need be made to existing procedures are so large that the chances of such accommodation in a cautious sector such as banking is very remote indeed. Any relaxation of strict supervision is precluded because should an Islamic bank fail it would undermine the confidence in the whole financial system, with which it is inevitably identified.

Some countries have been taken effective steps in order to supervise/monitoring of Islamic banks like Bangladesh.<sup>50</sup>

- Some legal provisions have been incorporated in the amended Bank Companies Act, 1991.
- Information is being disclosed by the Islamic Banks as per the same format designed for the conventional banks. A workshop was held in Bangladesh Bank in 1995 on "Islamic Banking Inspection Mythology" to devise separate inspection methodology for the Islamic bank.

In some central banks, especially in Pakistan, Iran and Malaysia, there are central Shariah Supervisory Board/Council to investigate and monitor the operations of the Islamic banks whether they are run by Islamic Shariah. Shariah Board/Councils examine the operating procedures. (International Journal of Islamic Financial Services Vol.2 No.1 Abdul Awwal Sarker).

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<sup>50</sup> Abdul awwal Sarker, Bangladesh Bank.



### Tax regulations

Another important consideration is the tax procedures in non-Muslim countries. While interest is a 'passive' income, profit is an earned income which is treated differently. In addition, in trade financing there are title transfers twice -- once from seller to bank and then from bank to buyer -- and therefore twice taxed on this account decreasing the profitability of the venture. The Director of the International Islamic Bank of Denmark says:<sup>52</sup>

Tax laws are against the Islamic philosophy and pose the greatest difficulty. In most countries Mudarabha is constrained by fiscal acts that define profits as an after tax item for the profit creator and a fully taxable item for the profit receiver.

### H. Discussion and suggestions

People have needs -- food, clothes, houses, machinery, services; the list is endless. Entrepreneurs perceive these needs and develop ways and means of catering to them. They advertise their products and services; peoples expectations are raised and people become customers of the entrepreneur. If the customers' needs are fulfilled according to their expectations they continue to patronize the entrepreneur and his enterprise flourishes. Otherwise his enterprise fails and people take to other entrepreneurs.

Banks are enterprises too; they cater to people needs connected with money -- safe-keeping, acquiring capital, transferring funds etc. The fact that they existed for centuries and continue to exist and prosper is a proof that their methods are good and they fulfill the customers' needs and expectations. Conventional commercial banking system as it operates today is accepted in all countries except the Islamic world where it is received with some reservation. The reservation is on account of the fact that the banking operations involve dealing in interest, which is prohibited in Islam. Conventional banks have ignored this concern on the part of their Muslim

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<sup>52</sup> [www.alrajhibank.com](http://www.alrajhibank.com)



clientele. Muslims patronised the conventional banks out of necessity and, when another entrepreneur -- the Islamic banker -- offered to address their concern many Muslims turned to him. The question is: has the new entrepreneur successfully met their concerns, needs and expectations?

Broadly speaking, banks have three types of different customers: depositors, borrowers and seekers of bank's other services such as money transfer. Since services do not generally involve dealing in interest Muslims have no problem transacting such businesses with conventional banks; neither do Islamic banks experience any problems in providing these services. Among the depositors there are current account holders who too, similarly, have no problems. It is the savings account holders and the borrowers who have reservations in dealing with the conventional banks. In the following paragraphs we will see how well the Islamic banks have succeeded in addressing their customers' special concern.

#### **H.1. Savings accounts and capital guarantee**

As pointed out earlier, our concern here is the savings account holders. As the name itself indicates the primary aim of the saving account depositor is the safe-keeping of his savings. It is correctly perceived by the conventional banker and he guarantees the return of the deposit in it. The banker also assumes that the depositor will prefer to keep his money with him in preference to another who might also provide the same guarantee if the depositor is provided an incentive. This incentive is called interest, and this interest is made proportional to the amount and length of time it is left with the bank in order to encourage more money brought into the bank and left there for longer periods of time. In addition, the interest rate is fixed in advance so that the depositor and the banker are fully aware of their respective rights and obligations from the beginning. And laws have been enacted to guarantee their enforcement. In Economic theory the interest is often taken to be the "compensation" the depositors demand and receive for parting with their savings. The fact that the depositors accept the paid interest and that, given other things being equal, they prefer the bank or the scheme which offers the highest interest proves the banker's assumption correct.



The scheme is simple, transparent and seems to have satisfied the requirements of all types of savers -- from teenagers to old-age pensioners, from individuals to large institutions, pension funds and endowments, from small amounts to millions, and from a few weeks or months to years -- that it has survived over centuries and operates across national, cultural and religious borders.

The situation is very different in the Islamic banks. Here the depositor's first aim is to keep his savings in safe custody too. Islamic bankers divide the conventional savings account into two categories (alternatively, create a new kind of account): savings account and investment account. The investment accounts operate fully under the PLS scheme -- capital is not guaranteed, neither is there any pre-fixed return. Under the savings account the nominal value of the deposit is guaranteed, but they receive no further guaranteed returns.<sup>53</sup> Banks may consider funds under the savings accounts too as a part of their resources and they use it to create assets. This is the theory. In practice, however, the banks prefer, encourage and emphasize the investment accounts. This is because since their assets operate under the PLS scheme they might incur losses on these assets which losses they cannot pass onto the savings accounts of the depositors on account of the capital guarantee on these accounts. In the process the first aim of the depositor is pushed aside and the basic rule of commercial banking --capital guarantee-- is broken.

It is suggested that all Islamic banks guarantee the capital under their savings accounts. This will satisfy the primary need and expectation of an important section of the depositors and, in Muslim countries where both Islamic and conventional banks co-exist, will induce more depositors to bank with the Islamic banks. At the same time, it will remove the major objection to establishing Islamic banks in non-Muslim countries.

But the question is how does the bank make an income from these deposits? We will examine this in the next section.

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<sup>53</sup> Iqbal, A:(274)

## H.2. Investment under PLS scheme

The idea of participatory financing introduced by the Islamic banking movement is a unique and positive contribution to modern banking. However, as we saw earlier, by making the PLS mode of financing the main (often almost the only) mode of financing the Islamic banks have run into several difficulties. If, as suggested in the previous section, the Islamic banks would provide all the conventional financing through lending from their deposit accounts (current and savings), it will leave their hands free to engage in this responsible form of financing innovatively, using the funds in their investment accounts. They could then engage in genuine *Mudaraba* financing. Being partners in an enterprise they will have access to its accounts, and the problems associated with the non-availability of accounts will not arise.

Commenting on *Mudaraba* financing:<sup>54</sup>

Some people in the West have begun to find the idea attractive. It gives the provider of money a strong incentive to be sure he is doing something sensible with it. What a pity the West's banks did not have that incentive in so many of their lending decisions in the 1970s and 1980s. It also emphasizes the sharing of responsibility, by all the users of money. That helps to make the free-market system more open; you might say more democratic.

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<sup>54</sup> The Economist (1994)



## I. Challenges facing Islamic Banks

Islamic banks certainly face many challengers today, which are due to the fact that we live in an economy that is driven and manipulated by interest. The following is an illustration of the different challenges facing Islamic banking.

In a market economy, the banking sector is supported and regulated by the central bank. One could see this kind of support in terms of discount rates and other interest rates on loans given by the central bank to commercial banks in times of need. Also, the central bank regulates commercial banks, which will add to the health of those commercial banks. Unfortunately, Islamic banks in the region do not enjoy such privileges. Because of the fact that most countries have a central bank, which operates in a market economy, there is no support to Islamic banks. Islamic banks debunk the theory of interest and hence will not operate or do transactions with the central banks. This lack of support situates Islamic banks in an unenviable position. No one would want to save or invest in a bank that has no means of support or acts solely. This would hence create the problem of the lack in liquidity, which is vital to a bank's existence.

Another hurdle is the absence of liquidity instruments, such as bonds and other marketable securities, which could be utilized to either cover liquidity shortages or to manage excess liquidity. This problem is aggravated since many Islamic banks work under operational procedures different from those of the central banks; the resulting non-compatibility prevents the central banks from controlling or giving support to Islamic banks if a liquidity gap should occur.

The previous were the most important or serious challenges for an Islamic banking system. I think that these challenges and many others are a result of trying to build an Islamic banking system in economies and banks that operate and literally exist around interest.

## J. Goals of Islamic Economics

The money and banking system should, like all other aspects of the Islamic way of life, be made to contribute richly to the achievement of the major socio-economic

goals of Islam. The system should also continue to perform the usual functions that relate to its own special field and which other banking systems perform. From the previous arguments in this project, I came up with a list of goals and functions in the framework of Islamic banking, which is illustrated in the following:

- Broad-based economic well-being with full employment and optimum rate of economic growth.
- Stability in the value of money to enable the medium of exchange to be and a stable store of value.
- A just return is ensured on investment and development projects.
- Effective rendering of all services normally expected from the banking system.
- Socio-economic justice and equitable distribution of income and wealth reliable unit of account

## **K. Conclusion**

Islamic banking is a very young concept. Yet it has already been implemented as the only system in two Muslim countries; there are Islamic banks in many Muslim countries, and a few in non-Muslim countries as well. Despite the successful acceptance there are problems. These problems are mainly in the area of financing.

With only minor changes in their practices, Islamic banks can get rid of all their cumbersome, burdensome and sometimes doubtful forms of financing and offer a clean and efficient interest-free banking. All the necessary ingredients are already there. The modified system will make use of only two forms of financing -- loans with a service charge and *Mudaraba* participatory financing -- both of which are fully accepted by all Muslim writers on the subject.

Such a system will offer an effective banking system where Islamic banking is obligatory and a powerful alternative to conventional banking where both co-exist.



Additionally, such a system will have no problem in obtaining authorization to operate in non-Muslim countries.

Participatory financing is a unique feature of Islamic banking, and can offer responsible financing to socially and economically relevant development projects. This is an additional service Islamic banks offer over and above the traditional services provided by conventional commercial banks.

## Resources

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## ENCLOSURE

No.1

### PT SYARIKAT TAKAFUL INDONESIA AND SUBSIDIARIES PROFIT & LOSS ACCOUNT

For The Year Ended 31 December 2000 dan 1999

	2000 (Rp.)	1999 (Rp.)
<b>INCOME</b>		
Premium Revenue	58.633.020.758	43.927.711.031
Cost of Claims	(37.288.098.429)	(25.057.345.532)
<b>Underwriting Surplus</b>	<b>21.344.922.329</b>	<b>18.870.365.499</b>
Investment Revenue	6.479.148.652	1.614.903.067
General Administration Expenses	(27.335.853.684)	(20.461.896.564)
<b>Operational Profit (Loss)</b>	<b>488.217.298</b>	<b>23.372.002</b>
<b>NON OPERATIONAL INCOME (EXPENSES)</b>		
Non Operational Income	1.052.482.933	2.115.210.744
Non Operational Expenses	(103.957.812)	(691.840.820)
<b>Total Non Operational Income (Expenses)</b>	<b>948.525.121</b>	<b>948.525.121</b>
<b>Net Profit (Loss) Before Income Tax</b>	<b>1.436.742.419</b>	<b>1.446.741.926</b>
Estimated Income Tax	(203.564.800)	(275.960.200)
<b>Net Profit (Loss) After Income Tax</b>	<b>1.233.177.619</b>	<b>1.170.781.726</b>
Minority Interest	(5.009.774)	(10.819.117)
<b>Net Profit (Loss) After Tax &amp; Minority Interest</b>	<b>1.228.167.845</b>	<b>1.159.962.609</b>

**PT SYARIKAT TAKAFUL INDONESIA AND SUBSIDIARIES**  
**BALANCE SHEET**  
**As at 31 December 2000 and 1999**

<b>ASSETS</b>	<b>31 Dec 2000 (Rp.)</b>	<b>31 Dec 1999 (Rp.)</b>
<b>CURRENT ASSETS</b>		
Cash & Cash Equivalent	12.373.065.561	5.191.365.273
Takaful Contribution Receivables	5.586.579.964	13.479.536.755
Retakaful Receivables	798.833.139	928.417.310
Shareholder's Receivables	-	1.600.000.000
Others Receivables	2.181.487.074	871.431.893
Advance Payment	433.254.808	199.590.656
Prepaid Payment	298.592.406	280.599.126
<b>Total Current Assets</b>	<b>21.671.812.952</b>	<b>22.550.941.013</b>
<b>INVESTMENT</b>		
Time Deposits	29.441.417.500	47.118.650.000
Quoted Stocks	7.055.997.044	3.142.088.082
Land & Building	6.400.703.885	6.400.703.885
Murabahah Financing	3.828.827.046	1.329.558.603
Mudharabah Financing	17.367.500.000	-
<b>Total Investment</b>	<b>64.094.445.475</b>	<b>57.991.000.570</b>
<b>FIXED ASSETS</b>		
Fixed Assets (at cost)	8.241.309.523	4.678.186.668
Accumulated Depreciation	(2.038.773.135)	(1.282.892.856)
<b>Book Value</b>	<b>6.202.536.388</b>	<b>3.395.293.812</b>
<b>OTHER ASSETS</b>	<b>305.984.404</b>	<b>58.174.711</b>
<b>TOTAL ASSETS</b>	<b>92.274.779.219</b>	<b>83.995.410.106</b>
<b>LIABILITIES &amp; EQUITY</b>	<b>31 Dec 2000 (Rp.)</b>	<b>31 Dec 1999 (Rp.)</b>
<b>CURRENT LIABILITIES</b>		
Claim Liabilities	2.218.591.254	596.981.212
Own Retention Estimated Claims	2.640.604.959	624.109.763
Titipan Premi	492.324.850	115.149.638
Premium Deposits	4.707.121.175	10.197.561.155
Commission Payables	687.247.252	350.496.466
Tax Payables	632.116.132	476.061.894
Dividend Payables	771.705.158	-
Other Payables	466.052.309	384.100.094



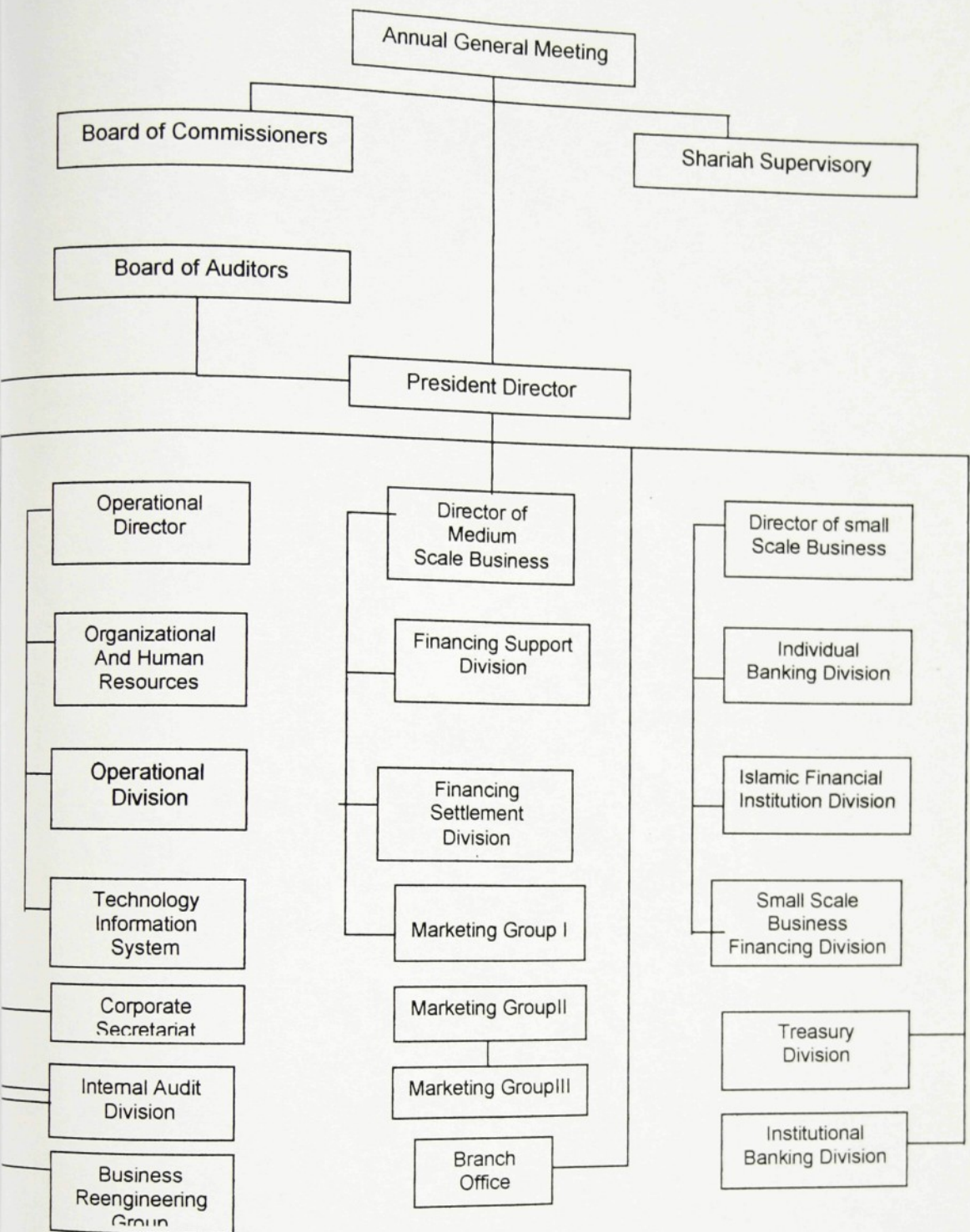
<b>Total Current Liabilities</b>		<b>12.615.763.089</b>	<b>12.744.460.222</b>
<b>LIABILITIES TO POLICY HOLDERS</b>			
Technical Reserve		62.112.714.305	49.035.230.469
Mudharabah Reserve		381.992.471	940.120.530
<b>Total Liabilities to Policy Holders</b>		<b>62.494.706.776</b>	<b>49.975.350.999</b>
<b>MINORITY INTEREST</b>		<b>141.012.110</b>	<b>139.065.910</b>
<b>EQUITY</b>			
Paid-up Capital		18.400.000.000	18.400.000.000
Subscribed Capital		-	1.600.000.000
Unrealized Increase (decrease) value on quoted stocks		(2.442.282.422)	(76.472.689)
Retained Earning		1.065.579.665	1.213.005.662
<b>Total Equity</b>		<b>17.023.297.243</b>	<b>21.136.532.974</b>
<b>TOTAL LIABILITIES &amp; EQUITIES</b>		<b>92.274.779.219</b>	<b>83.995.410.106</b>

Total Asset

TYPE	US \$mm	%
Murabaha	84.203	43.2
Ijara	37.711	19.3
Mudaraba	35.24	18.0
Islamic Securities	14.941	7.7
Other	23.115	11.8

Arab Banking Corporation, 2000





Organization of an Islamic Bank: Bank Muamalat

# Glossary

## A

**Al-Wadi'ah:** This refers to deposits in trust, in which a person may hold property in trust for another, sometimes by implication of a contract.

**Al-Wakalah al Mutlaqa:** Resale of goods with a discount on the original stated cost.

**Al-Qard al-Hassan:** Loans fixed for a definite period of time without interest or profit sharing.

**Allah:** The Name of the Creator of the Universe and all that it contains according to Islam. Derives from the word "Ilah" which means "the One deserving all worship", the One to Whom all hearts submit in love, fear, reverence, desire, trust and sincerity, and to Whom all limbs submit in all forms of worship such as prayers, supplications, sacrifices, invocations, etc.

**Amanah:** Something given to someone for safekeeping. Trust. The contract of amanah gives rise to fiduciary relationships and duties.

**Amwal:** Wealth. In business context, Amwal means wealth that is contributed as capital in a partnership. Plural: mal.

**Aqd:** A contract.

**Aqd Sahih:** A legal contract.

## B

**Bai':** Literally means sale. Commonly used as a prefix in referring to different types of sales: Muajjal, Murabahah, Tawliyah and Wadi'ah.

**Bai Mu'ajjal, also spelled as Bay Mu'ajjal:** Sale based on deferred payment, either in a lump sum or installments.

**Bai Salam, also spelled as Bay Salam:** This term refers to the advance payment for goods which are delivered later.

## D

**Dayn:** Loan or debt.



**Dinar:** Gold coinage; one dinar is 4.4 grams of gold.

**Dirham:** Name of a unit of currency, usually a silver coin used in the past in several Muslim countries and still used in some Muslim countries, such as Morocco and United Arab Emirates.

## F

**Falas:** Bankrupt

**Faqeeh:** An Islamic scholar who can give an authoritative legal opinion or judgement.

**Fard:** Obligatory. An act, which is obligatory on Muslims.

**Fard 'Ain:** An action, which is obligatory on every Muslim.

**Fard al-Kifayah:** Collective duty. A duty on the whole community. However, if the duty has been fulfilled by a part of that community then the rest are not obliged to fulfill it.

**Fatwa:** A legal verdict given on a religious basis. The sources on which a fatwa is based are the Holy Qur'an, Sahih Bukhari and Muslim, and all other authenticated Ahadeeth. Plural: Fatawa.

**Fiqh:** Islamic jurisprudence.

**Fuqahaa:** Jurists.

## G

**Gharar:** Uncertainty, hazard, chance or risk, ambiguity and uncertainty in transactions. Technically, the sale of something which is not present at hand; or the sale of something where the consequences or outcome is not known

**Gharim:** A person in debt.

## H

**Halal:** An act or product that is permitted by Islam.

**Hadith:** A saying or tradition of the Prophet Muhammad (S.A.W.). Plural: Ahadeeth.

**Hanafi:** Islamic school of law founded by Imam Abu Hanifa. Followers of this school are known as the Hanafis.

**Haram:** An act or product that is unlawful or prohibited in Islam.

**Haq:** Legal right.

**Hudud:** The boundary between what is Halal (lawful) and what is Haram (unlawful), set by Allah. Whoever transgresses these limits may be punished or forgiven by Allah.

**Hukum:** The closest equivalent in the English language is "verdict". It usually applies to a judgement on legal issues, especially with regard to religious matters.

## I

**Ijarah, also spelled ijara:** Literally means "to give something on rent".

**Ijarah wa iqtina:** Contract of renting, hiring or leasing.

**Ijma:** Consensus. What all the Ulama (people of religious knowledge) from among the Muslims agree upon.

**Ijtihad:** Technically, it means an endeavour of a jurist to derive or formulate a rule of law on the basis of evidence found in sources; scholarly effort through which a jurist/scholar derives Islamic law on the basis of the Qur'an and Sunnah.

**Ishtirak:** Equivocally; participation; partnership. Istidanah: Raising or building up credit through credit purchases. It however does not apply to the raising of cash loans.

**Istisna':** This is a kind of sale, where a commodity is transacted before it comes into existence.

## K

**Kafalah bi al-Thaman:** Surety for paying the price or sum if unpaid by the person originally liable.

**Kafil:** A person providing surety or a guarantor.

**Kharaj:** Tax imposed on the revenue from land taken from non-Muslims to ensure their equal rights under Islamic law.



## M

**Maiser:** Gambling. Literally means getting something too easily.

**Mu'amalah:** A term used for the transaction or agreement.

**Mubah:** Things or acts permissible in Islamic law.

**Mudharabah:** An agreement between two or more persons whereby one or more of them provide finance.

**Mudharib:** The partner who provides entrepreneurship and management in a Mudharabah.

**Mufti:** One who passes verdicts.

**Muhaddith:** A scholar of Ahadeeth. Plural: Muhaditheen.

**Muhadhitheen:** Scholars of Ahadeeth.

**Muqaradah:** Another name for Mudharabah used by Malikis.

**Murabahah:** Sale at a special profit margin. The seller purchases the goods desired by the buyer and sells them at an agreed mark-up price. The payment being settled within an agreed time frame, either in installments or lump sum. The seller undertakes all management needed for the purchase and also bears the risk for the goods until they have been delivered to the buyer.

**Musharakah:** A temporary equity participation agreement between a bank and a client for effecting a certain operation within an agreed period of time. Both parties contribute to the capital of the operation in varying degree and agree to divide the net profits or losses in proportions agreed upon in advance.

## N

**Nis'a (Riba al):** A type of interest. Taking interest on loaned money. An act which is Haram. See the Holy Qur'an, Al-Baqara (2):275-280 and Aali'imran(3):130.

**Nisab:** A threshold of wealth of which any excess is subject to Zakah.

## Q

**Qard:** A loan given for a good cause in the name of Allah, in hopes of repayment or reward in the Hereafter.

**Qard al Hassan:** A loan extended without interest or profit-sharing.

**Quadaa:** Paying in a debt.

**Qur'an:** A holly book of Muslims.

## R

**Ra's al-mal:** Capital invested in Mudarabah or Musharakah.

**Rabb al-ard:** Owner of the land in Musaqah or Musaqat and Muzara'ah contracts.

**Rabb al-mal:** A person who invests in Mudarabah or Musharakah.

**Rahn:** Pledge or mortgage.

**Riba:** Interest or usury.

## S

**Sadaqa, also spelled as Sadaqah:** Anything given away in charity in the name of Allah.

**Sahib al-Mal:** The financier in the mudharabah form of partnership agreement. **Shari'ah:** Islamic law as ordained by Allah .

**Sharikah:** The term is used for joint-stock companies and corporations

**Sharikat al-amwal:** A partnership in which participation is based on the contribution of wealth by all partners, but the partnership has to be of the type 'indn or mufdwadah.

**Shirikat al- 'aqd:** A partnership created through contract as opposed to co-ownership that may be the result of a joint purchase or agreement or it may result from inheritance or from some other legal situation.

**Shirkah:** Partnership between two or more persons, whereby unlike mudarabah, all of them have a share in finance as well as entrepreneurship and management, though not necessarily equally.



**Shurut:** Terms and conditions in Islamic law.

**Shukuk:** Check, certificate of debt, certificates of investment; plural of Shak

**Sunnah:** All the traditions and practices of Prophet Muhammad, that are recorded not only in such books as Sahih Bukhari and Sahih Muslim, but also in living people to whom these traditions and practices have been transmitted, from person to person, from then until now. Plural: Sunnan.

## T

**Takaful:** Islamic Insurance. A scheme of mutual support that provides insurance to individuals against hazards of falling into unexpected and dire need.

**Tijaarah:** Trade. Act of buying and selling.

## U

**Ulamaa:** Plural of 'Alim. The people who act on what they know and do what they say.

## W

**Wadi-ah:** Deposit.

## Z

**Zakah Al-Mal:** The Muslims' wealth tax: One must pay 2.5% of one's yearly savings above a certain amount to the poor and needy Muslims. The Zakah is compulsory on all Muslims who have saved (at least) the equivalent of 85g of 24 carat gold at the time when the annual Zakah payment is due.

**Zakah al-Fitr:** A small obligatory head-tax imposed on every Muslim who has the means for himself and his dependants. It is paid once yearly at the end of Ramadan before Eid al-Fitr.

**Zakatu-rid Tijaarah:** Zakah of profits of merchandise.