

## ISLAMIC MODES OF BUSINESS AND FINANCE

As indicated by the Pakistan's Council of Islamic Ideology (CII) (1980 Pp.4, 5) and almost all of the pioneers of Islamic finance in present age, ideally the real alternatives to lending on interest under an Islamic economic system are profit /loss sharing (PLS) or *qard-e-hasan* i.e. loaning without any charge over and above the principal amount. However, in view of the difficulties faced in practical application of PLS system (CII, Pp.9, 10) a number of other alternatives have been endorsed by the CII as also by other Shariah scholars. The Council, however, pointed out that "these alternative methods, though free of the interest element in the form in which they are specifically laid down in its Report, are no more than a second best solution from the viewpoint of an ideal Islamic economic system. Moreover, there is also a danger that they could eventually be misused as a means for opening a back door for interest along with its attendant evils. It is, therefore, imperative that the use of these methods should be kept to the minimum extent that may be unavoidably necessary under the given conditions and that their use as general techniques of financing must never be allowed."

The Council underlined the need to remove the widespread prevalence of unethical practices in the society and illiteracy so that PLS system could operate successfully. Unfortunately, however, the situation has rather deteriorated; the modes other than PLS would have to be used by banks by observing, of course, all Shariah essentials relating to such modes.

We can divide the alternatives to interest into three main categories: i.e. i) loans that could be either free of any charge or *qard-e-hasan* or with service charge; ii) profit/loss sharing and iii) debt creating modes based on trading or leasing that due to involvement of banks and financial institutions generate debt to which all rules relating to *riba* become applicable. It is pertinent to mention that the CII in its Report has not even mentioned the modes like *Musharakah*, Diminishing *Musharakah*, *Mudarabah* or its variant techniques probably because it did not like to confine joint enterprise to *Musharakah* and *Mudarabah* only. However, we would discuss them under separate headings so as to describe their principles that could be useful in practical application of the PLS system.

### 1. QARD-E-HASAN AND SERVICE CHARGE

Loans in the structure of Islamic banking and finance can take the form of either *qard-e-hasan* or service charge based financing. As a legal term loan (*Qard*) means to give anything having value in the ownership of other by way of virtue so that the latter could avail of the same for his benefit with the condition that same or similar amount of that thing would be paid back on demand or at the settled time. Jurists are unanimous on this legal definition<sup>1</sup>. Loans under Islamic law can be classified into *Salaf* and *Qard*, the former being loan for fixed time and the latter payable on demand.<sup>2</sup> *Dayn* is created as a result of any credit transaction in which one of

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<sup>1</sup> Ibn Hazm, *Al Muhalla*, Vol. 6, p. 347, No. 1191; *Al Jazeeri*, Vol 2, Pp. 300, 301, 677-680.

<sup>2</sup> Among the jurist, this is the opinion of Hanafi, Shafii and Hanbaly schools. To these jurists *Qard* is among *Duyun Haalah* (that can be demand any time). Particularly, Imam Abu Hanifa is of the view that any *Qard* can be called back by the lender any time. Same is the view of Ibn Hazm. According to Malik, when a time is settled for repayment (*Qard-e-Muajjallah*), the lender cannot demand its earlier payment (*Aini*, *Umdatul Qari*, *Kitab al Ishtiqraz*; Ibn Hazm, *Al Muhalla*, Vol. 6, P. 350, 351; *Sharah al Majallah* (*Atasi*), Vol. 1, p. 439.

the counter values is deferred. In *qard-e-hasan*, lender has claim on his principal only. By providing such virtuous loan an individual having surplus funds helps any needy person without any counter value or material consideration. He is obliged to reschedule or postpone the repayment of the principal asset, if the borrower's condition is such that he does not have ability to repay. The same is the case of Dayn or debt, only its principal has to be repaid.

As the banks are commercial organization, providing *qard-e-hasan* would not be a part of their normal business. However, on the line given by the central bank/Government from time to time they can provide economic support to specified classes of the society out of the 'Charity Fund' to which the proceeds of penalty charged on account of default would be credited in line with the judgment of the SAB. Keeping in view the emphasis on repayment of loan in Islam, banks would be required to undertake all possible measures including guarantee, surety or collateral to recover principal of such loans.

The other category of loans that banks could advance in interest free system would be the loans carrying service charge. It means that banks would provide loans with full guarantee for return of the principal plus a charge that may be just sufficient to cover the administrative costs of the banks/financing institutions. However, like *qard-e-hasan*, service charge based financing would not be a part of banks normal business. The CII has discussed in detail as to why 'service charge' cannot serve as an ideal alternative to interest in the business of banks and financial institutions (1980, Pp. 10-12).

## MAJOR ISLAMIC MODES AT A GLANCE

### Modes & their Close Conventional Equivalents

Islamic Finance	Conventional Finance	
<i>Intermediated</i>	<i>Intermediated</i>	<i>Not Intermediated</i>
1. <i>Murabaha</i>	None	None
2. <i>Salam</i>	None	Future contracts
3. <i>Istisna'a</i>	None	None
4. <i>Ijarah</i>	Leasing	Leasing
5. <i>Musharakah</i>	Shareholding	Venture capital
6. <i>Mudarabah</i>	None	Venture capital

## Part – I

### 2. PARTICIPATORY MODES OF FINANCING

Islamic modes are assets-based and involve real economic activity and/or liability. The most preferable category of modes belonging to participatory or profit/loss-sharing (PLS) techniques is described as hereunder.

## 2.1 SHIRKAH/MUSHARAKAH

1. In the early books of *Fiqh*, the partnership business has been discussed mainly under the caption of *Shirkah*. *Musharakah* is a term used by contemporary scholars both for broad and limited connotations. Technically, *Musharakah* means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses arising from a joint enterprise or venture. Broadly, it is referred to as a traditional *Shirkah* contract while in specific sense, a combination of *Shirkah* and *Mudarabah* is sometime termed as *Musharakah* wherein a Mudarib, in addition to the capital provided by the *Rabbul Mal*, employs his own capital as well. This arrangement is also permissible according to the jurists.
2. There are mainly two kinds of *Shirkah* : *Shirkat-ul-Milk* & *Shirkat-ul-Aqd*.
 

*Shirkat-ul-Milk* is the mixing of ownership mandatory or by choice; Basically, it is not for sharing of profit. The distribution of the revenue of *Shirkat-ul-milk* is always subject to the proportion of ownership; Co-owners are not agents of each other; Co-owner can sell his shares without other co-owner's consent and can guarantee the shares of other co-owner.

*Shirkat-ul-Aqd* is created through a contract with the basic purpose of Seeking profit; Partners are agents of each other; A partner cannot sell his share without other partners' consent; Partners cannot guarantee shares, or any profit, of other partners
3. Forms of of *Sharkat-ul-Aqd*: *Shirkat-ul-Amwal* Where all the partners invest some capital into a commercial enterprises; *Shirkat-ul-A'mal* Where partners jointly undertake to render some services to their customers and share the fee charged by them according to agreed ratio, and *Shirkat-ul-Wujooh* (Partnership in Goodwill) Where all the partners will avail credit from market using their credibility and sell the commodity to share the profit so earned at an agreed ratio. *Musharaka* rules discussed hereunder relate to *Sharkat-ul-Aqd*.
4. The partners may contribute funds, not necessarily equally – the arrangement covered under caption of '*Inan*' as discussed in *Fiqh* books. Partnership business can also be conducted by contributing labour, management, skill and goodwill.
5. Capital to be invested by the partners can be unequal and should preferably be in the nature of currency. If it were in the shape of commodities, the market value would be determined with mutual consent to determine the share of each partner. It may also be in the form of equal units representing currency called shares and the intended partners may buy these shares disproportionately. Cash/Receivables are to be taken at face value and the conversion rate of the day of transaction in case of currencies. In case of running finance facility on *Musharaka* basis the average utilized amount will be considered as *Musharaka* capital.
6. Capital of *Musharaka* has to be merged; merger can be actual as also constructive.
7. All assets of *Musharakah* are jointly owned in proportion to the contribution of each partner.
8. A person can become a partner of a running business having fixed assets by investing capital in cash/kind; merger of various partnership firms is also allowed.
9. Each partner has a right to take part in *Musharaka* management, but some of the partners may decide not to work for the *Musharaka* and work as a sleeping partner and they may appoint a managing partner by mutual consent. If all the partners agree to work for the joint

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

10. Power of appropriation in the property and participation in the affairs of the *Musharakah* may be un-proportionate to the capital invested by the partners.
11. In *Musharakah* (as also in *Mudarabah*), ratio of profit distribution may differ from ratio of investment in the total capital, but the loss must be divided exactly in accordance with the ratio of capital invested by each of the partners.
12. Profit can be divisible unequally and un-proportionate to the capital invested on the basis of work to be conducted for *Musharakah*. It is not allowed to fix a lump sum amount for any of the partners, or any rate of profit tied up with his investment. The profit ratio must relate to the actual profit accrued to the business and not to the capital invested by any partner. For example, it can be agreed that profit earned would be distributed between two parties on fifty: fifty, sixty: forty, or thirty: seventy, basis. It can also be agreed that partners A, B and C, for example, would get 30%, 40%, and 30% respectively of the net profit earned by the joint business.
13. Profit, in excess of the ratio of capital contribution can be on the basis of work done for the *Musharakah*. It means that if one or more partners choose to become non-working or sleeping partners, the ratio of their profit cannot exceed the ratio which their capital investment bears to the total capital investment in *Musharakah*.
14. The partners may at the later stage agree to change the profit sharing ratio, and on the date of distribution, a partner may surrender a part of his profit to another partner. Similarly, one partner can cap his share of profit. It is also permissible for partners to decide not to distribute a portion of profit and create reserve(s).
15. Profit ratio can either be fixed or variable according to the tiers. For example, one partner can say to the managing partner that his share in profit will be 50 % if earnings are up to 30 per cent and 40 percent if profit of the business exceeds 30 per cent.
16. Traditionally, the liability of the partners in *Musharakah* is unlimited. Therefore, if the liabilities of the business exceed its assets and the business goes in liquidation, all the exceeding liabilities shall be borne *pro rata* by all the partners. However, if all the partners have agreed that no partner shall incur any debt during the course of business, then the exceeding liabilities shall be borne by that partner alone who has incurred a debt on the business in violation of the aforesaid condition. Thus, liability of the partners in a partnership firm is unlimited since a partnership is not a legal person like a limited liability company. In case of business failure, and if *Musharakah* goes under loss, all liabilities in excess of remaining assets are to be shared proportionally by the partners.
17. Scholars have approved the concept of 'projected profit', but that will be subject to final settlement at the end of the term, meaning that any amount so drawn by any partner shall be

treated as 'on account payment' and will be adjusted against the actual profit due to each partner at the end of the term.<sup>3</sup>

18. In case when the whole Shirkah business comes to an end at the maturity or termination before the expiry, the business shall be liquidated actually and the settlement between the partners will take place. In case when one of the partners withdraws his shares without closing the business, the venture will be liquidated constructively.
19. Firms desiring to raise funds for investment can use this arrangement and offer to sell *Musharakah* Certificates in the market. After the project is started by acquiring non-liquid assets, these certificates can be traded in the secondary market.
20. *Musharakah* can be based on a written agreement between the bank and the client for a specific transaction or for a fixed period of time that can be renewed. Profit projections can play an important role in the *Musharakah* operations. The client would be required to provide periodically the results of operations of the business to the bank. The disputes can be resolved through a Review Committee comprising persons to be named in the *Musharakah* agreement with mutual understanding of the parties.
21. A partner cannot guarantee the capital of the other partners. However, in the case of *Musharakah* agreements with clients, the banks can obtain a pledge of security or guarantee to ensure safety and proper handling of the *Musharakah* business. Such security can be utilized in case the damage or loss to the principal amount/profit was due to sheer negligence of the client. Any third party that is legally independent from the *Musharakah* can guarantee to make up loss of capital, but the guarantee should neither be provided for any consideration nor linked in any manner to the *Musharakah* contract.
22. Banks can use the *Musharakah* instrument for working capital financing, project financing, import and export financing and for other types of single transactions. For widespread use and promotion of *Musharakah* financing, the Commission for Islamisation of Economy (CIE), in its Report of 1992 had recommended following steps:
  - a. Interest paid by businesses on borrowings should not be admissible as an expense under tax laws after a certain cut-off date.
  - b. Treatment of dividend paid by listed companies shall be at par with the profit paid on other interest free finance.
  - c. Banks should ensure that they have no intention to interfere in the day to day business of clients so long as the terms of the contract are faithfully adhered to.
  - d. Adequate training of the banks staff.
  - e. Interest-based borrowing by the Government should be replaced by a system based on profit and loss sharing.

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<sup>3</sup> According to rules set by Dubai Islamic Bank, if the actual profit is less than the projected profit, the trading partner has to give the genuine reasons for lesser profit. If he cannot prove, he will be liable to pay but the amount will go to charity.

- f. Existing interest bearing schemes for mobilization of resources should be discontinued and strict instructions should be given not to introduce any such scheme in future.
- g. A law should be enacted to prohibit all interest-based transactions.
- h. Reforming the taxation system to suit the application of *Musharakah*.
- i. Making the recovery laws more effective and stringent.
- j. Provision for a permanent Advisory Committee to advise and assist the Commission and the Government with regard to various aspects of Islamisation of banking system.
- k. Earmarking a portion of banks profit for *Qard-e-Hasan* to deserving and needy families.

## 2.2 DIMINISHING MUSHARAKAH

1. The participatory contracts that can be more suitable for present day ongoing projects, particularly for financial intermediaries, can be based on the concept of 'Diminishing *Musharakah*' (DM). In the Diminishing *Musharakah* contract, a party after participation in ownership of any business/project can liquidate periodically its investment from the ongoing enterprises. Such contracts contain a sale provision according to which a party agrees to sell its part of ownership to the other party periodically. It is a new type of contract suggested by contemporary jurists keeping in view the problems perceived while discussing the traditional *Musharakah/Mudarabah* principles in the long run economic perspective.
2. A DM contract may consist of two or three sub contracts, i.e. partnership by ownership (*Shirkatul Milk*) between two or more persons, leasing by one partner its share in the asset to the other partner(s) and selling by one partner its share to the other partner(s). Conditions relevant to partnership, lease and sale at various stages of DM arrangement should be fulfilled. Contracts relevant to commercial assets that do not involve leasing will involve two sub contracts – partnership and sale. All, two or three sub-contracts are considered permissible by the jurists particularly when the sale/lease contracts are stipulated among the partners, i.e. assets are sold/leased to the partners.
3. Diminishing *Musharaka* can be created only in fixed assets.
4. Proportionate share of each partner must be fully known and disclosed. In view the tax issues, property can be registered in the client's (partner) name. *Musharaka Agreement* can be executed between the partners to confirm share of each partner.
5. We can infer from the contemporary juristic opinions that an arrangement in which any of the parties makes a promise to purchase or sell the leased asset, that arrangement cannot be held to be contingent or conditional. A number of jurists particularly some *Maliki* and *Hanafi* jurists have opined that promises are enforceable, and the court of law can compel a promisor to fulfill his promise, especially in the context of commercial activities.
6. In case of house purchase, for example, a joint ownership (*Shirkatul Amwal*) can be created for the purpose of Diminishing *Musharakah*. The financier partner will give his undivided share on lease to the partner using the house. The client can purchase the share of the financier partner. It is preferable to sell / purchase each unit on market value, but it is also permissible to transact sale at any agreed price. Islamic banks can provide following facilities in respect of housing finance: Buying a home under ownership arrangement with

bank, Building a home by funds from banks and joint ownership, Renovating a home, or Balance Transfer facility (BTF) to replace interest payable loan with financing from the Islamic bank.

7. If a contract does not involve leasing, price of share units cannot be fixed in the promise to sell.
8. The preferable modus operandi, unanimously approved by *Shariah* scholars, is that three separate contracts are entered into in such a manner that each contract is independent of the other two contracts. However, from *Shariah* angle *Shirkah* and leasing contracts can be entered into simultaneously. Sale has to be a separate contract in any case meaning that it would be a unilateral undertaking and each Unit will be sold through proper Offer & Acceptance. Sequencing of contracts should be:-
  - a. A contract between partners to create a joint ownership through *Shirkatul Milk*.
  - b. Financing partner gives units of his share to the client on lease.
  - c. Partner (client) will go on purchasing the units of ownership of financing partner periodically at the mutually agreed price. Accordingly, the rent will go on decreasing.
9. If separate contracts are not entered into at different times, any of the parties may make a promise or agree to sell/purchase, before or after the lease agreement is finalized.
10. According to a Resolution of the OIC Fiqh Academy, and research undertaken by IRTI (Boualem, 1995), the sale provision of the contract can be made binding on the financier partner and the sale will be affected at the prices prevailing in the market at the time of actual sale.

### 2.3 MUDARABAH

1. In typical *Mudarabah*, one party provides the necessary capital and the other provides human capital needed for the economic activity to be undertaken. The contract of *Mudarabah* (also known as *Qirad/Muqaradah*) is traditionally applied to commerce alone, but it provides the basis of the relationship between banks, depositors and the entrepreneurs, and according to majority of the contemporary scholars, can be applied in all sectors of the economy like trade, industry, agriculture, etc. According to majority of jurists, *Mudarabah* is also a type of *Shirkah* when used as a broad term.
2. A *Mudarib* who runs the business can be a natural person, a group of persons, or a legal entity and a corporate body. *Mudarabah* shall include banks, unit trusts, mutual funds or any other institutions or persons by whatever name called.
3. Different Capacities of Mudarib
  - Ameen (Trustee): The money given by Rabb-ul-maal and the assets required therewith are held by him as a trust.
  - Wakeel (Agent): In purchasing goods for trade, he is an agent of Rabb-ul-maal.
  - Shareek (Partner) : In case the enterprise earns a profit, he is a partner of Rabb-ul-maal who shares the profit in agreed ratio.

- Zamin (Liable): If the business suffers a loss due to his negligence or misconduct, he is liable to compensate the loss
  - Ajeer (Employee): If the Mudaraba becomes void due to any reason the Mudarib is entitled to get a fee for his services
4. *Mudarabah* may be of various types, which may be multi purpose or specific purpose, perpetual, or for a fixed period, restricted or unrestricted and close or open-ended in accordance with the conditions respective to each of them.
  5. The capital in Mudaraba may be either in cash or kind. If the capital is in kind, its valuation is necessary, without which Mudaraba becomes void. *Rabbul Mal* shall provide his investment in money or goods, other than receivables, at a mutually agreed valuation which shall be placed at the disposal of the *Mudarib*.
  6. It is necessary for the validity of Mudaraba that the parties agree, right at the beginning, on a definite proportion of the actual profit to which each one of them is entitled. They can share the profit at any ratio they agree upon. However, in case the parties have entered into Mudaraba without mentioning the exact proportions of the profit, it will be presumed that they will share the profit in equal ratios. Some incentives can be given to the Mudarib as bonus for “good business”.
  7. The profit shall be divided according to the proportion agreed at the time of contract and no party shall be entitled to a predetermined amount of return or remuneration.
  8. Apart from the agreed proportion of the profit, the Mudarib cannot claim any periodical salary or a fee or remuneration for the work done by him for the Venture.
  9. *Rabbul Mal* will suffer the operational loss unless it is proved that the Mudarib has been guilty of fraud, negligence or misconduct, or has acted in contravention of the mandate. For the Mudarib, the loss is in terms of his un-rewarded labour or entrepreneurship.
  10. The liability of *Rabbul Mal* is limited to his investment, unless otherwise specified in the *Mudarabah* contract.
  11. In the case of deposits mobilized by banks on the basis of Mudaraba the profit from the banking business is shared between the Bank (as Mudarib) and the investment account holder (as *Rabb-ul-maal*) in a pre-agreed ratio
  12. The *Mudarib* can invest his funds in the business of the *Mudarabah* with the permission of *Rabbul Mal*. Profit of a *Mudarabah* project can also be reinvested in the business and the jurists have discussed this aspect in detail. It also refers to the arrangement of combination of *Musharakah* and *Mudarabah*. The *Mudarib* in that case would be entitled to get profit on his own capital in the proportion that his capital bears to the total capital of the *Mudarabah*. In addition to such share in the profit, the *Mudarib* shall also be entitled to share the remaining profit in agreed proportion. For example, a *Rabbul Mal* provides Rs 2000 for *Mudarabah*, the *Mudarib* contributes Rs 1000 to the same with the permission of *Rabbul Mal*, and the parties have agreed to share the profit in the ratio of 50:50. Let us assume the profit earned by the *Mudarib* is Rs 300. The *Mudarib* will get Rs 100 as profit on his own investment of Rs 1000. The remaining profit of Rs 200 will be distributed between the *Mudarib* and the *Rabbul Mal* on the agreed ratio of 50:50. In other words, out of the profit of

Rs 200, *Mudarib* will get Rs 100 and the *Rabbul Mal* Rs 100. The loss, if any, shall be shared in proportion to the capital of the parties.

13. While entering into *Mudarabah* contract, both parties may agree that no party shall terminate the contract during a specified period except in particular circumstances.

### 2.3.1 *Mudarabah* Certificates

Islamic *Fiqh* Academy of the OIC in its fourth session (February 6-11, 1988) resolved the following in respect of *Mudarabah* or *Muqaradah* Certificates (*Muqaradah* is synonymous with *Mudarabah* – two names of the same mode of business).

1. The term '*Mudarabah* Certificates' be used in place of '*Mudarabah* bonds'.
2. *Mudarabah* Certificates are investment instruments which mobilize the *Mudarabah* capital by floating certificates, as an evidence of capital ownership, on the basis of shares of equal value, registered in the name of their owners, as joint owners of shares in the venture capital or whatever shape it may take, in proportion to the each one's share therein.
3. The formula acceptable to *Shariah*, in general, for *Mudarabah* Certificates, must consist of the following elements:
  - a. *Mudarabah* contract must represent a joint share in the project, for whose establishment or financing it has been issued. Ownership remains valid throughout the duration of the project from its beginning to its end. It also confers all rights and privileges provided by *Shariah* upon the owner over its property, e.g. sale, donation, mortgage, inheritance, etc., bearing in mind that such certificates represent the *Mudarabah* Capital.
  - b. The contract, with regard to *Mudarabah* Certificates, is concluded on the basis of the terms defined in the prospectus, that offer is expressed by subscription and acceptance by approval of the issuing authority. The prospectus must provide all data required by *Shariah* for the "*Qirad*" contract (the *Mudarabah*), such as the nature of the capital, the distribution of profit and all other conditions related to the issue, which must be compatible with *Shariah*.
  - c. The *Mudarabah* certificates must be negotiable at the end of the subscription period, since the *Mudarib* has authorized to do so once the certificates have been issued, taking into account the following rules prescribed by *Shariah*:
    - If the *Mudarabah* capital, collected from subscription prior to its use in the project, is still in the form of cash, negotiating the *Mudarabah* certificates is considered as an exchange of money with money, governed by *Shariah* rules on money exchange.
    - If the *Mudarabah* capital turns into debts, *Mudarabah* certificates should be negotiated according to the rules applied to loans.
    - If the *Mudarabah* capital is converted into mixed assets, e.g. cash, debts, goods, benefits, *Mudarabah* certificates may be negotiated at the price agreed upon provided the major part of the capital is in the form of goods and benefits.
  - d. The one who received the funds collected from the subscribers to the certificates, for investment in the proposed project is called "*Mudarib*"; his ownership in the project is limited to the extent of his subscription. Thus, he is capital contributor in addition to his

share in the profit, after it is actually generated in accordance with the terms in the prospectus. The *Mudarib's* role in handling the subscribed funds and the project property is that of a trustworthy person, who may not be held responsible, unless his liability is permitted under *Shariah* rules.

4. Taking into account the preceding rules of exchange, *Mudarabah* Certificates can be exchanged in stock markets, if they are governed by the rules prescribed by *Shariah*, in accordance with the principles of supply and demand, and subject to the approval of contracting parties. They can also be negotiated if, at a given period of time, the issuing authority makes an announcement or an offer to the public, by virtue of which it pledges to purchase the said certificates, operation to be funded by the profits yielded by the *Mudarabah* at fixed price set by qualified experts in the light of conditions prevailing in the stock market and the financial status of the project. A party other than the issuing authority, indicating its commitment to purchase the certificates using its own funds may also make an announcement.
5. Neither the prospectus nor the *Mudarabah* contract should contain a guarantee, from the manager of the funds, for the capital or a fixed profit or a profit based on a percentage of the capital. If such clause is provided explicitly or implicitly, the guarantee condition is void, and the *Mudarib* is entitled to a profit equal to that of a similar *Mudarabah*.
6. The Prospectus of *Mudarabah* contract issued pursuant to it should not contain any statement obligating a sale, even if conditional or related to future. However, the *Mudarabah* contract may include a promise to sell and, in such case, sale is effected only on a contract basis, at a price fixed by qualified experts and agreed upon by the two parties.
7. The Prospectus or *Mudarabah* Contract issued pursuant to it should not contain any statement that the company would give fixed dividends in advance. If such clause exists, the contract is null and void. It implies that: -
  - a. The Prospectus or *Mudarabah* Contract issued pursuant to it, may not stipulate payment of a specific amount to the shareholder or to the owner of the project;
  - b. Only the profit is to be divided, as determined by applying rules of *Shariah*; that is, an amount in excess of the capital, and not the revenue or the yield. Liquidation or valuation of the project in monetary terms determines the extent of profit. What is in excess of the capital after liquidation or valuation is the profit to be divided between the shareholders and the *Mudarib*, in accordance with the terms of the contract.
  - c. The profit and loss account of the project must be published and brought to notice of the shareholders.
8. It is permitted by *Shariah* to include, in the Prospectus or the *Mudarabah* Contract, a clause stating that at the end of each period, a certain percentage shall be deducted either from the share of the shareholders in the dividend – if periodic liquidation is carried out or from their share in revenue or yields distributed on account, and deposited as special reserve for contingencies, such as loss of capital.
9. There is nothing in *Shariah* preventing the inclusion of a statement in the Prospectus or the *Mudarabah* Contracts, about a promise made by a third party, totally unrelated to the two parties to the contract, in terms of legal personality or financial status, to donate a specific

amount, without any counter benefit to meet losses in a given project, provided such commitment is an independent one, not related to the *Mudarabah* contract, in the sense that the enforcement of the contract is not conditional to the fulfillment of the promise, or that the promise underlines the terms of the contract. Hence, neither the shareholder nor the *Mudarib* may invoke this clause to avoid the contract or renege on his commitment, alleging that said commitment made by the third party had been duly taken into consideration in the contract. (Fiqh Academy, pp: 61-65)

## PART-II

### 3. FINANCING THROUGH NON PARTICIPATORY / DEBT CREATING MODES

The modes belonging to low risk category, when used by banks for financing, normally create debt. As trade and lease based modes may generate fixed return, they may be treated as non-participatory modes of financing. However, once the debt has been created, there can be no increase over the amount of debt in a manner which leads to additional return for creditor/debt holder on the principal. These modes are briefly discussed hereunder:

#### 3.1 MURABAHA WITH DEFERRED PAYMENT

1. *Murabaha* refers to mutually stipulated margin of profit (mark-up) in a sale transaction where the cost of the commodity is known or made known to the buyer. The parties negotiate the profit margin on cost and not the cost. If payment of the sale price is deferred, it also becomes *Muajjal*. The due date of payment of the price must be fixed in an unambiguous manner. Other terms used for similar transactions are installments sale, cost-plus/mark-up based sale, etc.
2. *Murabaha* can be used only where a commodity is intended to be purchased by the customer. If funds are required for some other purpose, *Murabaha* cannot work. Similarly, funds cannot be provided in *Murabaha* for unspecified purposes.
3. The ideal way is that the bank itself purchases the commodity directly from the supplier and after taking its delivery, resells it on *Murabaha* basis. Making the client agent to purchase on behalf of the financier renders the arrangement dubious. For this very reason, some Shariah Boards have forbidden this technique, except in cases where direct purchase is not possible at all. However, majority of the contemporary scholars have allowed that a financier makes the customer his agent to buy the commodity on his behalf. In this case, the client first purchases the commodity on behalf of his financier and takes its possession as such. At this stage, the commodity must remain in the risk of the financier who is seller in this finance cum trade transaction. Thereafter, the client purchases the commodity from the financier for deferred price. (Usmani, Taqi: 2000, p-106)
4. Banks should make sure that the client really intends to purchase a commodity which may be subject of *Murabaha*. In order to ensure that the transaction is genuine, they should take the following steps:

- a. Instead of giving funds to the customer, the purchase price should be paid directly to the supplier.
  - b. If it becomes necessary that funds be given to the client to purchase the commodity on behalf of the financier, his purchase should be evidenced by invoices or similar other documents which client should present to the bank.
  - c. If either of the above two requirements is not possible to be fulfilled, the bank should arrange for physical inspection of the purchased commodities.
5. *Murabaha* arrangement when practiced by the banks is a package of different contracts which come into play one after another at their respective stages. Banks must make sure that all these stages have been really observed and every transaction is effected on its due time.
  6. Possession of Goods by the Seller: - The seller must have a good title and should take possession (Physical or constructive) of the goods before selling them to his client. The scholars consider it sufficient in respect of the condition of 'possession' that the supplier from whom the bank has purchased the item, sets it aside for the bank and hands it over to any person authorized by the bank. In other words, the commodity must be in seller's risk, even though for a short period. The Islamic *Fiqh* Academy of the OIC in its Sixth session (14-20 March, 1990) resolved in respect of forms of 'Possession': "Just as the possession of commodities may be physical, by taking the commodity in one's hand or measuring or weighing the eatables, or by transferring or delivering the commodity to the premises of the buyer, the possession may also be an implied or constructive possession which takes place by leaving the commodity at one's disposal and enabling him to deal with it as he wishes. This will be deemed a valid possession, even though the physical possession has not taken place. As for the mode of possession, it may vary from commodity to commodity, according to its nature and pursuant to the different customs prevalent in this behalf". (*Fiqh Academy*, P:107)
  7. One can promise to sell something that is not yet owned or possessed by him. However, the actual sale will have to be effected after the commodity comes into the possession of the seller. This will require separate offer and acceptance.
  8. The absolute certainty of price is a necessary condition for the validity of a sale. If the price is uncertain, the sale is void.
  9. The price that is to be deferred can be more than the cash price. But it should be certain and settled at the time of sale once for all and neither be decreased in case of earlier payment, nor can be increased in case of default. In addition to the relationship of buyer and seller, there also emerges a relationship of debtor and creditor and therefore, the amount of debt once created should not increase.
  10. The bank as seller may ask the client (buyer) to furnish a security for payment of the price whether in the form of mortgage or in the form of a lien or a charge on any of his existing assets.
  11. In order to ensure that the buyer pays the installments promptly, he may be asked to promise that in case of a default, he will pay certain amount of penalty for a charitable purpose. Such penalty shall not constitute bank's income and shall be utilized for charitable purposes only.

12. The Supreme Court has prohibited purchase of the commodity from the client on 'buy-back' arrangement. The buy-back arrangement takes the form of *Bai 'inah* or *Bai al wafa* prohibited by the Holy Prophet (Peace be upon him).
13. The promissory note or bill of exchange resulting from the credit sale cannot be sold to a third party on a price different from the face value. (SAB, The Court Order, Para: 40)
14. The Shariat Appellate Bench of the Supreme Court in its Judgment on *Riba* has observed: "*Murabaha Muajjal* is a transaction of sale effected on the basis of deferred payment. One of the basic conditions of this transaction, like any other sale, is that the price is fixed at the time of the original contract of sale. This price may include a margin of mark-up (profit) added on the cost incurred by the seller. To determine the amount of mark-up, the seller may take different factors into consideration including the deferred payment, but, as already explained, once the price is fixed, it will be attributable to the commodity and cannot be increased or decreased unilaterally, because as soon as the sale is accomplished, the price of the commodity became a debt payable by the purchaser. If this debt is evidenced by a promissory note or a bill of exchange it is not different from a note or a bill evidencing a loan, and no return, whatsoever, can be charged over that note or bill, because it will amount to charging interest on the debt. ....after a sale is effected on the basis of mark-up, and the price is evidenced by a promissory note or a bill of exchange, including the original mark-up, no further return on the note or the bill is permissible in Shariah on the basis of the original mark-up".
15. Murabaha through Shares:- In recent years some Islamic banks have conducted shares Murabaha i.e. they purchase shares and sell them on Murabaha basis to the clients. It is permissible, but Islamic banks need to take extra care with regard to Shariah compliance matters. Banks should make payment directly to the brokers and the clients should not be appointed agent for purchasing the shares. After the shares are transferred to the bank actually or through any central depository, banks can sell them onward on Murabaha basis. Further, the shares in respect of which Murabaha is to be conducted should not be of any sister concern of the client, otherwise it will be 'buy-back' and therefore prohibited.
16. Default or Delay in Payment:- The Islamic *Fiqh* Academy of the OIC in its Sixth session (14-20 March, 1990) resolved the following in case of default or delay in payment by the client:
  - a. If the buyer/debtor delays the payment of installments after the specified date, it is not permissible to charge any amount in addition to his principal liability, whether it is made a pre-condition in the contract or it is claimed without a previous agreement, because it is '*Riba*', hence prohibited in *Shariah*.
  - b. It is *Haram* for a solvent debtor to delay the payment of the installments from their due dates. However, it is not permissible in *Shariah* to impose compensation in case he delays the payment.
  - c. It is permissible for the seller to impose a condition in the sale agreement that if the debtor/buyer delays the payment of some installments, all the remaining installments shall be due at once before their agreed date. This condition may be a valid condition, provided that the buyer had agreed to it when entering into the sale agreement.

- d. The seller has no right to secure the ownership (of the sold commodity) after the sale has taken place. However, it is permissible for him to impose a condition that the buyer shall mortgage the sold commodity with the seller to secure his right of receiving the deferred installments of the price.
17. In case of default by the client the Supreme Court has observed: "If the purchaser has delayed the payment despite his ability to pay, he may be subjected to different punishments, but it cannot be taken to be a source of further 'return' to the seller on percent per annum basis". In order to assure the bank about timely payment, the client may undertake that in case of default, he will pay a penalty to be calculated on percent per annum basis. This penalty will invariably be spent for pure charitable purposes and should in no case form part of the income of the bank.
  18. In case of default, *Murabaha* contract cannot be rolled over because the goods once sold by the bank, are property of the client and, hence, cannot be resold.
  19. The banks can ask for liquidated damages or solatium through courts in case of default. The S.C. Judgment says: "The legislature can also confer a power on the Court to impose penalty on a party who makes a default in meeting out his liability or who is found guilty of putting up vexatious pleas and adopting dilatory tactics with a view to cause delay in decision of the case and in discharging liabilities and from the amount of such penalty a smaller or bigger part depending upon the circumstances can be awarded as solatium to the party who is put to loss and inconvenience by such tactics. The amount of penalty can be received by the State and used for charitable purposes and in the projects of public interest including the projects intended to ameliorate economic conditions of the sections of the society possessing little or nothing *i.e.* needy people/peoples without means".
  20. In brief, *Murabaha* operations by banks should fulfill following conditions:
    - a. The commodity is in existence and owned by the seller.
    - b. The bank must have a good title to the commodity before it sells it to its client.
    - c. The commodity must come into the possession of the bank, whether physical or constructive, in the sense that the commodity must be at its risk, though for a short period.
  21. Discharging the Promise: The Islamic *Fiqh* Academy of the OIC in its Fifth session (10-15 December, 1988) resolved the following in respect of discharging or fulfilling the promise in *Murabaha* (sic):
    - a. According to *Shariah*, a promise (made unilaterally by the purchase orderer (client) or the seller), is morally binding on the promisor, unless there is a valid excuse. It is also legally binding if made conditional upon the fulfillment of an obligation, and the promisee has already incurred expenses on the basis of such a promise. The binding nature of the promise means that it should be either fulfilled or compensation is paid for damages caused due to the unjustifiable non-fulfillment of the promise.
    - b. Mutual promise (involving two parties) is permissible in the case of *Murabaha* sale provided that the option is given to one or both of the parties. Without such an option, it is not permissible, since in *Murabaha* sale, mutual and binding promise is like an

ordinary sale contract, in which the pre-requisite is that the seller should be in full possession of the goods to be sold, in order to be in conformity with the *Hadith* of the Holy Prophet (Peace be upon him) forbidding the sale of anything that is not in one's possession. (Fiqh Academy, pp: 86, 87)

### 3.1.1 Possible Procedure for *Murabaha* Operations by Banks

In case, the client is appointed as bank's agent as normally is the case, the *Murabaha* transactions would involve following five stages. Each of these five steps is necessary in its own right and neglecting any one of them renders the whole arrangement unacceptable:

1. The client and the bank sign an 'Agreement to Sell'<sup>#</sup> whereby the bank promises to sell and the client promises to buy a commodity for a purchase price plus a profit margin of 'X' percentage or amount over the cost.
2. The bank can appoint the client as its agent for purchasing the commodity on its behalf, and both the parties sign an agreement of agency.
3. The client purchases the commodity on behalf of the bank and takes its possession as an agent of the bank.
4. The client informs the bank that he has purchased the commodity on its behalf, has taken possession thereof, and makes an offer to purchase it from the bank at profit margin over cost as agreed to in the "Agreement to Sell".
5. The bank accepts the offer; the sale is concluded whereby the ownership as well as the risk of the commodity is transferred to the client. The Purchase Order, Material Receiving Report and Delivery Challan, by whatever name called, should be in the name of the bank. (Usmani, Taqi, 2000 pp: 107,108)

The Nature of Relationship in the above arrangement would be:

1. Bank and the Client : Principal and Agent.
2. Bank and the Client : Promisor and Promisee.
3. Bank and the Supplier : Buyer and Seller.
4. Bank and the Client : Seller and Buyer.
5. Bank and the Client : Creditor and Debtor.

Banks profit in *Murabaha* should be related to the schedule of payment, recognized as and when the payment is due. Profit that is not yet due can be debited to "Unrealized Income Account".

### 3.2. MUSAWAMAH (BARGAINING ON PRICE)

*Musawamah* is a general and regular kind of sale in which price of the commodity to be traded is bargained between seller and the buyer without any reference to the price paid or cost incurred by the former. Thus, it is different from *Murabaha* in respect of pricing formula.

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<sup>#</sup> This is different from the 'Sale Agreement' in which ownership rights are transferred to the buyer upon signing of the Agreement. In 'Agreement to Sell' a promise is made to sell any commodity in future and it does not involve conveyance of the ownership rights.

Unlike *Murabaha*, seller in *Musawamah* is not obliged to reveal his cost. Both the parties negotiate on the price. All other conditions relevant to *Murabaha* are valid for *Musawamah* as well. *Musawamah* can be used where the seller is not in a position to ascertain precisely the costs of commodities that he is offering to sell.

### 3.3. SALAM (ADVANCE PAYMENT - DEFERRED DELIVERY OF GOODS)

1. *Salam* is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange for an advance price fully paid on spot.
2. Seller and the buyer can agree on any price at their free will. Price in *Salam* can be lower than the spot sale price.
3. The buyer should pay the price in full to the seller at the time of finalising the sale. Otherwise, it will be tantamount to a sale of debt against debt, which is expressly prohibited by the Holy Prophet (Peace be upon him). The Islamic *Fiqh* Academy has resolved that the seller may give a concession of two or three days to the buyers but this concession should not form part of the agreement. Because of this consideration, a debt liability of the seller cannot be adjusted against price for *Salam* sale, in part or in full. *Allama Ibn Qudama* says "It is not permissible for a person to use (for instance) one *Dinar* owed to him by somebody else as *Salam* principal for purchasing a certain quantity of food from that person. *Ibn al Monzer* says: a consensus on prohibition of this (adjusting the debt in *Salam* price) had been reached by all the *Ulama* from whom I learned, including *Malik, al Awza'i, al Thawri, Ahmad, Es'haq, As'hab al rai* and *al Shafi'e*. However, *Ibn al Qayyim* and *Ibn Taymiah* allow that amount of debt can be subtracted from the price to be paid in *Salam*. (Umar, Haleem; 1995, pp. 32, 33)
4. Although the buyer has to pay the price in full at the time the *Salam* contract is finalized, yet the payment of hard cash is not necessary; banks may credit the seller's account or issue a pay order, in favor of the seller, which will be encashable on demand. *Salam* borrower (seller) may deposit the amount or the price he receives with the same bank with which he had entered into a *Salam* deal. However, granting a line of credit in *Salam* will not be advisable because in that case it would be difficult to fulfill the Shariah conditions relevant to *Salam*.
5. *Salam* can be applied in those commodities only that are normally available in the market and whose quality and quantity can be specified exactly. It may include any marketable goods with definable features, like raw materials, agricultural produce or manufactured goods.
6. The quality of the commodity that is intended to be purchased should be fully specified leaving no ambiguity leading to dispute.
7. Date of delivery must be well set either by linking it to a specific date or to an event whose happening is an absolute certainty although the date of its occurrence may be subject to a slight variance, provided it does not result in a conflict.
8. The time of delivery should be long enough to affect prices. Preferably, it should be fifteen days or one month from the date of agreement. But as the Holy Prophet (SAW) did not

specify any minimum period for the validity of *Salam*, it is all right to have an earlier date of delivery if the seller consents to it and other conditions of *Salam* are fulfilled.

9. The banks will receive certain commodities, not money, from their clients. They cannot sell commodities purchased through *Salam* before they are actually delivered to them. The Islamic *Fiqh* Academy of the OIC in its Eighth session (21-27 June, 1993) resolved in respect of *Salam* that: "As *Salam* (forward buying) contract covers a wide scope considering its terms and conditions, it benefits the buyer in investing his surplus funds for profit, as well as the seller in securing adequate commodity prices. A commodity which is subject of a forward contract (purchased through *Salam* contract) cannot be sold until it is received" (Also see Mu'watta, No. 1352, P. 301).
10. A parallel contract of *Salam*, however, is possible with any third party. The bank (buyer in *Salam*) can enter into a parallel *Salam* contract without any condition or linkage with the original *Salam* contract. In one contract, the bank will be the buyer and in the second the seller. Each one of the two contracts shall be independent of the other. They cannot be tied up in a manner that the rights and obligations of one contract are dependant on the rights and obligations of the parallel contract. Further, parallel *Salam* is allowed with a third party only. For example, if a bank has purchased from farmer 'A' 50 tons of wheat by way of *Salam* to be delivered on June 30, the bank can contract a parallel *Salam* with a trader 'B' to deliver to him 50 tons of wheat on June 30. But while contracting parallel *Salam* with 'B', the delivery of wheat to him cannot be made conditional upon taking delivery from 'A'. Even if 'A' does not deliver wheat on June 30, bank will be duty bound to deliver 50 tons of wheat to 'B'. Bank can seek whatever recourse it has against 'A', but he cannot back out from his liability to deliver the wheat to 'B'. Similarly, if the farmer delivers poor quality wheat, the bank will be still obligated to deliver the wheat of stipulated quality to 'B' according to the original *Salam* contract.
11. In order to ensure that the seller shall deliver the commodity on the agreed date, bank can ask him to furnish a security, which may be in the form of a guaranty, mortgage or hypothecation.
12. The jurists disallow the operation of the Islamic law of option (*Khiyar*) in the case of *Salam* because this disturbs or delays the seller's right of ownership over the price of the goods.
13. In case of multiple commodities, the amount and period of delivery for each item should be separately fixed.
14. *Salam* was allowed by the Holy Prophet (Peace be upon him) to fulfill the needs of farmers and traders. Therefore, it is basically a mode of financing for small farmers and traders in agricultural goods. Banks can use this mode to finance the agricultural sector in particular and other trading activities in general. If a parallel contract of *Salam* is not feasible, banks can also obtain a promise from a third party to purchase the goods. This promise should be unilateral from the prospective buyer. The buyers will not have to pay the price in advance as they are merely making a promise. However, bank can ask for earnest money. As soon as the bank receives the commodity, it will be sold to the third party at a pre-agreed price, according to the terms of the promise.
15. Regarding contemporary application of *Salam*, banks can use it for Agricultural Finance, Export Finance, Working Capital Finance, Inventory Finance, Operational Cost

Management, Liquidity Management-Short term financing, etc. Islamic *Fiqh* Academy (pp: 185-187) has observed that the wide range of applications of *Salam* may include the following:

- a. A *Salam* contract may be used to finance various agricultural operations, in which case an Islamic bank may deal with farmers expected to have the commodity in the right season, either from their own crop or from that of others, which they may purchase and deliver in case of failure on their part to honour the delivery out of their own crops. The bank would thus have extended to them a benefit of great value and protected them against the failure to achieve their production targets on account of resource constraints.
- b. A *Salam* contract may be used to finance agricultural or industrial activities particularly for financing the stages before the production and export of the manufactured goods, by means of buying them under *Salam* and marketing them again at profitable prices.
- c. A *Salam* contract may be applied in financing handicraftsmen, small manufactures, farmers and industrialists by providing them with the necessary production needs in the form of tools, equipment, or raw material as a forward capital against access to some of their produce and remarketing them.

### 3.3.1 Salam in Currencies

Islamic *Shariah* has treated money differently from commodities. Gold, silver and other metallic money like *Fulus* can be used for some purposes other than for making payments. However, the paper money can be used only as price, it cannot serve as a commodity to be sold. The currency notes in vogue are monetary values. They have no value in the absence of Government commitment and are wanted only for the purpose of exchange and payments and not for themselves. Accordingly, the present fiduciary money in the form of currency notes is cash money or monetary value and unlimited legal tender for making payment, as the creditors are obliged to accept them for recovery of debts.

Justice Khalil-ur-Rehman, in his part of the Supreme Court's Judgment on *Riba*, says: "The consensus, which appears now to have been made, is that the fiat money is money for all practical purposes and will have to be taken as a substitute for gold and silver, the real and natural money". (SAB, Feb., 2000, P. 269). About *Fulus*<sup>4</sup> he says: "As far as the copper *Fulus* are concerned, it has already been pointed out that their position was not that of an independent currency. They were a form of sub-money used only to make payments of the fractions of a silver coin because it was not easy to break one silver *Dirham* into two equal parts for making payment of half nor it was easy for the Government or the money changers to issue smaller silver coins to facilitate such factional payments. Therefore, the principles developed by the jurists to regulate the exchange of copper *Fulus* will not be applicable to the paper currency and fiat money of today. Today's paper money has practically become almost like natural money equal in terms of its facility of exchange and credibility to the old silver and golden coins. It

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<sup>4</sup> *Fulus* were copper or other inferior metal coins. Every district/area had its own *Fulus* of different genus, quality and quantity. For example, one district had 100 coins of one kilogram of copper while the other had 50 coins of the same amount of copper. They were commodity having intrinsic value. (Encyclopedia of Islam; Vol.2, p.49)

will, therefore, be subject to all those injunctions laid down in the Qur'an and the Sunnah, which regulated the exchange or transactions of gold and silver". (SAB, Page. 273)

In exchange/trade transactions, commodity to be sold (*mabi*) and the price (*thaman*) should be differentiated. A commodity is the principal object of sale from which the benefit is ultimately to be derived, in lieu of a price as settled between the contracting parties. The *thaman*, on the other hand, is only a medium of exchange. Currency notes represent *thaman* and money. A lawful sale, therefore, is the sale of commodities for money or for any other consideration measurable in terms of money possessing utility, but money sold for money is generally not a lawful contract and is qualified with a number of conditions. As regard trading in goods as distinct from exchange of various currencies, Justice M. Taqi Usmani in his part of Supreme Court's Judgment says: Money, being a medium of exchange and a measure of value cannot be taken as a "production good" which yields profit on daily basis, as is presumed by the theories of interest. This is a mediator and it should be left to play this exclusive role. To make it an object of profitable trade disturbs the whole monetary system and brings a plethora of economic and moral hazards to the whole society (Paras : 152).

The counter values to be exchanged in *Salam* include prompt price payment on the one hand and the commodity on the other. However, if price in *Salam* is US Dollars, for example, and the commodity to be purchased/sold is Pak Rupees, it will be a currency transaction which cannot be made through *Salam* because such exchange of currencies requires simultaneous payment on both sides while in *Salam*, delivery of the commodity is deferred.

A study conducted by IRTI, IDB (Umar Halim, 1995) on *Salam* has thoroughly discussed the issue whether money can be used as commodity in *Salam*. It says, "The second form: when principal is money (Saudi Riyals) and commodity sold is another type of money (US Dollars). This is a currency exchange transaction that cannot be made through *Salam* which requires deferred delivery of commodity sold while such exchange requires simultaneous payment of the two exchanged amounts. Allama Shirbini Al Khatib gives the following opinion in case where the principal (price) is money and the commodity sold is also money: "It is not permissible to pay one of them as *Salam* principal for the other because *Salam* requires payment of only one of the two exchanged objects of the contract at the time of signing the contract while the currency exchange requires simultaneous payment of both the exchanged amounts".<sup>5</sup>

The commodity is to be deferred in *Salam* and if the price is also deferred, the *Salam* contract will mean the exchange of debt against debt which is disapproved by the Holy Prophet (Peace be upon him) and therefore, unanimously prohibited by the *Fuqaha*. According to all schools of thought of Islamic jurisprudence and particularly to the *Hanafi & Maliki Fuqaha*, the principal paid in *Salam* should be in the form of money and the two transacted items should not be of the kind whose exchange would lead to *Riba*.<sup>6</sup> According to the jurists, it is a condition of *Salam* that 'price and commodity sold should be of the kind that can permissibly be dealt in on

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<sup>5</sup> IRTI, IDB *Shariah' Economic and Accounting Framework of Bai' ' Al-Salam* (1995) p.39 with reference from Al Shirbini, Mughni al Muhtaj, Mustafa al Babi, Egypt 1377H (1958) vol. 2, p.114

<sup>6</sup> IRTI, IDB, p.42,43.

deferment basis'. Allama Ibn-e-Rushd explained this issue in a comparative manner when he said about this condition, "if they are not of that kind, *Salam* cannot be practiced in them."<sup>7</sup>

In view of the above it is concluded that forward sale or purchase of currencies to take the form of *Salam* is not a valid contract. *Fulus*, that were the form of metallic money could be used for trading on the basis of their metal contents. But the currency notes are *thaman* wanted only for exchange and payments and not for themselves. Allowing exchange of heterogeneous currencies through *Salam* would open a floodgate of explicit *Riba*. The objects of *Salam* sale are commodities of trade and not currencies because these are regarded as monetary values, exchange of which is covered under rules of *Bai al Sarf*.

### 3.4. ISTISNA'A (ORDER TO MANUFACTURE/CONSTRUCT ANYTHING)

1. *Istisna'a*, like *Salam*, is a special kind of sale where sale of a commodity is transacted before it (the commodity) comes into existence. It is an agreement culminating into a sale at an agreed price whereby the purchaser places an order to manufacture, assemble or construct, or cause so to do, anything to be delivered at a future date. *Istisna'a* can be used for providing the facility of financing the manufacture or construction of houses, plants, projects, building of bridges, roads and highways, etc.
2. It is used in the field of manufacturing wherein *Al-Saani* (manufacturer) would arrange both the raw material and the labour. (If material is supplied by the purchaser and the manufacturer is required to use his labour and skill only, it will be the contract of *Ujrah* and not of *Istisna'a*.)
3. The subject of *Istisna'a* (things to be manufactured or constructed) must be known and specified to the extent of removing any ignorance or lack of knowledge of its kind, type, quality, and quantity.
4. The price should also be known in advance to the extent of removing ignorance or lack of knowledge, and price once settled, cannot be increased or decreased. However, it can be readjusted by the mutual consent of the contracting parties because of making material modification in the commodity (*al-Masnoo*) or due to unforeseen contingencies or changes in prices of inputs.
5. It is not necessary in *Istisna'a* that the price is paid in advance (unlike *Salam* in which spot payment of price is necessary). Price can be paid in installments within a fixed time period. Against the general rule set out for *Salam*, the contemporary scholars have legalized it on the basis of *Istihsan* as the construction of huge plants may require long gestation period and payment through installments according to the pace of implementation of such projects.
6. OIC Islamic *Fiqh* Academy recommends that time of manufacturing should be fixed.
7. It is not necessary for *al-Sanii* (seller) to manufacture the commodity himself. He may enter into a contract with a manufacturer to provide the subject matter of *Istisna'a*. On this basis,

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<sup>7</sup> IRTI, IDB, p.43 with reference from *Ibn Rushd, Bidyat al Mujtahid wa Nihayat al Muqtasid*, Dar al Kutub al *Hadith*, un-dated, vol. 2, p.168

the banks may undertake financing based on *Istisna'a* by getting the subject of *Istisna'a* manufactured through another such contract.

8. The bank (buyer in *Istisna'a*) can enter into a Parallel *Istisna'a* contract without any condition or linkage with the original *Istisna'a* contract. In one of them, the bank will be the buyer and in the second, seller. Each of the two contracts shall be independent of the other. They cannot be tied up in a manner that the rights and obligations of one contract are dependant on the rights and obligations of the parallel contract. Further, Parallel *Istisna'a* is allowed with a third party only.
9. Before a manufacturer starts the work, any one of the parties may cancel the contract by giving a notice to the other. However, after the manufacturer has started the work, the contract cannot be canceled by the buyer unilaterally. The Civil Law of some Muslim countries like Jordan and Sudan, the 'Unified Arab Law' proposed by the League of Arab Countries and the *Fiqh* Academy of the OIC treat *Istisna'a* a 'binding contract' provided that certain conditions are fulfilled. If the commodity conforms to the specifications agreed at the time of the *Istisna'a* contract, the purchaser is bound to accept the goods and he cannot exercise the option of inspection.
10. *Al-Mustasni* (purchaser) has the right to obtain collateral from the *al-Sanii* for the amount he has paid and as regards delivery of the commodity with specifications and time.
11. The contract may also contain a penalty clause on account of breach of the contract. It can be agreed, in other words, between the parties that in the case of delay in delivery, the price shall be reduced by a specified amount. The scholars have contended this on the basis of analogy. The classical jurists have allowed such condition in *Ijarah*, e.g. if a person hires the services of a tailor, he may tell him that the wage would be Rs 100 in case he prepares the clothes within a week and Rs 150 if within two days. By analogy, experts allow a penalty clause in the *Istisna'a* agreement in case of delay in delivery of the subject of *Istisna'a*.
12. The Council of the Islamic *Fiqh* Academy of the OIC in its Seventh session (9-14-May, 1992) recommended the following in respect of *Istisna'a*:
  - a. The *Istisna'a* (manufacture) contract is binding on both parties if it meets the basic requirements and conditions.
  - b. The *Istisna'a* contract must stipulate the following:
    - The nature, type, amount and required specifications of the product to be manufactured.
    - The time limit should be specified.
  - c. In the *Istisna'a* contract, payment may be deferred in full or scheduled according to pre-determined installments and specific due dates.
  - d. It is permissible to include a penalty provision in the *Istisna'a* contract except for inevitable circumstances.

### 3.5. IJARAH (LEASING)

1. In *Ijarah/Leasing*, the corpus of leased commodity remains in the ownership of the lessor and only its usufruct is transferred to the lessee. Any thing, which cannot be used without consuming the same, cannot be leased out like money, eatables, fuel, etc. In case such commodity is leased out, it will be deemed a loan and all the rules concerning the transaction of loan shall accordingly apply. Any rent charged on this invalid lease shall be treated as interest charged on a loan.
2. *Ijarah* or letting on lease can be used as a financing technique when a financier may buy and rent a productive asset to a person short of funds and in need of such asset. Bank may also purchase the asset as per specifications provided by the prospective lessee. A financier may invite other banks/investors to participate in the purchase and leasing operations. The rent and other terms of lease are to be agreed at the time of affecting the contract.
3. Rental can be fixed as also floating; for a floating rental it is necessary to be specified for the first period and there could be a provision in the contract to subject it to a certain benchmark for subsequent period. Such benchmark can have a ceiling and floor but should be based on a clear formula.
4. Different amounts of rental can be agreed for different phases during the lease period provided it is agreed for each phase while finalizing the lease. The lessor cannot increase the rental for any phase unilaterally. It can be mutually agreed in the agreement that the rental will be increased by a specified amount/proportion after specified intervals. As allowed by experts, the rate of increase in the rental can also be tied up with any defined benchmark like inflation and tax rates, etc.
5. All liabilities emerging from ownership are borne by the lessor. Thus, maintenance of the asset, other than routine operation expenses, during the lease period is responsibility of the bank, the owner of the asset, as the benefit (rental) is linked to the responsibility. The lessee can be made liable to the wear and tear that normally occurs to the asset during its use. Any harm caused by factors beyond the control of the lessee shall be borne by the lessor. *Takaful* (insurance) expenses will be borne by the lessor and not by the lessee.\*
6. In case any harm is caused to the leased assets by any misuse or negligence on the part of the lessee, he will be liable to compensate the lessor for the harm.
7. The lease period shall not commence from the date the payment is made by the lessor to supplier of the asset, but from the date the asset, in working condition, is delivered to the lessee, no matter whether the lessee has started its use or not. The lessee can be asked to pay any advance that will have to be adjusted from the rental after its being due. The lessor is liable to pay all expenses like freight, custom duty, etc. incurred up to the time of delivery to the lessee.
8. The lessee can be asked to undertake that, in case of failure to pay rent on its due date, will pay certain amount of penalty to be used in charity.

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\*Some religious boards allow the conventional insurance so long as Shariah Compliant *Takaful* or solidarity/mutual help technique of insurance is not available.

9. The leasing contract is terminated if the asset ceases to give the service for which it was rented. If the asset becomes damaged during the period of the contract, but the same can be repaired to make the asset usable, the contract will remain valid. If the parties to the lease do not contravene the terms of the agreement, the lease cannot be terminated unilaterally. In case of termination, the lessee will be liable to pay rent up to the date of termination and handing over the asset to the lessor. He shall not be liable pay the rent for the remaining period.
10. Out of the two types of leasing, i.e. operating lease and finance lease, only the former is permissible which is a hire arrangement whereby rentals are dealt with in the Profit and Loss Account and the asset is shown in the balance sheet of the lessor. The finance lease is akin to an arrangement of financing whereby accounting takes the form as if the client, the user, has indeed purchased the asset.
11. In conventional Hire-purchase where buyer starts using the asset with initial payment of installment, ownership may or may not be transferred to him, and after he makes the payment of complete price, obtains the title of the subject matter. It (transaction) is neither a sale nor Ijarah. For valid Ijarah ownership must remain with the lessor who should also bear the ownership related risks and expenses.
12. Islamic Hire-purchase or Ijarah Muntahee Bittamleek, there would be only the lease contract, and after the lease is complete or terminated, there would be separate sale or transfer ownership agreement. However, while entering into a lease agreement there could be a unilateral undertaking that the asset would be sold / purchased to / by the client.
13. While fixing the rent of the financed equipment, the financial institutions calculate the total cost they have incurred in its purchase and add the stipulated interest that they plan to claim on such amount during the lease period. The cost and the return thereon can be kept in view while determining the rent, but if the lease transfers the risks and rewards of ownership of the asset to the lessee, it will not be a valid contract.
14. Any express or implied bilateral agreement that title of the asset will pass on to the lessee at the end of the lease period is not in accordance with the Shariah principles. This is because one transaction cannot be tied up with another transaction so as to make the former a pre-condition for the other. However, as suggested by OIC *Fiqh* Academy, there can be a unilateral promise to gift or sell the asset at end of the lease period subject to following conditions (sic): (a) Firstly, the agreement of *Ijarah* itself should not be subjected to signing this promise of sale or gift but the promise should be recorded in a separate document. (b) The promise should not be binding on both parties because in that case it will be a full contract ascribed to a future date, which is not allowed in the case of sale or gift.
15. It can be agreed that the rental would consist of two specified parts: one to be paid to the lessor and the other to be held by the lessee to cover any expenses or cost (e.g. major maintenance, insurance, etc). The part of rental received by lessor in advance will be treated as. If the lessee cancels the Ijarah contract, the lessor reserves the right to retain the earnest money. It is preferable for the lessor to wave any amount in excess of the actual damage, which is the difference between the rental specified in the contract and the rental decided in a new Ijarah with another lessee.

16. The *Shariat* Appellate Bench has observed in respect of leasing: “The correct position according to *Shariah* is that once the lessee has enjoyed the usufruct of the leased asset for the period of lease, the amount of rent has become a debt due on him and it will be subject to all the rules relevant to a loan or debt, and as mentioned in the case of mark-up, if the lessee is unable to pay on account of his poverty, he will have to be given further time according to the clear Quranic command, and if he is purposely delaying the payment, he will be subjected to punitive steps. But his delay will not be taken as an automatic source of return to the lessor, ....”
17. Flexibility in the Mode of *Ijarah*: If the asset being leased and amount of rent both are clearly known to the parties at the time of the contract, *Ijarah* can be contracted on an asset or a building that is yet to be constructed, as long as it is fully described in the contract provided that the lessor should normally be able to acquire, construct or buy the asset being leased by the time set for its delivery to the lessee. Payment of rentals can be unrelated to the period of taking usufruct by the lessee, i.e. it can be made before beginning of the lease period, during the period or after the period as the parties may mutually decide.
18. Sale and Lease back: It is permissible to lease an asset to a party that had sold the same asset to the bank, provided that the *Ijarah* transaction should not be stipulated as a condition of the ‘purchase contract’ and the both contracts are executed separately. However, some scholars don’t prefer this kind of lease and restrict its use to only those clients who intend to convert their interest based borrowings to Islamic modes.

### 3.5.1 *Ijarah* and Diminishing *Musharaka*:

*Ijarah* based financing could also be provided on the basis of Diminishing *Musharaka*. According to the Report of CII, “the banks, under hire purchase arrangement may finance the purchase of machinery and equipment as well as consumer durables under a joint-ownership arrangement subject to provision of security or surety. They would receive, in addition to repayment of the principal, a share in the net rental value (after allowing for depreciation) of these items in proportion to their outstanding share in total investment. The items may also be insured and the cost of insurance may be shared between the bank and the other party proportionately on the basis of their outstanding investment. However, unforeseen repairs may be entirely the responsibility of the user of the equipment.” (1980: 16).

The Council itself has referred to the difference of opinion and its recommendation in the following words: “From the point of view of *Shariah*, this opinion may be open to objection on the ground that in this contract, hire is made contingent upon future sale. However, the *Fuqaha* have, on the basis of usage, tacitly approved the making of such conditions with hire as are customary and mutually agreed upon and are not likely to cause a dispute. According to them, a conditional hiring can cause such disputes. Ibn Abidin, in his book ‘*Nashr al-Urf*’, has considered a number of conditions incorporated in a contract, which are governed by custom, as permissible. Since no dispute can be anticipated in case of hire purchase governed by the method suggested, as visualized in the light of usage and custom, the Council has accepted the conditional contract of hire-purchase on the ground of necessity.” (Notes; Page 90, 91). However, this arrangement is covered under Diminishing *Musharaka* and not under Hire-

purchase and in case of Diminishing Musharaka, creating joint ownership and leasing can be simultaneous, but sale would have to be separate.

### 3.5.2 Assignment of Lease

Assignment of lease wherein the lessor sells the leased assets to a third party is allowed provided ownership in the assets is also transferred to the purchaser/assignee. Assignment only for monetary benefit, without assigning the ownership alongwith its risk/reward is not permissible.

### 3.5.3 Securitisation of Lease Contracts

Flexibility in the contract of *Ijarah* is useful to evolve different forms of contracts and Sukuk to suit issuers and investors. Most of the Sukuk issued by SPVs in recent years are based on the *Ijarah* concept. Moreover, banks can also securitize their leased assets. A lessor, after entering into *Ijarah*, can sell the leased assets wholly or partly either to one party or to a number of individuals. In the latter case, each individual would be given *Ijarah* certificates representing the holder's proportionate ownership in the leased assets and will assume the rights and obligations of the owner/lessor to that extent. All certificate holders will have the right to enjoy a part of the rent according to their proportion of ownership in the asset. These certificates, being an evidence of proportionate ownership in a tangible asset, can be negotiated and traded freely in the market and can serve as instruments convertible into cash. However, if such *Ijarah* certificates are issued that represent the holder's right to claim certain amount of the rental only without assigning to him any kind of ownership in the asset meaning that the holder of such a certificate has no relation with the leased asset at all and his only right is to share the rentals received from the lessee, it will not be allowed.

The rent after being due is a debt payable by the lessee. The debt or any security representing debt only is not a negotiable instrument in *Shariah*, because trading in such an instrument amounts to trade in money or in monetary obligation which is not allowed, except on the basis of equality. It is, therefore, necessary that the *Ijarah* certificates be designed to represent real ownership of the leased assets, and not only a right to receive rent.

## 3.6 TIME MULTIPLE COUNTER-LOANS (TMCL)

Sheikh Mahmud Ahmed (Late), a Member of the Panel of Economists and Bankers that was appointed by the Council of Islamic Ideology to prepare a comprehensive report on Islamic banking had suggested this Scheme in 1978 (Ahmed, Mahmud, 1989). The loaning arrangement under this scheme is that the loan taken by the borrower multiplied by time of that loan will be arithmetically equal to the counter-loan given by the borrower, multiplied by time. For example, a person who wants to borrow Rs 100,000/- for one year will have to give counter-loan of Rs 12,500/- for 8 years. By use of TMCL as a major alternative to interest, the author of this Scheme visualized infinite credit creation to provide as much credit as demanded by economic agents.

This model of interest free banking is based on a misconception of Islamic theory of finance and the modern banking practices. It ignores the key role of modern banks, namely, the intermediation between savers and investors. It fails to propose ways and means to woo primary

deposits – the very basis of credit creation. The model also does not visualize any role for the central bank with regard to changes in the level of primary money. The foundational notion and the rationale of other ingredients of the model are hardly tenable both from economic as well as Islamic point of view. Infinite credit creation, as proposed, would be a recipe for injustice, exploitation and chaos in the economy. Analysis of the scheme in brief is given in the following points:

1. The loan-values of the original bank loan and the counter-loan advanced by the borrower-whose equality the author considers to be the foundational notion of TMCL banking are not equal.
2. Equality between two exchangeable loan-values do not make them Islamic for these values could remain equal even if the original and the counter-loans are advanced on interest.
3. The ruling bank-deposit multiplier as assumed by the author does not arithmetically result in the supply of bank credit. Its level is by and large dictated by actions of the central bank, which in turn are dictated by national interests. Accordingly, banks expand and contract credit according to prevailing economic and political circumstances and not merely with reference to their cash-base.
4. The idea that a banking system without statutory reserves is capable of infinite credit creation is a myth. There are other important factors which also limit banks power to create credit.
5. There is no economic rationale to justify infinite credit creation as expansion of bank credit is limited by the absorption capacity of an economy. It is bridled credit creation, which is important from the point of view of a sound monetary policy, and not the infinite credit creation.
6. Screened through the built-in flexibility of the TMCL system, one of the suggested alternatives (counter-loan ratio) does not appear to make any real impact as control instrument.

In the case of TMCL, the Council of Islamic Ideology observed the following: “The concept of counter-loans, in essence, is quite simple and can best be explained with the help of an example: Suppose a small trader ‘A’ wishes to borrow Rs 100 from a bank ‘B’ for three months, free of interest. ‘B’ may provide the required loan to ‘A’ if the latter, simultaneously with receiving the loan, deposits a fraction of the loan for a proportionately longer period, says Rs 10 for 30 months. After three months, ‘A’ repays Rs 100 to ‘B’ but would pay back to ‘A’ his deposit of Rs 10 after the expiry of 30 months from the date of the deposit. During this period, ‘B’ can use this deposit or “counter-loan” for profit earning investment. However, just as ‘A’ would not be required to share the income earned by him by deploying the loan provided by ‘B’, the latter would also not pay any additional amount when ‘A’s deposit (counter-loan) matures”(Report: 1980).

“The Council is of the view that it would not be correct to use this method by way of a permanent alternative system to the interest based system. However, if it is desired that provision may be made for providing personal loans to people of small means, then instead of the above stipulations the banks may adopt it as a principle that they would provide loans for personal and non-productive purposes only to those persons who already hold accounts with

them. In laying down the repayment schedule and the amount of the loan, however, the banks may keep in view the amount of the deposit of the applicant for the loan and the period over which he has maintained his deposit with the bank.” This arrangement suggested by the Council for sparing use is not the TMCL as suggested by its author.

### **3.7 TAWARRUQ BASED COMMODITY CONTRACTS**

A new contract namely Tawarruq is being used by Islamic banking industry in the GCC region. This product is to cover the customer's need of cash through the mechanism of trade. Tawarruq is buying goods on credit and selling it to a buyer other than the seller for a spot price to get the cash. In crude form it is permissible and a person who is not able to get funds as Riba free loan can use this modus operandi to fulfill his needs. As it could become a Hilah and a back-door to interest, most of the Shariah scholars do not recommend it as a banking mode. Allamah Ibne Taymiah considers it reprehensible.

According to a ruling issued by Religious Board of Kuwait Finance House, it is permissible from Shariah point of view to purchase a commodity on deferred payment basis and then sell it to any third party on cash payment to get cash, though some scholars have disliked it, particularly if someone habituates this sort of transaction (Question 113, page 162 of Sheikh Yusuf DeLorenzo's "Compendium of Legal Opinions on the Operations of Islamic Banks" - first edition). However, it will be Bai al Inah and therefore prohibited if the commodity is sold on credit to the same person from whom it was bought on credit. If allowed, Shariah advisors should approve Tawarruq transaction on case to case basis.

Some Islamic banks used Tawarruq and after selling the commodity to the client on Muajjal-Murabaha basis sold the commodity to any third part as agent. This resulted in a number of Shariah compliance problems and sometimes the clients even did not know the nature of commodity sold to him on Murabaha or he had no right to get delivery. Accordingly, now Shariah scholars recommend that Tawarruq if used by banks should not involve Wakalah argument.

According a BMA Newsletter, Islamic commercial banks have been able to leverage the structure to offer indirect working capital financing as well as for short-term liquidity management. The new structure has Shariah endorsement and the application allows Islamic banks to benefit from institutional and corporate funding, as well as enabling them to finance customers and place their own surplus liquidity with other institutional counter parties. Bahrain-based Islamic Finance Consultants (IFC) and London-based Dawnay Day have outlined the process flow of Tawarruq contracts as follows:

#### **Investment Facilitation**

To transact a client investment, the Islamic bank, as agent for the client, will acquire the commodity directly from the supplier on terms of spot delivery and spot settlement. The Islamic banks, as principal, will purchase the commodity from the client on terms of spot delivery and deferred settlement and then will sell the commodity to the purchaser on terms of spot delivery and spot settlement.

#### **Financing Facilitation**

To transact a client financing, the Islamic bank, as principal, will purchase the commodity directly from the supplier on terms of spot delivery and spot settlement. The Islamic bank will sell the commodity to the client on terms of spot delivery and deferred settlement. The Islamic bank, as agent for the client, will sell the commodity to the purchaser on terms of spot delivery and settlement.

*Tayseer Al-Ahli* is an Islamic financial instrument introduced by The National Commercial Bank of Saudi Arabia (NCB) for its customers by buying a commodity from the International Market that is known for its non-fluctuated price and selling it to the customer; then reselling it back to the International Market. The NCB's roll is to serve the customer and to sell to him the commodity that it owns and to make it easy for the customer to resell the commodity as an agent back in the International Market to get the cash.

### PART-III

#### 4. SOME SUB-CONTRACTS

In the literature on Islamic law a number of other contracts have been discussed that can be considered as sub-contracts within the main contracts like *Shirkah*, *Ijarah* or *Bai*. It is pertinent to discuss some of these sub-contracts like *Hawalah*, *Kafalah*, *Bai-al-Dayn*, etc.

##### 4.1 HAWALAH (ASSIGNMENT OF DEBT)

*Hawalah*, derived from word '*Tahawwul*' or '*Tahwil*' literally implies transfer or change of locality, from a person to another or from a situation to another. Legally, *Hawalah* is an agreement by which a debtor is freed from a debt by another becoming responsible for it, or the transfer of a claim of a debt, by shifting the responsibility from one person to another – endorsement or assignment of debt. Transfer of debt should take effect immediately, not to be suspended for a period of time and not to be concluded on a temporary basis or contingent on future unlikely events. However, it is permissible to defer payment of the transferred debt until a future specified date. *Hawalah* is a generous contract and not a contract of sale. It also refers to the change of creditor and in that sense it would mean transfer of a right. Assignment of debt is allowed at nominal value of the debt/debt instrument with recourse to the original debtor or the assignor in case the assignee defaults in payment of the liability. *Hawalah* is a binding contract and not subject to unilateral termination. In the case of bankruptcy or death of the transferee, the obligation to pay the debt, would return to the assignor. No obligation of debt will be left without being paid, in case the assignee goes bankrupt, dies and so on. If the transferee or delegated payer does not pay the debt, the responsibility of such payment returns to the assignor. *Hawalah* also applies to a mandate to pay and denotes the document by which the transfer of the debt is completed. As such, it also means a promissory note or a bill of exchange.

The Prophet (Peace be upon him) is reported to have said, "Procrastination in paying debts by a wealthy man is injustice. So, if debt is transferred from your debtor to a trustworthy rich debtor, you should agree". This *Hadith* indicates that the order of the Prophet (Peace be upon him) to accept *Hawalah* by a rich debtor is a recommendation, as is held by the majority of the

jurists. This *Hadith* also implies that *Hawalah* is valid when it is contracted as a result of mutual consent between assignor (the creditor) and assignee (the delegated payer).

The Muslim jurists encouraged this contract and it was carried to Europe through Spain and Sicily during the crusades of the 12<sup>th</sup> century of the Common Era (See Hassan, Abdullah Alwi, 1993).

#### 4.2 DEBT TRADING (*BAI- AL-DAYN*)

OIC *Fiqh* Academy and *Shariah* scholars in Pakistan and Arab countries consider sale/purchase of securities or documents representing debt on a price other than their nominal value incompatible with tenets of the Islamic *Shariah*. Banks in Pakistan were allowed in early Eighties to purchase trade bills considering the same as a *Murabaha* contract. But the CII and the *Shariah* Court disapproved such transactions. There is no difference of opinion with regard to a credit document emerging from any transaction of credit sale that the amount of the document represents a debt and it should conform to the *Shariah* rules relating to *Riba*. The *Shariah* Court has declared that interest arising from the government and other approved securities falls under the category of *Riba*. Similarly, securities that carry return on the basis of indexation with regard to inflation have not been accepted by the Court as permissible mode of investment.

Assignment of debt instruments is possible on the concept of '*Hawalah*' that implies transfer of debt obligation from the originator to the third party. For validity of such transfer, certain conditions are mentioned in the books of *Fiqh*. Most important condition would be that such trading takes place at face value since exchange of debt instruments at a value different from the face value (i.e. discounting) is not permissible under *Shariah* (SAB, Court Order, Para: 40). The difference between 'sale of debt' that is prohibited and the 'assignment of debt' that is permissible is that in the latter there is recourse to the assignor or the original debtor in case the assignee does not pay the debt due to any reason what so ever. In the sale of debt, the purchaser of debt instrument has no recourse to the seller of the debt and therefore, due to involvement of *Gharar* and *Riba*, sale of debt is prohibited.

Semi-debt instruments like leasing contracts resemble debt in the sense that they oblige the user to certain specific commitment (rent). Such contracts can be traded under certain conditions since such trading represents the sale of leased assets, which can be conducted on negotiated prices.

Islamic banks, therefore, would not trade in debts, as do the conventional banks, for the basic reason that debts/debt instruments are not saleable at premium or discount. *Murabaha* can be used in trading of goods and merchandise and not in credit documents. Islam forbids the sale of one instrument of debt for another. This prohibition affects when obligations (to perform or to pay) are delayed, and when such obligations may be bought, sold or otherwise transferred. According to Islamic law, property is either a specific existent object ('*ayn*') e.g. a house, or an object defined generically or abstractly by an obligation (*dayn*) e.g. to pay Rs 1000 or to deliver 100 tons of wheat. One can subdivide sale according to the types of property being exchanged. Many restrictions apply to the sale of debt for debt, summed up by a maxim forbidding the sale of *al kali bil kali*, meaning literally the exchange of two things both delayed or to exchange of delayed counter value for another delayed counter value. This principle has near universal application and earned canonical authority in Islamic law as *Ijma'* or consensus.

### 4.3 KAFALAH (GUARANTEE)

There are two forms of guarantee i.e. *Kafalah* or suretyship and *Rahn* or pledge/surety. The two pre-Islamic contracts used for guarantee or safe return of loans to their owners were approved by the Holy Prophet (Peace be upon him) and their elaborated applications were extended by the later generations in order to avoid any iniquities to both parties in the contract of loan, especially to the creditor.

Literally, *Kafalah* means responsibility, amenability or suretyship. Legally, in *Kafalah* a third party becomes surety for the payment of debt, if unpaid by the person originally liable. It is a pledge given to a creditor that the debtor will pay the debt, fine or any other liability. Suretyship in Islamic law is the creation of an additional liability with regard to the claim, not to the debt, or the assumption only of a liability and not of the debt.

*Kafalah* and *Rahn* interrelate in the case of debt, but they have different functions. In the contract of *Kafalah*, a third party becomes surety for the payment of debt, but in *Rahn*, the debtor hands over something as pledge to ensure the payment of debt. Mutual consent/agreement is the basis for validity of both the contracts, as in other business transactions. In addition, *Rahn* is also regarded as a trusteeship. In *Kafalah* the degree or scope of suretyship should be known and should not be with preconditions. It is not permissible to give surety to an unknown degree or scope. As for the legality of *Kafalah* in the case of debt, it is reported that the Holy Prophet (Peace be upon him) was willing to be held responsible for the debts of a dead person.

*Kafalah* is of two types *Kafalah bil-nafs* and *Kafalah bil-mal*. *Kafalah bil-nafs* (suretyship for the person) is also known as *Daman Wajh*. Standing surety for a person means assuming liability for the appearance of the debtor or of his agent in a lawsuit. This is not relevant for our purpose. *Kafalah bil-mal* (suretyship for the claim) can be independent or additional to suretyship for the person; if the guarantor agrees that the debt of the principal debtor be remitted, its effect is that of *Hawalah* or transference of debt.

It is also permissible to make a contract of suretyship in a sale being given by the guarantor in a written letter on behalf of the principal debtor to a creditor to secure the guaranteed amount. Such a suretyship is valid for as long as lifetime or for as long as the guarantor remained in affluent circumstances.

Normally, the Shariah scholars do not allow any remuneration to be received against financial guarantee. OIC Fiqh Academy resolved in its second session (December, 1985) that no return can be taken for issuing guarantees; the reason being that guarantor's payment of the guaranteed sum will resemble a loan generating a profit to the lender that is forbidden in Shariah. However, a fee representing actual administrative expenses is allowed for the services rendered by the banks in both kinds of guarantee, i.e. with or without cover.

The approach of the Jordan Islamic Bank, in this regard, is as follows: "A bank guarantee is an undertaking (given by the Bank) to settle a debt at the request of a client ordering it. The Islamic Bank offers this service to its clients on a fee basis (*Wakalah bil Ajr*), and it claims the right to seek fees commensurate with those charged by other banks. The fees will, of course, exclude the interest which accumulates from the date of demand (if this occurs) and the date of actual settlement by the client. (IIBI, 2000, P: 192).

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