Islamic Finance and Banking

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Chapter 1 - An Overview of the Islamic Financial System

Introduction

An Overview of the Islamic Financial System.
An economic system can be defined as a collection of institutions, policies, and rules established by society. It deals with the allocation of resources, exchange of goods and services and trading and distribution of wealth.

The Islamic economic system shares the key characteristics and objectives of a conventional economic system. The additional and vital factor is the Shari'ah’s rules, which are designed by Allâh (Subhanahu wa ta'ala), operationalised through the Sunnah, and made contemporary by the Ijtihad.

The Islamic economic system adopted in various countries may differ with regard to some policy decisions taken by legitimate national authorities. However, the core rules and institutions must be the same. All policies, transactions, contracts and economic activities must be Shari'ah-compliant.

On completing this chapter, you will be able to:
- Describe the core principles of an Islamic economic system.
- Identify the characteristics of an efficient financial system.
- Describe the roles of financial institutions.
- Explain the two main tasks for financial institutions.
- Identify the different types of financial markets.
- Explain the role of ethics, and how differences, areas of conflict, and priorities are managed in an Islamic financial system.
- Describe the concept of a contract and the core types of contracts including two types of transactional contracts and four types of financing contracts that are at the core of an Islamic financial system.

Principles of an Islamic Economic System

Islamic ethics has defined ten core principles of the Islamic economic system. They are:
1. Property Rights
2. Property Obligations
3. Contracts
Property Rights
The modern Western concept of property rights defines the right to property as the right of an individual to exclude others from using, enjoying, and disposing material assets. The right to public property, that is, the right of an individual not to be excluded by others from the right to use and enjoy material assets has diminished as market principles have taken over.

Islam differs from this concept through two basic principles derived from the need to be just towards the individual and society.

According to first principle, Allâh (Subhanahu wa ta’ala) is the ultimate owner of all properties present in the world. He has given the right of possession of property to humans to enable them to perform their duties and obligations.

According to the second principle, an individual has rights to the resources owned collectively and the products created by his or her own creative use of those resources, without impinging on the collective rights to those resources or products. Individuals may gain property through own labour or by transfer from another entity.

Everyone has the right and obligation to use natural resources to produce goods and services. Every individual has equal rights on natural resource before these are transformed through work. The individual only gains priority over the collective in using and enjoying assets created by their own labour.

Property Obligations
The Shari'ah describes two private property obligations that are aligned with its definition of property rights. Of these, the first one is concerned with the responsibility of sharing the
income through property or sharing the use. The second obligation is to avoid the destruction, wastage, squander or misuse of the property.

Islam recognises that some individuals are capable of earning more assets and property using their greater mental and physical capacities compared to others. These individuals have greater responsibilities and obligations than others. However, their property rights are considered inviolate when they have shared the assets and property in the recommended manner.

Contracts
In an economic system, individuals interact with others through transactions facilitated by contracts that may be explicit or implicit. Contracts are most important in Islam to legalise exchange and as the framework of all activity. Some of the key conditions with regards to contracts in Islamic economic systems are:

- Every contract must be *Sharī'ah*-compliant.
- All Muslims are required to honour their contracts. This is fundamental to all activity.
- Contracts must be documented to avoid misunderstanding and to ensure that all parties to the contract have full knowledge of their respective responsibilities and commitments.
- Any agreement that is not specifically prohibited by the *Sharī'ah* is treated as valid and binding on all parties. It can be enforced by the courts; all parties are treated as equals by the courts.

Trust
Trust is the central element of Islam.

- It is the foundation of an individual’s relationship with *Allâh (Subhanahu wa ta’ala)* and with others.
- Islam considers trustworthiness as an obligatory personality trait.
- Keeping trust and promises are major characteristics of the faithful, emphasised in several verses of the Qur’ân (e.g. Chapter 23, Verses 1-8, chapter 17, Verse 34, Chapter 2, Verse 58 and 283)
- Several verses of the Qur’ân emphasise trustworthiness and the importance of keeping it in the verses 107, 125, 143, 162, 178 and 193.
- The life of the Prophet (peace be upon him) illustrates the importance of trustworthiness in both individuals and within community.
- Justice links an individual to *Allâh (Subhanahu wa ta’ala)* and to others.
• The Shari'ah judges a person’s just nature by the actions and the intent (Niyyah) with which the person enters into a contract.

**Individual Rights and Obligations**

According to Islam, human freedom comes from personal surrender to the will of Allâh (Subhanahu wa ta’ala).

• The Shari'ah holds that the rights of an individual are gained not intrinsically but as a consequence of meeting obligations to Allâh (Subhanahu wa ta’ala), nature, self, and to others.

• Individuals have natural, guaranteed rights.

• For an individual, pursuing one’s economic interests is an obligation, a duty, and finally a right no one can abrogate.

• When the ability of an individual increases, the obligation and rights also increase.

• If an individual lacks the skill to pursue one’s economic interests, the right to economic benefits is not negated. It is negated only if the individual is able but does not perform his obligation.

**Work**

The exhortation to work or Al-Amal, in the holy Qur’ân for all Muslims is a means of seeking the bounty of Allâh (Subhanahu wa ta’ala). Every person is obligated to carry out good or beneficial work to reap rewards.

Work is regarded as a right, as a duty and also as an obligation. Hence, Islam allows everyone to choose the type of work they like provided the Shari'ah permits that type of work.

The selection of work by an individual should be based on natural skills and talents, technology or personal inclination. Based on these, Islam mandates that workers perform the tasks to the best of their ability. However, every individual has different talents, so the productivity may differ for everyone. Therefore, justice calls for commensurate return for every individual’s work, based on their productivity.

**Wealth**

Islam encourages man to utilise all the resources that Allâh (Subhanahu wa ta’ala) has created. Non-utilisation of these resources for his benefit is considered as ingratitude to Allâh (Subhanahu wa ta’ala). Acquiring wealth can be an individual’s ultimate objective.
However, that wealth must necessarily be earned by the means of work that is good, productive, and beneficial.

The Shari‘ah specifies some non-permissible professions, trade and economic activities and lawful practices within each permissible profession. Earning wealth through non-permissible work is considered as unlawful wealth.

According to Islam, the wealth must be continuously circulated. It is necessary that lawfully earned wealth be invested within the community in order to help it prosper.

The Shari‘ah outlines some rules regarding disposal of wealth. These include the recognition of the right of others in that wealth, which results from the principle of invariant claim to ownership. The rules include levies, some of which are specified amounts, and others, which are owner of the wealth can determine. When the wealth surpasses a minimum amount known as Nisáb, these levies will be due. Upon meeting these obligations, the remainder of the wealth can be used by the owner, but according to Shari‘ah rules.

Shari‘ah indicates that the owner of the wealth is a trustee, who holds the wealth in the form of a trust on behalf of Allāh (Subhanahu wa ta‘ala) and the community. Therefore, any inability on his part to use the wealth and property can be used to enforce forfeiture of his right to his wealth.

**The Concept of Barakah**

An economic system is incomplete without an incentive-motivation structure. Such a structure helps determine if individuals will follow the rules or not.

The concept of Barakah or divine blessings guides the incentive structure in an Islamic economic system. It covers the all aspects of an individual’s conduct, which includes economic behaviour.

According to this, the rate of return on activities increases with righteous conduct. More righteous conduct provides for stronger presence of Barakah. This concept creates a positive connection between the conduct of the system and prosperity.

The converse of the concept applies as well.
Risk Sharing

Risk-sharing is founded on the principle of taking on liability if return is desired as well. The Prophet (peace be upon him) himself has said that “profit comes with liability”.

According to the Shari‘ah, only profit obtained by lawful means is permitted, and that too if the entity is willing to take the risk.
**Competition and Cooperation**

Islam guides individuals to direct their actions and participate responsibly in economic affairs to improve the well-being of society. Therefore, the individual is responsible for the moral effect of their social actions, including economic activities.

Islam attempts to reconcile competition and cooperation to build an ideal society. One of Islam’s defining characteristics is its powerful emphasis on integrating human society as a necessary consequence of the unity of Allâh (Subhanahu wa ta’ala).

According to the Holy Qur'ān and the Holy Prophet (peace be upon him), cooperation and competition are two sides of human nature. Humans can cooperate and compete among themselves, for good or evil. These attributes can lead to both integration and disintegration of human society.

**Characteristics of an Efficient Financial System**

The efficiency of a financial system is measured based on how well the savings from SSUs are allocated to SDUs that need the funds. Efficiency in mobilization of funds improves on increasing the range of financial assets and instruments.

An efficient system refers to a stable system in which the prices and rates fluctuate steadily as a result of irrational behaviour of the participants.

Every investor expects more return for less risk. On basis of risk-return expectations, we can classify the financial system efficiency into four categories. They are allocation efficiency, pricing efficiency, information efficiency, and operational or transactional efficiency.

**Allocation Efficiency**

Allocation efficiency involves the allotment of more funds into desirable projects with lower risk and higher profitability and vice versa. Therefore, such higher value projects issue financial instruments that involve a lower cost of funds for the issuer.
Allocation efficiency of the system improves when any change reduces costs of transaction, simplifies the transaction system, increases the accuracy and availability, or improves processing of information by participants.
**Pricing Efficiency**

Pricing efficiency impacts allocation efficiency. If an instrument or project is more valuable, the price of an instrument linked with it increases. A high price for financial instruments indicates low cost of funds or low rates. Pricing efficiency qualifies allocation efficiency.

Let us take an example of a student scholarship of Saudi Riyal 10,000. Since tuition fees, study materials, and living expenses all add up to Saudi Riyal 5,000, you invest the remaining in a high-return scheme in an Islamic bank. The bank in turn will loan this amount to a businessman who will bring in more profits than any other business. If the financial system is working fine, your investment will receive the highest possible return for your tenure and the businessman would have received his loan at the lowest possible rates. All this depends on the efficient working of the financial system.

**Information Efficiency**

Information efficiency is a prerequisite to pricing and allocation efficiencies. If a financial institution has adequate information on the project, then the prices and rates will indicate the intrinsic value of financial assets. Thus, it is essential that the financial system provides a flow of information that is relevant as well as costless.

**Operational Efficiency**

Operational or transactional efficiency is also a prerequisite for pricing efficiency. This involves the execution of transactions at the minimum possible costs. If the transaction costs are high, prices and rates cannot adjust to changes.

**The Roles of Financial Institutions (FIs)**

Financial institutions perform two major types of roles. They are direct or facilitator and indirect or intermediaries. Apart from these roles, there are many different players that help accomplish the financial system’s overall objectives of.

For example, insurance companies are savings institutions that use contracts to acquire funds for long-term use and invest them in the capital markets. The policyholders of these institutions provide them with a steady inflow of funds. Insurance companies provide various products to manage risk to economic units, thereby helping the system achieve full insurance efficiency.
**Direct or Facilitator**
Well-developed financial systems enable SDUs to directly offer investment products by to SSUs.

In these systems, FIs act as facilitators in the flow of funds and help governments and companies to raise the funds from households.

In addition, FIs help SDUs design and create “securities”, price and market them to SSUs. Facilitating FIs are known as investment banks.

**Indirect or Intermediaries**
Less-developed financial systems comprise FIs that perform an indirect or intermediary role.

First, they raise funds from SSUs through diverse “deposit” products. After that, they invest these funds in SDUs through various “financing” products. SSUs and SDUs do not interact directly in such a system. They don’t have any rights or obligations towards each other.

Intermediary FIs are also known as commercial banks.

**Two Main Tasks for FIs**
A financial system performs two main tasks. They are mobilising funds from SSUs and channelling the funds into SDUs.

**Mobilise Funds from SSUs**
Every investor or buyer may have a unique need or expectation and maturity preference. FIs offer a variety of financial products to SSUs that align with their requirements and expectations.

Every investor likes returns and dislikes risks.

Products with higher expected returns than others will be more attractive to investors. This works the other way as well. Thus, the investors will not take risk on the less attractive products.
In the Islamic financial system, the SSUs always need to conform to the *Sharī'ah*. No product or service of an Islamic bank should violate the *Ribâ*-prohibition norm.

**Channel the Funds into SDUs**

FIs design financial products and services based on the requirements and needs of governments and companies.

These requirements may be concerned with cost of funds, level, maturity, and pattern of cash inflows expected from the project.

However, the financial products must not violate the *Ribâ*-prohibition norm. "Risk may be linked with the volatility of returns. The risk increases with the increase in volatility. A product’s liquidity, which refers to the ease with which it can be traded for a fair price, can also be a factor of risk.

**Types of Financial Markets**

Financial intermediaries trade products and securities in different types of financial markets. There are different types of financial markets available to trade the various financial products. They are primary and secondary market, money and capital market, spot and futures market, options market, and foreign exchange market. They must conform to norms of *Sharī'ah* and Islamic ethics in Islamic financial system.

**Primary and Secondary Market**

A primary market trades new or fresh financial products and securities. Here, an SDU can sell the products and securities only once.

In a secondary market, the primary market buyers sell the products and securities they possess before these reach maturity. Secondary markets provide liquidity for the products.

**Spot and Futures Market**

Participants in a spot market trade products for immediate delivery and payment. Some examples of products traded in a spot market are stocks, commodities or foreign currencies. Therefore, the spot market is also known as the cash market.
Participants in the futures market trade products to be delivered in the future at an agreed price.
**Money and Capital Market**
This market depends on the maturity of the traded financial products.

The money market involves short-term debt instruments that mature in one year or less. The capital market involves long-term debt instruments and equity obligations.

**Option Market**
Participants in the option market trade stocks, commodities or currency for conditional future delivery.

An option typically gives a party the right to trade a product, but does not obligate the party to do so.

**Foreign Exchange Market**
The foreign exchange market trades only foreign currencies. This market trades either for spot or future delivery.

**The Role of Ethics in an Islamic Financial System**
A recent study identifies seven classes of fairness relevant to a conventional financial system. They are: freedom from coercion, freedom from misrepresentation, right to equal information, right to equal processing power, freedom from impulse, right to trade at efficient prices, and right to equal bargaining power.

The holy *Qurān* and the *Sunnah* provide the basic principles or norms for an Islamic financial system. They are,
- Freedom to Contract
- Freedom from *Al-Ribā*
- Freedom from *Al-Gharar*
- Freedom from *Al-Qimār and Al-Maisir*
- Freedom from Price Controls or Manipulations
- Freedom from *Darar*
- Right to Transact at Fair Prices
- Right to Equal, Adequate, and Accurate Information
- Mutual Co-Operation and Solidarity
Freedom to Contract
Islam provides the basic freedom to enter into transactions. In the Holy Qur‘ān:

- Verse two hundred and seventy five of Surah Al-Baqarah says “Allâh has made trade lawful.”
- Verse twenty nine of Surah An-Nisâ’ says “Let there be among you traffic and trade by mutual goodwill.”

However, it does not imply unrestricted freedom to contract. Only certain commodities or property (māl) are permitted to be exchanged. For example, entities may not trade in alcohol and pork or in stocks of companies that produce or deal with these commodities.

The freedom to contract is subordinate to other norms requiring specific injunctions. Any contract that involves coercion is invalid.

Freedom from Al-Ribâ
All forms of transactions and contracts must be free from Al-Ribâ or Ribâ. Ribâ means excess or interest. Its prohibition implies that rewards are not for time preference alone. At all times, liability or risk also must determine reward, returns or benefits.

Freedom from Al-Gharar
No forms of contracts and transactions must involve excessive Gharar (or uncertainty). Contracts are disallowed under conditions and situations that involve high uncertainty in the view of Islamic scholars.

Freedom from Al-Qimâr and Al-Maisir
Contracting under excessive uncertainty, or Gharar, and uninformed speculation are closely related to gambling, or Al-Qimâr.

The holy Qur‘ān and the traditions of the Prophet (peace be upon him) prohibit unearned income, or Al-Maisir, such as from games of chance. Speculation always involves a risky attempt at earning greater profit. While all business decisions are speculative to some extent, the lack of relevant information and conditions of excessive uncertainty make business speculation closely related.
Freedom from Price Controls or Manipulations

Islam conceives of a free market in which the forces of demand and supply determine prices. Even the regulators should not hinder the process of price formation. Any attempt to affect prices by creating an artificial supply shortage, or Ihtikar, is not permissible by Islam. Likewise, attempts to increase prices through the creation of artificial demand, or Najash, is also not permissible. However, historically, the Hisba intervened to ensure that the market produced fair and just prices.

Freedom from Darar

Darar is the chance that a third party will be adversely affected by a contract between two parties.

Sometimes, a contract executed with mutual consent between two parties affects the interests of a third party unfavourably. For example, any decision taken by the controlling shareholders may adversely affect the minority shareholders. In such a case, the third party is entitled to certain rights and options, for example, the pre-emptive right, or Al-Shufa, of a partner in joint ownership.

Right to Transact at Fair Prices

Prices are believed to be fair when they result from free interplay of forces of demand and supply. However, sometimes, the pricing is based on valuation by experts and may be manipulated. In these instances, the gap between the transaction price and the fair price is termed as Ghubn-e-fahish or Ghubn. A transaction becomes unethical if Ghubn exists.

Right to Equal, Adequate, and Accurate Information

Islam considers equal, adequate, and accurate information as vital for the financial market.

Releasing wrong information, hiding vital information, or Ghish, or misrepresenting parties in a transaction, or Jahalah, violates the norms of Islamic ethics.

While these Ahadith relate to commodity transactions, Islamic ethics also refer to information on expected cash flows and asset valuation. Because these are revised continuously with events, Islamic ethics require that all such information should be available equally to all investors.

Mutual Co-Operation and Solidarity
This is a fundamental norm in Islamic ethics. The second verse of *Surah Al-Maida* in the holy Qur’ān says:

“Help you one another in *Al-Birr* and *At-Taqwā* (virtue, righteousness and piety); but do not help one another in sin and transgression. And fear Allâh. Verily, Allâh is severe in punishment.”

The following *Ahadith* by the Prophet (peace be upon him) reinforce this principle of cooperation and mutual assistance.

“Believers are to other believers like parts of a structure that tighten and reinforce each other.” (*Al-Bukhari* and *Muslim*)

**Differences, Conflicts, and Priorities in Islamic Finance**

What happens if there is potential conflict between norms of Islamic financial ethics? In such cases, the holy Qur’ān is most important, followed by the Sunnah, and then any other principles such as unrestricted public interest called *Maslahah Mursalah*. *Maslahah* comprise considerations, which in line with the objectives of the *Sharī‘ah*, provide benefit or prevent harm. The *Maslahah Mursalah* framework compares benefits and costs at a macro-level. It involves providing maximum social benefits. Apart from these potential conflicts, the fundamental conflict is between ethics and efficiency in a financial system.

Ethics is primary in Islamic financial system, but efficiency is priority in conventional finance.

**Types of Contracts in Islamic Finance**

Contracts are the basis of economic relationships. Therefore, financial instruments are also considered as contracts. The terms and conditions of financial instruments define the mix of risk and return.

Contracts can be classified into four different categories according to their function and purpose.

- Transactional Contracts
- Financing Contracts
- Intermediation Contracts
• Social Welfare Contracts

This classification helps to understand how credit is created, how financing instruments are created, how intermediation works, and the different roles played by each group within the economic system.

Transactional Contracts
Transaction contracts are about real economic transactions such as exchange, trade of goods and services. Exchange can be on spot or deferred basis. Goods may be exchanged for goods, money, or simply promises to pay. Such contracts generate assets that can further create financing opportunities.

Financing Contracts
Financing contracts help to generate and extend credit, fund transactional contracts, provide means to form capital and transfer resources between investors and entrepreneurs. Financing contracts do not comprise debt. Financing contracts can be used to provide capital through equity partnership.

Intermediation Contracts
Intermediation contracts provide the mechanisms to execute execution of transactional and financial contracts efficiently and transparently. In these contracts, economic agents perform financial intermediation and offer fee-based services for economic activities. Among these contracts are Mudarabah, Musharakah, Kifala, Amanah, Takaful, Wakala, and Jo’alah.

Social Welfare Contracts
Social welfare contracts, which are between individuals and the society, are meant to enhance the wellbeing of less privileged members of society. An FI can offer services to the community through the institutionalisation of social welfare.

Types of Transactional Contracts
Islam emphasises trade of physical assets and of rights to use the assets.

The basic transactional contracts are:
• Exchange and Sale of an Asset
• Sale of Rights to Utilise an Asset
The first contract involves transfer of ownership, but the second only involves the transfer of rights to use the asset.

Let us discuss these contracts in detail.

**Contracts of Exchange and Sale**
A contract of exchange facilitates cash sale, deferred payment sale, deferred delivery sale, sale on order, sale on debt, sale on currency, and so on.

The contract of sale can be classified using subject of sale and mode of payment. Sale contracts can be of six types when viewed from the subject matter of sale.

1. **Bai’**: Sale of an asset to others for a price.
2. **Sarf**: Sale by exchange of money for money on the spot.
3. **Sale by barter**: Exchange of goods for goods.
4. **Bai’ al-Dayn**: Sale of debt or liability.
5. **Bai’ al-Salam**: Sale by immediate payment against future delivery and
6. **Bai’ al-Istisnah**: Sale on order.

Sale contracts can be of five types, when viewed from the perspective of mode payments.

1. **Spot cash sale**: The purchaser pays the agreed price at the time of contract conclusion.
2. **Instalment sale**: The purchaser pays the agreed price in a deferred manner and pays in a number of instalments.
3. **Lump sum payment payable in the future**: The purchaser agrees to make the payment on a pre-determined date. Except Bai’ al-Salam, this type of payment is applicable for all types of sales.
4. **Bai’ al-Arabun**: The purchaser makes a partial payment in good faith as earnest money. In this type of payment, if the buyer decides to abandon the sale, the seller does not refund the advance payment.
5. **Bai’ al-Mu’ajjil**: The purchaser agrees to pay in instalments or in a lump-sum payment. But the buyer cannot include any charges for deferred payment.

**Sale of Rights to Utilise an Asset**
Ijarah, or lease is an example of sale of rights to utilise an asset. The contract of Ijarah means to give something on rent and it also means a sale of the usufruct for a specified period.

Renting of an asset is also the contract of Ijarah. In Ijarah, the lessor continues to own the asset and only the right to use that asset transfers from lessor to lessee for specified period.

Types of Financing Contracts
Financing contracts offers low-risk asset-backed securities and promote risky equity financing. Financing contracts are classified as four major contracts. They are:

- Murabahah,
- Bai’ Bithaman Ajil,
- Tawarruq and
- Musharakah.

Let us discuss about these contracts briefly.

Murabahah
The Murabahah, or cost-plus sale, contracts help the individual to purchase a product on credit. Based on this contract, the financier purchases goods and supplies them to the entrepreneur. In this contract, the entrepreneur makes payment of the product after a specific period. For this delayed payment, the financier and entrepreneur add an agreed profit margin or mark-up to the cost of the product.

For Murabaha to be valid, according to Shari’ah, that contract should involve original sale, not any existing inventory.

Bai’ Bithaman Ajil or BBA
In some Islamic countries, the payment of a Murabahah contract is made in instalments after delivery of goods. This kind of contract is known as Bai’ Bithaman Ajil or BBA. The features of BBA are similar to Murabahah, except the mode of payment. In this contract also, the financier purchases goods and resells to entrepreneur at a higher price. Bai’ Bithaman Ajil differs from Murabahah as follows:

- It is used for long term financing.
- The financier is not obligated to disclose the profit margin.
**Tawarruq**

*Tawarruq* is also known as “reverse Mudarabah”, and this contract involves two separate transactions.

According to *Shari’ah*, the practice is legitimate, but some scholars consider that the money borrowed in the transactions is a kind of *Ribâ*.

**Musharakah**

The *Musharakah*, or Partnership contract, is a pre-Islamic contract and was widely accepted and promoted by the Holy Prophet (peace be upon him). It is a combination of *Shirkah* and *Mudarabah*, which deals with both investment and management.
Chapter 2 - General Principles

Introduction

General Principles.

Islamic ethics has certain norms that have high priority in the Islamic financial system. All financial and business transactions must adhere by the norms of Islamic ethics, as derived by the Shari’ah.

Basically, one may describe an Islamic financial system as a “fair” and “free” system. However, to ensure “fairness”, it restricts the “freedom” of the system’s participants. It provides the freedom to enter into transactions, while maintaining that these norms and ethics of Islam do not imply unbridled freedom to contract.

The basic norms of the Islamic financial system include:

- Freedom to contract,
- Freedom from Al-Ribâ,
- Freedom from Al-Gharar,
- Norms of Al-Qimār, Al-Maisir and
- Norms of Ghubn.

This chapter will also acquaint you with the tenets of the Shari’ah, which lay down the norms of profit and the norms of mutual cooperation or Ta’wun. The idea of profit is based on one of the most important maxims of the Shari’ah, Al Kharaj bi-al-Daman or Al Ghunm bil Ghurm. Al Kharaj bi-al-Daman is the standard of legality of return on capital. It says that a person has to accept loss, if he wants to earn profit over his investment.

The norms concerning mutual cooperation, solidarity, and brotherhood are in the nature of advice and instances that extol and encourage good behaviour.

On completing this chapter, you will be able to:

- Explain the view that Islamic jurists take on the freedom to contract,
- Explain the prohibition of Al-Ribâ, in loan contracts and exchange contracts,
- Describe the norm that prohibits Al-Gharar, and
- Explain norms prohibiting Al-Qimār, Al-Maisir and Ghubn.
• Describe the norms relating to profit in financial transactions.
• Describe the norms related to mutual cooperation or *Ta‘wun* in financial activities.

**The Freedom to Contract**

Islam provides the necessary freedom to enter into transactions.

The Holy *Qur‘ān* asserts that trade is lawful, but *Ribâ* or usury is not.

In verse two hundred and seventy five, the *Surah Al-Baqarah* of the *Holy Qur‘ān* says this: *Allāh* has permitted trading and forbidden *Ribâ*. So whosoever receives an admonition from his Lord and stops eating *Ribâ* or usury shall not be punished for the past; his case is for *Allāh* to judge.

The *Surah An-Nisā’,* in verse twenty nine, provides this guidance: O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent.

The Holy *Qur‘ān* also asserts that an *‘Aqd* or contract is rendered invalid if either of the parties involved employs elements of coercion.

However, this norm does not imply unrestrained freedom to contract. The terms of acceptability are:

• An exchange is acceptable only when it involves permissible merchandise or property.
• Trade in the stock or ownership interests in firms dealing with or producing commodities containing alcohol and pork is not acceptable.
• Trade in financial options is not permitted as rights are not deemed to be *māl*.
• A contract may also be invalid when there is a transaction with other norms that require specific injunctions.

**The Freedom to Contract – Elements of a Contract**

*‘Aqd*, which means conjunction or to tie, is synonymous with the word “contract” of modern law. No *‘Aqd* or contract is valid if one party has been coerced in some form or the other.

A contract involves:
The existence of two capable and sane parties together called 'Aqidain;
The issuance of an outward act depicting internal willingness,
An offer, or Ijab, and acceptance, or Qabul, together called Sighah,
A legal union between the two declarations, concerning the subject matter or Ma'qud 'alayh and the contractual obligations, and
Freedom from all prohibitions.

The first, third, and fourth elements are essential to a contract.

According to Sanhuri, an exponent in Islamic finance, there are seven components in a contract:
The agreement of offer and acceptance,
The agreement of the Majlis, which is a session or meeting, of a contract,
Plurality of the contracting parties,
Maturity of the contracting parties,
Subject matter susceptible to delivery
The object, or Mahall, defined, and
The beneficial nature of the object, as permitted by Shari'ah rules.

The Concept of Al-Ribâ

Al-Ribâ or Ribâ means interest. Prohibition of Ribâ is fundamental to Islamic financial ethics and law.


Surah Al-e-Imran, verse 130 says: O who you believe! Do not consume doubled and multiplied Ribâ or usury, and fear Allâh (Subhanahu wa ta'ala) so that you may prosper.

Surah Al-Baqarah, verses 278 and 279 say:

O who you believe! Fear Allâh (Subhanahu wa ta'ala) and give up what is still due to you from Ribâ or usury, from now onward if you are true believers.
If you do not do so, then take notice of war from Allâh (Subhanahu wa ta'ala) and His Messenger (salla Allâh alaihi wa sallam). But, if you repent, you can have your principal sum. Do not deal unjustly by demanding more than your principal, and you will not be dealt with unjustly by receiving less than your principal sum.

The Holy Qur‘ân also recommends the prohibition of:

- Ribâ in Loans or Debts and
- Ribâ in Sales or Exchange Transactions.

**Ribâ in Loans or Debts**

A loan or *Qard* is any commodity or a sum of money that is given by one party to another for a certain estimated time.

A debt or *Dain* is a liability to pay, which results from any credit transaction like a trade on credit or due rentals in *Ijarah* or leasing. The amount of debt has to be paid back at a specified time and the creditor has no right to demand payment of the debt before the mutually agreed time.

The Holy Qur‘ân states that in both loans and debts, the creditor has right only over the principal amount or *Ra’asul-māl* and not on an excess amount or interest on it.

The Holy Qur‘ân explains that all income and earnings, salaries and wages, remuneration and profits, usury and interest, rent and hire, and so on, can be categorized either as permitted or prohibited profit. Permitted profit refers to the profit from trade and business along with its liability and prohibited profit is the return on cash or a converted form of cash. This form of cash does not bear liability in terms of the result of deployed cash or capital.

Permissible and prohibited transactions are distinguished based on their nature as sale or purchase, loan and lease.

In sale, the ownership of the commodity is transferred to the buyer from the seller. This ownership transfer may take place on cash or credit; but this involves some profit margin for the seller, which is permitted.
A loan involves a temporary transfer of ownership of goods or assets. In Islamic finance, the loan is always free of any charge. The buyer should pay only the principal amount as an excess amount or interest is prohibited.

In leasing or *Ijarah*, the ownership of the leased asset does not transfer and only the usufruct of the asset is made available to the lessee against the payment of rent. In Islamic finance, taking rent on leasing of assets like houses, vehicles, etc. is permissible while charging rent on money is prohibited.
**Ribâ in Sales or Exchange Transactions**

The act of changing a commodity or asset for another commodity or asset is known as exchange. The exchange rules are different for different types of assets and contracts.

According to the rules of exchange of monetary units, an equal and on-the-spot exchange is mandatory for the exchange of any asset with the same kind of asset.

Exchange rules summarized by Imam Nawawi, the commentator of Sahih Muslims are as follows:

- When the two goods being exchanged are different, excess and delay or both are permitted. For example, exchanging gold for wheat or dollars for a car.
- When the two goods being exchanged are similar, excess and delay, both are prohibited. For example, exchanging gold for gold or wheat for wheat, dollars for dollars, etc.
- When the two goods being exchanged are different but the effective cause is the same, then excess or deficiency is permitted, but delay in exchange is prohibited. For example, exchanging gold for silver or US Dollars for Japanese Yen or wheat for rice.

**The Concept of Al-Gharar**

In Islamic finance, the second major prohibition is that of Al-Gharar or Gharar. Gharar means risk, uncertainty, and legal ambiguity or uncertainty that any one of the parties to a contract can exploit at the expense of the others. Economic risk or uncertainty are intrinsic to any economy, but contractual risk can be mitigated by scrutinising contracts based on the Shari‘ah. Legal uncertainty cannot be justified under any circumstances. Unlike Ribâ, the Islamic framework permits a small degree of Gharar, but excessive Gharar is prohibited.

Gharar occurs with the sale of a commodity or asset, which is not present at hand or the sale of a commodity whose quality of being good or bad is not known to the buyer. It also occurs with a sale involving the hazard that one does not know whether it will come to be or not, for example, the sale of a fish in water or a bird in the air.

Siddiq M. Al-Amen Al-Dhareer (1997) has classified the principles covering Gharar as follows:

Gharar in the terms and essence of the contract includes:
- Two sales in one,
- Down payment sale,
- "pebble", "touch" and "toss" sales,
- Suspended sale or Mu’allaq sale and
- Future sale.

Gharar in the object of the contract includes:
- Ignorance about the genus or species
- Ignorance about attributes
- Ignorance about the quantity of the object
- Ignorance about the specific identity of the object
- Ignorance about the time of payment in deferred sales
- Explicit or probable inability to deliver the object
- Non-existent object and
- Not seeing the object.

In order to avoid uncertainty, Islamic law prohibits the sale of a commodity in the following situations.

1. Things which do not exist,
2. Things which exist, but the seller is not the owner or the availability is doubtful, and
3. Things which are exchanged under conditions of uncertain delivery and payment.

Examples of transactions/contracts involving Gharar include:
- Sale of goods that the seller cannot deliver, as this involves counterparty or settlement risk,
- A contract that is conditional on an unknown event,
- Two sales in a single transaction, such as the sale of one article at different prices, one for cash and one for credit, or the sale of two different articles at the same price, one for immediate payment and the other for a deferred payment,
- Contracts that are too complex to clearly define the benefits/liabilities of the parties,
- Sale of goods based on false description, and
- All contracts where value-relevant information is not clearly available to the parties.

**Concepts of Al-Qimār and Al-Maisir**

*Al-Qimār* and *Al-Maisir* are terms associated with unethical and prohibited financial transactions. For example, mobilisation of funds, by the Government, through a lottery is
considered as gambling and therefore, is prohibited. This is because only the lottery organiser obtains consistent returns, which are at the cost of those who buy the tickets.

**Al-Qimār**

Al-Qimār or simply Qimār means a game of chance, which implies that one gains at the cost of others. This resembles gambling, which the Holy Qur’ān explicitly prohibits. Islamic banks prohibit conventional transactions and bank products that involve such gains. Qimār also means receipt of money, profit or usufruct at the cost of others, having entitlement to that money or benefit by resorting to chance.

**Al-Maisir**

Al Maisir, or simplyMaisir, means wealth obtained by chance. It also means wishing for something valuable without working for it. This resembles gambling, which the Holy Qur’ān explicitly prohibits. In Islamic banks, the conventional transactions and bank products that involve Maisir are prohibited. Conventional insurance is not Shari'ah-compliant, because it involves both Ribā and Maisir.

The Shari'ah permits the following kinds of Maisir:

- Lotteries in which no individual has any personal right or stake, and no one is deprived of what they already had or contributed to the process.
- Drawing lots if an authorized man wishes to select and confer some right, privilege, or provide concessions to people with equal status.
- Entrepreneurs offering incentives and additional products to customers when products are sold for a price.

The Shari'ah prohibits the following kinds of Maisir:

- When loss of funds of one investor benefits another investor
- Some schemes in which tickets, coupons, or tabs given on purchase of products, but the purchaser may or may not avail the prize later; in such cases, the incentive is uncertain and is therefore considered as gambling.
- Some bank schemes in which the bank offers a prize through a lottery for the depositors. The prize is pre-determined additional return from the bank on the deposit. The winner can take the prize through the lottery, and others will wait for their chance. This resembles gambling.
The Concept of *Ghubn*

*Ghubn* is the difference between the manipulated price (price at which a transaction is executed) and the fair price (according to the valuation by experts). The presence of *Ghubn* makes a transaction unethical.

The Holy Prophet (peace be upon him) prohibited *Ghaban-e-Fahish*, which means selling something at a higher price and giving the impression to the client that he is being charged according to the market rate.

*Ghaban-e-Fahish* involves excessive profiteering with deception. A person sells a commodity stating explicitly or giving the impression that he is charging the market price, but actually he is charging an exorbitant price by taking benefit of the ignorance of the purchaser. In such cases the purchaser has the option to revoke the sale and get back the price paid.

**Norms Relating to Profit**

Islamic banking practices do not allow charging or paying interest, hence the financial system promotes the practice of sharing both profit and loss.

**Risk and Return**

Profit-sharing is based on the principle that money by itself is not considered as capital. Since all commercial activities involve risk, one has to bear that risk for the legality of the profit or earnings. The return expected on funds invested often determines how willing and capable a business person is to add value or bear potential loss. Interest, lotteries and gambling, are prohibited. This is because rewards of business should be the result of productive activity. They should not be based on luck, chance or hazard.

**Ownership Transfer Risk**

Transfer of commercial risk without the transfer of the reward is not permitted under the *Shari‘ah*. The principle followed here is that ownership cannot be separated from the risk of potential loss. This has different connotations depending on the nature of the transaction.

In loans, creditors do not have rights over profit as they regain the full amount irrespective of the nature of investment.
In trade, the risk of loss or destruction is the responsibility of the owners as long as the assets remain with them.

But the risk is transferred to buyers the moment the asset is sold. Buyers have to pay the full price at the time of settlement, even if the asset shows signs of destruction. Buyers may then lessen their loss by way of Takaful.

In Ijarah, land or asset owners may collect rent or lease only if they keep the asset in usable condition by taking the responsibility of ownership-related expenses.

Shirkah
This is a partnership of capital and labour. The parties share both profit and loss in proportion to their individual investments.

In Shirkah, all loss in a joint venture is borne by the capital owner while entrepreneurs lose the benefits of their labour.

In the case of bank depositors, the risk comes from the failure of business and the uncertainty regarding the profit that has to be shared.

When financing through the Shirkah mode, the bank faces the risk that clients may conceal their profits and the bank might end up losing the capital; according to the Shari'ah, loss is the loss of capital, not decrease in potential profit.

Norms Relating to Mutual Cooperation
Norms concerning mutual cooperation, solidarity, and brotherhood are central to Islamic ethics. These norms are laid out in the form of validations of age old practices such as the Aqilah and Daman Khatr al-Tariq, advice on good and ethical behaviour, and instances that encourage good living.

Surah Al-Maida and Ahadith
The second verse of the Surah Al-Maida says: Help one another in Al-Birr and At-Taqwâ (virtue, righteousness and piety); but do not aid one another to sin and transgress. Fear Allâh (Subhanahu wa ta'ala), who is severe in punishment.
The following *Ahadith* support mutual cooperation:

- "Believers are to other believers like parts of a structure that tighten and reinforce each other."
- "The Believers, in their affection, mercy and sympathy towards each other, are like the body- if one of its organs suffers and complains, the entire body responds with insomnia and fever."
- "Whosoever removes a worldly hardship from a believer, *Allah (Subhanahu wa ta'ala)* will remove from him one of the hardships of the Day of Judgment.
- Whosoever alleviates from one, *Allah (Subhanahu wa ta'ala)* will alleviate his lot in this world and the next."

**Early Islamic Practices**
The tribal members of the Arabian peninsula practiced mutual cooperation 14 centuries ago. During the emergence of Islam, the Prophet (*salla Allâh alaihi wa sallam*) sanctioned some of these practices. These became part of the *Sunnah* subsequently as the *Hadith* show.

- Merchants of Makkah gathered funds to help victims of natural disasters or hazardous journeys undertaken for trade. A security known as *Daman Khatr Al-Tariq* was set in place for this purpose.
- Help relating to "blood-money" or *diyâh* was provided to prisoners and the families of murder victims through an alliance known as *a'qila*.
- People entered into contracts, known as *Aqd Muwalat*, to end mutual enmity or revenge.
- People started associations, by means of a *Hilf*, and signed agreements for mutual assistance.

**Social Insurance**
All these forms of cooperation and assistance led to social insurance. The Islamic state of Medina’s first constitution even had references to the concept of social insurance.

It contained three features relating to insurance:

- Stipulation for social insurance for the Jews, the Ansar and the Christians.
- The statement "the immigrants among the *Quraish* shall be responsible for their word and shall pay their blood money in mutual collaboration."
Provisions for *Fidya*, or ransom, which was paid to rescue prisoners, and the *A’qila*, an alliance, which cooperated to free them.

Note that modern Islamic insurance is designed as *Takaful Ta’wuni*, which integrates the principle of mutual cooperation.

**Chapter 3 - A Framework for the Islamic Financial System—Part 1**

**Introduction**

*A Framework for the Islamic Financial System—Part 1.*

An Islamic financial system works on a very simple premise – Savings Surplus Units or SSU and Savings Deficit Units or SDUs.

SSUs usually comprise individuals, households and government sectors, while SDUs comprise business houses and government sectors.

The availability of funds is governed by the forces of demand and supply and the risk profiles of various stakeholders.

Financial institutions, such as commercial and investment banks, micro-credit institutions, savings and loan institutions, act as intermediaries linking SSUs and SDUs.

Financial institutions charge a rate of return from the fund users, give a part of the return to the fund owner, and retain the excess of the amount deposited for themselves.

Islamic financial institutions, SSUs, and SDUs must conform to the *Sharī’ah*, especially with regard to *Ribā*, when investing and using funds. On completing this chapter, you will be able to:

- Explain the strategic role of financial institutions in society.
- Describe the services and benefits of financial institutions in society.
- Explain how a commercial bank essentially works.
- Explain how an investment bank essentially works.
- Explain the nature of non-banking financial institutions and financial markets.
Describe the primary characteristics of an Islamic financial system.
Describe the basic operations of an Islamic bank.
Identify the most suitable organisational model for Islamic banks.
Describe the two types of deposits that Islamic investment banks can provide.
Explain how a deposit may be managed by an Islamic bank.
Identify the appropriate modes of financing through which Islamic banks can invest funds in diverse sectors.
Recognise the difference between the profit or loss-sharing and exchange contract approaches used by Islamic banks to generate returns.
Describe the advantages and disadvantages of the profit or loss-sharing approach adopted by Islamic banking, and
Explain the types of services that Islamic investment banks can provide.

The Strategic Role of Financial Institutions in Society

Financial Institutions or FIs play an intermediary role to facilitate efficient flow of funds. This system protects fund users from the possible disadvantages of direct transaction between lenders and borrowers. FIs smoothen out the lender-borrower glitches by transforming the nature of funds and their maturity terms to suit the needs of fund users. This process of transformation is known as intermediation, and such companies are known as financial intermediaries, or financial institutions. Commercial banks are known to be the principal financial intermediaries. Other FIs include investment banks, non-bank FIs, development FIs and the Bank of International Settlements or BIS. The BIS coordinates and standardises the services of international banks and financial institutions at a global level.

Commercial Banks

Commercial banks connect the fund saving and the fund using units through intermediation. They also provide checking or current account facilities to savers and investors.

Non-Bank Financial Institutions or NBFIs

NBFIs do not provide checking or current account facilities to savers. They facilitate the raising of funds for business and commerce directly from the saving entities or households.

Development Finance Institutions or DFIs

DFIs operate in dual mode - as banking and non-banking institutions. They also provide finance to business, agriculture and other sectors that aid developmental activities.
Investment Banks
Investment banks are like NBFIs and draw their profit mainly from fee-based activities. The other main source of income is the profit earned by trading in securities.

Investment banks offer services such as:
- Underwriting securities,
- Trading in stocks and bonds,
- Assisting mergers and acquisitions,
- Organising and funding syndicated loans and
- Offering financial advice.

The Services and Benefits of Financial Institutions
Financial institutions provide a variety of services and enjoy benefits due to their size and the range of services they offer.

Services
Financial intermediaries offer four essential services:
- An extensive range of denominations for direct investment in securities by pooling in the finances of many fund-owners,
- Securities with an extensive range of maturities,
- Risk that spreads by investing in a variety of assets and
- More liquidity and reduced transaction costs, which are accrued while converting financial assets into cash.

Benefits
Financial intermediaries benefit from certain advantages:
- Economies of scale and economies of scope leading to lower fixed cost per transaction owing to specialisation and the use of specialised equipment,
- Reduction in transaction costs incurred while obtaining credit information,
- Easy access to borrower’s sensitive and crucial financial information due to their history of exercising discretion in financial dealings, and
- Production of financial merchandise at lower cost, when compared with that for individual consumers.
The Working of Commercial Banks

Commercial banks conduct their business on the basis of the interest they levy. Most commercial banks undertake the following functions:

- Obtaining deposits with checking facility,
- Funding short and medium-term loans - through overdrafts, discounting bills and commercial papers,
- Providing advances against securities - for business and households,
- Financing Long-term mortgage,
- Investing depositors’ funds,
- Offering merchant banking,
- Exchanging foreign currency and money,
- Issuing letters of credit and letters of guarantee,
- Making and receiving payments on behalf of customers,
- Safeguarding valuables and
- Providing advisory services.

In commercial banks, all deposits are considered a liability because the deposits have to be paid back regardless of a return. Current accounts are used for managing cash flow and therefore, carry no return while savings, term, notice deposits and certificates of investment or certificates of deposit or COIs, are fee-based deposits.

Deposits or Liabilities

The main types of deposits are:

- Current accounts, which are maintained by corporate clients and individuals to avail credit facilities. This type of account may or may not carry remuneration.
- Savings Accounts are normal accounts that carry interest and require a minimum balance.
- Fixed-term Accounts are also known as certificates of investment or COIs, by investment banks and NBFIs. They are accounts where money is locked for a fixed period of time and carries a fixed rate of interest. Early withdrawal may carry penalty or an equivalent charge. Term deposit receipts, or TDRs, are issued on par or at a discounted value and grows to value in the given time frame. They are also known as
- Annuities or Perpetuities are built on savings accounts. A deposit holder is allowed to withdraw an approved amount for an indefinite period at an approved timeframe.
- Products offered by life insurance companies, mutual funds and share markets, which are also known as dividend reinvestment plans.
• Advance Profit-paying Products are accounts where the expected profit is discounted and paid in advance, comparable to a term deposit receipt issued at discount, and
• Cash Management or Fund Management Accounts deal with deposit of money for an agreed period and for a fixed rate of return or a rate concurrent with activities in the capital market. In non-discretionary accounts, the client may even instruct the bank regarding the investments.

**Assets or Loans**

Commercial banks invest depositors’ money as short, medium and long-term loans that earn interest.

• Productive loans are offered for trade, commerce and housing,
• Consumption and consumer durable loans are offered for household items, automobiles,
• Clean advances are given without collateral, in the surety of the borrower or a third party assurance,
• Discounting of commercial papers deal with notes, bills of exchange and
• Cash credit, like over drafts but drawn from a limit set by the bank.

**The Working of Investment Banks**

The following are the principal characteristics of investment banking. Investment banks:

• Facilitate direct flow of funds from surplus to deficit units.
• Help business houses and governments with financial aids.
• Engage in primary as well as secondary markets through the sale of debt or equity securities and as brokers and dealers respectively.
• Obtain their income from fees accrued through financial activities or profits from trading securities.
• Provide services such as
  o Underwriting securities,
  o Trading in stocks and bonds,
  o Assisting mergers and acquisitions,
  o Organising and funding syndicated loans and
  o Offering financial advice.
• Investment banks mobilise funds from venture capitalists through private placements, as general investors do not come forth with investments for small and start-up companies.
• They facilitate initial public offerings or IPOs and serve as brokers, arbitrageurs and corporate advisors.
• Investment banks mobilise medium and long-term finance through closed and open-ended funds by issuing COIs or CODs and offer assured dividend accounts without checking facilities and
• COI holders avail pre-agreed interest income and dividend at a certain rate for the period of the deposit. In exceptional cases, account holders are offered a minimum guaranteed return, which is below the market rate while the upside is kept open.

**NBFIs and Financial Markets**

NBFIs do not provide checking or current account facilities to savers. They facilitate the raising of funds for business and commerce directly from the saving surplus entities or households.

Financial markets facilitate the management of liquidity for investors. They also help security holders by selling their securities to third parties.

**Working of NBFIs**

NBFIs that finance various sectors in an economy are:
• Discount houses,
• Leasing companies,
• Venture capital companies,
• Asset management and fund management companies and
• Insurance companies.

NBFIs assist business and industry through direct intermediation between savers and investors, and money and capital market transactions. Investors earn interest or a guaranteed dividend while the fund users pay interest. Some NBFIs deal in real estate and manage property and other finances to earn fixed and variable returns like interest or dividends.

**Working of Financial Markets**

Financial markets in the conventional framework comprise money and capital markets.

The money market is based on:
• Receipts and payments of interest on short-term lending and borrowing and
• Trading in short-term debt instruments.
The capital market is based on:
- Medium and long-term debt
- Medium and long-term equity-based transactions and
- Foreign exchange trade.

Financial markets are further divided into primary and secondary markets. Instruments created in the primary market are traded in the secondary market.

Global depository receipts or GDRs are negotiable certificates that are held in the bank of one country. But they represent a specific number of securities or shares of a stock traded on an exchange of another country. They are being traded in the developed financial markets.

**Primary Characteristics of an Islamic Financial System**

Islamic financial institutions or IFIs, perform the same functions of an intermediary between the surplus and deficit units. The major difference between the two units is ‘interest’, which is replaced by a number of other financial instruments.

Some of the striking characteristics that set them apart from modern commercial banks are:
- IFIs share profit or loss that accrues on investments,
- IFIs earn returns on trading and leasing activities,
- IFIs mobilise deposits earned through profit or loss-sharing and to an extent through the *Wakalah* against pre-agreed service charges or agency fees,
- The owner is responsible for the asset and the liability of a loss is borne by them in the *Musharakah* or *Mudarabah* mode of financing and

This mode also defines leasing terms, where the owner bears the risks and expenses.

**Basic Operations of an Islamic Bank**

An Islamic bank is a banking institution that takes deposits and performs all banking activities except interest based borrowing and lending. This implies there is no attached fee involved in the services they offer.

On the other hand, commercial banks with share capital charge for all the services they provide.
Banking activities can be categorised as activities for mobilising funds and investing funds. Let us now take a look at the general outline of Islamic banking as depicted by several Islamic banking experts including Mabid Ali Al-Jarhi and Munawar Iqbal (2001).

**Mobilising Funds:**
On the liabilities side, an Islamic bank mobilises funds based on:
- Demand deposits and
- *Mudarabah or Wakalah* (agency) contract.

Demand deposits are short-term interest-free loans offered to customers on the basis of a contract. An Islamic bank shares its net profit with customers based on the size and maturity value of their deposit. Note that the formula for sharing net profit with customers should be informed prior to the contract agreement.

Further in this chapter, you will learn about the basic process of the *Mudarabah* contract and its application as a mode of financing.

**Investing Funds:**
On the assets side, deposits in investment accounts may be invested through:
- Actual partnership in business where the bank makes profit-sharing investments or
- Interest-free modes in accordance with principles of *Sharī'ah*:
  - Advancing funds on a profit and loss-sharing basis.
  - Purchasing assets on a fixed-return basis.

Examples of profit or loss-sharing modes include *Mudarabah* and Diminishing *Musharakah* with participation in the equity capital of companies. Examples of asset purchase and leasing include *Murabahah, Istitna'a, Salam* and *Ijarah*.

**Organisational Model for Islamic Bank**
The three organisational models that banks can adopt, according to their span of activities are:
- Universal Banking Model
- Bonafide Subsidiary Model, where all subsidiaries have their own capital and separate operations and
• Bank Holding Company Model, where a bank holds separate organisations owned by it for different activities. Examples include investment banking, Murabahah or trading transactions and commercial banking.

The first two models may not best suit Islamic banks due to the nature of their operations.

The fully owned subsidiaries model is best suited to banks if they establish a number of subsidiaries for various types of operations like, investment banking, commodity trade-based banking, leasing-based banking, Istisna'a-based banking and the normal commercial banking. IFIs can also have special branches for industry, agriculture, commerce, real estate and Takaful businesses.

The modes available to banks or their subsidiaries in order of priority will be:
- Musharakah or equity participation
- Mudarabah or profit-sharing and loss-absorbing
- Ijarah
- Bai' Mu'ajjal, or trading in real goods or sale contracts with deferred payment and
- Bai' Salam and Istisna'a or deferred delivery of goods.

**Types of Deposits in Islamic Banks**

Islamic banks must innovate techniques to mobilise deposits and safeguard depositors from loss on PLS deposits. The two types of deposits offered by Islamic banks are Current deposits and Savings deposits.

**Current Deposits**

The characteristics of current deposits are:
- No return is given on current accounts because such deposits are like loans given to Islamic banks and loans cannot carry any return.
- They are kept as Amānah. But if the earnings of such accounts are used by banks in their business, they are treated as loans that have to be paid back without any increase or decrease.
- Banks shall guarantee the principal amount of deposits and
- The bank and the depositor shall agree at the time of account opening whether the bank is allowed to use the money in its business or not.
**Savings/Investment/Term Deposits**

The characteristics of Savings/Investment/Term Deposits at Islamic banks are:

- All remunerative deposits in Islamic banks, including saving deposits shall be accepted on a PLS basis.
- The ratio of profit distribution between the bank and the depositor shall be agreed at the time of account opening subject to the condition of the *Sharī'ah*.
- Deposits of longer duration shall be compensated through assignment of higher weightages. Regulators may notify a range within which these allocations could be made.

The following are the other considerations in this regard:

- Deposits of risk-averse clients are accepted either in current accounts or by creating special pools, or establishing *Murabahah* and leasing funds, where they will be treated as *Rabbul-māl* and get a quasi-fixed return out of profits or rentals earned by the respective funds.
- Risk-prone deposits are a part of the bank’s equity, which involves a weightage system on a daily product basis, or DPB.
- Specific investment accounts can be managed, according to savers’ instructions, on a *Mudarabah* or *Wakalah* basis and
- Banks may set up closed or open-ended mutual funds.

**An Example of Deposit Management**

Most Islamic banks follow a profit-sharing system known as the *Mudarabah* plus *Musharakah* or as the *Mudarabah* model.

**Mudarabah Process**

The process flow of the *Mudarabah* model is as follows.

- First, the bank creates an investment pool with categories based on different tenors of deposits. Let us assume that the bank launches the following deposit tenors: three months, six months and one year.
- Next, each depositor will deposit funds in a specific category of the investment pool, which will be assigned a specific weightage. Weightage can only be amended at the beginning of the accounting period. All members of the pool have a *Musharakah* relationship with each other, which implies they are partners in the pool with the above mentioned weightages. The bank may invest in the pool as a depositor.
- Then, the pool, in its collective capacity, enters into a *Mudarabah* contract.
The bank undertakes business with funds from the pool and the profit earned is shared between the parties in an agreed ratio.

Assume that the profit-sharing ratio is 50:50. The bank deploys $10,000 of the pool for one month and earns a profit of $1,000 at the end of the month. The profit is shared as follows: bank – $500 and the pool, $500. The Mudarabah contract would be completed at this stage.

**Profit and Loss-Sharing**

The profit earned by the pool is distributed as per the weightage allocated at the beginning of the month. The relationship within the pool is governed by the rules of Musharakah.

According to the rules of Musharakah, loss to the pool, if any, is distributed among the pool members, known as Rabbul-māl, based on their investment ratio.

In practice, these pools are created only for use with restricted investment accounts. In the case of unrestricted investment accounts, the bank is free to use the deposits for any Shari'ah-compliant financing.

**Modes of Financing Trade, Industry, and Agriculture**

Islamic banking practice is open to utilising all rightful modes, including those based on:
- Shirkah
- Trade or lease
- Finance trade
- Industry or a budget deficit through domestic or foreign sources.

Banks should manage diversified portfolios and select proper modes to avoid risks. Some of the modes are Musharakah or Mudarabah, Murabahah, Musawamah, Salam, Istitna'a, Ijarah and Istijrar.

**Trade and Industry**

The following modes can be used for trade and industry.
- Murabahah, instalment sale, leasing and Salam are suitable for trade, purchasing of raw materials and inventory.
- Istitna'a is specific to industry.
Salam or Istisna’a are funds for recurrent expenses that can be obtained by the advance sale of final products of the company.

**Agriculture and Forestry**

The following modes can be used for agriculture and forestry.

- **Murabahah, Salam** can be used to fund agricultural needs (plough cattle, milk cattle, other livestock, dairy and poultry).
- **Ijarah Muntahia-bi-Tamleek, Salam, Murabahah** are suitable for tube wells, tractors, trailers, farm machinery and transport, that include fishing boats.
- Diminishing **Musharakah** or rent-sharing is best suited for storage and other farm construction like sheds for animals, fencing, etc.
- Operating **Ijarah, Salam** is specific to land development and
- **Salam, Musāqah** is best suited for orchards, nurseries, forestry.

**Consumer Finance**

The following modes can be used for consumer finance.

- **Murabahah**, leasing, return-free loans out of the current accounts is the personal finance for consumer durables, where the depositors’ money in PLS accounts is a trust in the hands of banks and should not be used for charitable and social purposes without their explicit approval.
- **Wakalah** and **Murabahah** are suitable for cash financing through charge and credit cards.
- **Ijarah Muntahia-bi-Tamleek** and **Murabahah** are the alternatives for auto finance and
- **Murabahah**, Diminishing **Musharakah** and rent-sharing are suitable for housing finance.

**Treasury Operations**

Islamic banks may sell and purchase Shari'ah-compliant money and capital market instruments like stocks and Sukuk.

- In **Sukuk**, an investor earns returns on the basis of ownership rather than interest. **Sukuk** is the key to liquidity management.
- Liquidity can be generated by trading in **Sukuk** in the secondary market. If the regulatory structure allows it, Islamic banks can generate liquidity by selling the **Sukuk** to the central bank. **Sukuk** can be structured on an amortising or bullet maturity basis.

Direct placement or acquisition of funds on the basis of **Mudarabah** and **Musharakah** is also possible. In the case of **Mudarabah**, the following process can be adopted:
A Mudarabah relationship is created with itself as Mudarib.
- Funds received are allocated to pools.
- Weightages are allocated periodically.
- Profit earned is allocated according to weightages.

The bank will charge a pre-agreed Mudarib fee as a percentage of the realised profit; the bank can earn additional profit from its own share of capital. The investor will bear a loss unless it arises from misconduct or neglect of the Mudarib.

**Foreign Exchange**

Foreign exchange operations are subject to the following.
- Exchange of currencies and monetary units has to be subjected to the rules of Bai’ al Sarf.
- Spot purchase and sale of one currency against another currency is allowed.
- Forward purchase and sale is not allowed.
- IFIs can enter into an undertaking to purchase and sell foreign currency. On this principle, foreign currency forward cover is permissible with certain conditions. In order to ensure that the transaction actually goes through, parties may specify any earnest money, and
- Negotiation of export documents is partially allowed.

**Public Sector Financing**

Modes for financing public sector projects are as follows.
- Government and public sector enterprises can purchase equipment or utility-generating assets through Mudarabah or Musharakah certificates.
- Ijarah Sukuk and Istisna’a are best suited for infrastructure projects in the public sector.
- Using syndication, Islamic banks can supply highly valuable goods or assets to government entities or corporations by setting up joint Murabahah funds.

**Two Approaches for Returns in Islamic Banking**

A majority of scholars believe that profit or loss-sharing or PLS, encompassing Musharakah, Mudarabah and their variants, is the main instrument that can replace the interest-based system. On the other hand, there are scholars who think that contracts of exchange are more relevant to Islamic financial institutions.
The idea of replacing interest by profit-sharing in the depositor–bank and bank–business relationships, first debated during the 1940s to 1960s, gained considerable approval in the 1980s and 1990s. However, there are minor differences in approach and priorities.

Let us now look at varied opinions of scholars on PLS.

- No risk equals no gain.
- PLS is extensively used for non-trade operations.
- PLS does not involve unlawful traits like Ribâ, Qimār, fraud, coercion, exploitation of needs, hazard and uncertainty.
- Islamic banking and finance should rely on profit-sharing contracts to achieve the objectives of economic justice, efficiency and stability of the economic system.
- Mudarabah, Shirkah or acquisition of shares of joint stock companies is a good form of financing.
Exchange Based Contracts
The approach of Islamic bankers is different from the general approach adopted by Islamic economists. Exchange contracts both for instant and deferred prices are more relevant to Islamic financial institutions and equally legitimate as per Qur’ānic injunctions.

The Holy Qur’ān considers contracts of exchange on par with contracts of profit-sharing. The present practice of Islamic finance, in contrast to the general perception of Islamic finance theory, is largely based on trade or exchange-based transactions. Islamic scholars have not forbidden debt-creating modes; the issue is of preference and that too on account of the possible impact of risk-based versus risk-free capital in an economy.

Islamic economists have allowed exchange-based modes, subject to the fulfilment of relevant conditions.

Profit/Loss Approach in Islamic Banking
The substitution of the interest-based system by a profit-sharing system raises a number of fundamental theoretical, practical and policy questions.

The key questions are:
- What theoretical framework forms the basis of Islamic banking and finance?
- Will the Islamic system be more or less stable than the conventional interest-based system?
- What effect will the adoption of an interest-free Islamic system have on important macroeconomic variables such as saving and investment? And
- Will monetary policy have a role to play in such a system?

Theoretical Framework
Research for the IMF indicates the following.
- The Islamic financial system replaces interest-based transactions with a form of profit sharing.
- Islamic system is equity-based rather than debt-based as in conventional finance.
- Islamic system does not guarantee the nominal value of deposits because it treats them as shares.
- In the traditional system, either the banks or the government guarantee such deposits, which often leads to the need for intervention in times of crises.
**Stability of the System**

On the stability of the system, research also shows that:

- The equity-based Islamic system may be better able than the interest-based banking system to adjust to banking crises.
- In an equity-based system, shocks due to non-performing assets or NPAs are instantly absorbed by the changes in the nominal values of shares, that is, deposits held by the public in banks.
- In the conventional debt-based system, the nominal value of deposits is guaranteed. Therefore, shocks can result in huge discrepancy between real assets and liabilities, preventing a quick return to equilibrium.

**Macroeconomic Impact**

On the macroeconomic impact of the profit-sharing system, research findings suggest that a full Islamic system the costs of monitoring would be minor and the equity participation arrangement would be superior to the interest-based system.

Other research suggests that:

- A profit-sharing arrangement between the lender and investor as in the Islamic system may raise monitoring costs and could have an adverse effect on the supply of credit and thus on investment.
- To minimise this, individual contracts can be structured to account for moral hazard.
- By implementing a legal and institutional framework based on the *Sharī'ah*, Islamic nations can facilitate contracting and safeguard the terms of contracts.

Research results also indicate that specifically in the PLS based Islamic system:

- Expectation-based profit-sharing ratios can serve as a means of pricing to restore equilibrium to the loanable funds market.
- Risk-free assets with positive returns will be eliminated, improving the situation of lenders.
- Profit-sharing ratios are relatively inefficient in implementing monetary policy.
- Interest-free banking does not ensure that all profitable projects will receive funds regardless of their rate of return.

Other studies, however, do not agree and conclude that:

- The rate of return increases with risk, so savings may rise.
Implementing an Islamic financial system will cause structural changes that may be favourable for the rate of return on financial assets. Therefore, savings may not be lower than in a traditional system.

**Monetary Policy**
Sami Hasan Homoud (1998) presents an outline of how monetary policy based on modes of an Islamic financial system can pump huge number of funds into an economy and lift millions from poverty.

Let’s look at how this can happen.

- **Mudarabah** serves as a source of business conducted by the combination of funds and financial expertise. *Mudarabah Sukuk* can be issued to raise funds and fortify trading and industrial activities.
- **Shirkah**-based (PLS) modes can be used for short, medium, and long-term project financing, import financing, pre-shipment export financing, working capital financing, and financing of all single transactions.
- SPVs manage such assets as trusts or funds for their own benefit as well as for the *Sukuk* holders. This generates higher rates of return for the investors compared with most interest-based investments.
- **Murabahah** carries less risk and has several advantages over other techniques; it can spark employment generation and mitigation of poverty.
- **Ijarah** facilitates the creation of fixed assets, medium and long-term investments.
- **Salam** has vast potential for financing productive activities in crucial sectors. These include agriculture, agro-based industries and the rural economy.

In practice, the most popular forms of Islamic financing are *Murabahah* and *Ijarah*, not *Mudarabah* and *Musharakah*.

**Islamic Investment Banking**
Islamic investment banks provide the same products and services as a conventional bank. The distinguishing factor is that their products and services are *Shari’ah*-compliant while meeting the customers’ requirements. Islamic investment banks handle portfolios for institutions, corporate clients and high net worth individuals, and pooled investment mediums such as unit trusts and mutual funds.

**Asset Management**
Asset management or management of funds comprises equity funds, real estate funds, and alternative investments in *Ijarah* and other *Sukuk*. They engage in treasury operations for managing the asset–liability mismatch generated by different tenors of investment opportunities and different return profiles.

The opportunities for Islamic Asset management are:

- Open and closed-end mutual funds,
- Equity benchmarks and
- Leasing companies involved in asset-backed financing.

**Venture Capital for Small and Medium Enterprises**

Venture capital financing activities must avoid involvement in prohibited and unlawful activities and provide services to all projects, except those dealing in forbidden products and services, such as alcohol, pork, entertainment, interest-based financial services and the like. Their services relate to venture capital and corporate finance, including syndication finance, project finance and transactions in the capital markets.

**Corporate Finance**

Islamic corporate finance activities are *Shari’ah*-compliant.

Their services include:

- Equity issues such as IPOs, offers for sale, rights issues,
- Private placements,
- Strategic reviews,
- Financial restructurings,
- Acquisitions, divestments, mergers and
- Joint ventures, alliance searches and studies.

**Syndicate Finance**

Syndicate financing is a large financing facility granted to a key industrial or trading company and lead-managed by a bank with a strong base. Since the sum involved is huge, a number of financial institutions participate in the financing. An Islamic syndication facility can be provided through *Murabahah, Mudarabah, Musharakah, Ijarah* or leasing.
Chapter 4 - A Framework for the Islamic Financial System - Part 2

Introduction


Islamic banks can be involved in sale and purchase of goods in accordance with Shari‘ah rules. Islamic banks should not charge any interest on funds but are entitled to profit by undertaking business risks.

Banks sell goods on credit to their customers thus creating receivables. This kind of credit sale or Bai’ Mu‘ajjal takes on two forms.

In Musawamah or normal sale, customers bargain on price whereas in Murabaha or cost-plus sale, customers bargain on the margin of profit. It is important to note that Shari‘ah permits these two forms of exchange contracts.

On completing this chapter, you will be able to:

- Explain the concept of Bai’ Bithaman Ajil or Bai’ Mu‘ajjal or credit sale and conditions for it.
- Explain the concept of a Murabaha sale with Bai‘-Bithaman Ajil facility.
- Identify the conditions for a valid Murabaha sale.
- Describe the structure of a Murabaha contract.
- Explain the Murabaha to purchase orderer (MPO) contract.
- Explain the steps in the MPO contract and the pre-requisites for each step, and
- Describe the various issues that need to be managed for Murabaha contracts.

Concept and Conditions of a Bai’ Mu‘ajjal (Credit Sale)

Islamic banks offer various credit sales to their customers. The important forms of credit sales are Bai’ Bithaman Ajil or BBA, or Bai’ Mu‘ajjal, Murabaha and Musawamah.

Bai’ Bithaman Ajil (BBA) or Bai’ Mu‘ajjal

Bai’ Bithaman Ajil or Bai’ Mu‘ajjal is a credit sale where customers make deferred payment. This often includes the Murabaha features. BBA implies that payment of price will be
deferred regardless of whether the cost and mark-up are known to parties. The mechanism of *BBA* is described as follows:

**Step 1**
Customer requires a commodity X. He approaches the bank.

**Step 2**
Bank buys X from the vendor at price P.

**Step 3**
Bank sells X to the customer at a marked-up price; say P+M, where M is the agreed profit or mark-up taken by the bank.

**Step 4**
Customer makes payment of P+M in a deferred manner.

*Murabaha*
*Murabaha* is a cost-plus sale, where customers bargain on the profit margin over the known cost price. In *Murabaha*, the profit margin is fixed over the cost and both the bank and customer agree on a specified profit to be added to that cost. This mechanism of *Murabaha* is described as follows:

**Step 1**
Customer approaches the bank, selects the commodity and collects information of base price and mark-up. Now bank also acts as a vendor.

**Step 2**
Bank sells the commodity at a marked-up price to the customer.

**Step 3**
Customer makes spot or deferred payment.

*Musawamah*
Musawamah is a normal sale, in which the customer bargains on price. In Musawamah, the seller does not disclose the original cost of the goods. Once the goods are delivered, the customer makes spot payment or in a deferred manner.

**Conditions of Bai’ Mu’ajjal**

All Islamic financial institutions should follow the conditions and rules outlined by the Shari’ah for sale transactions. Let’s discuss some key conditions and rules.

**People Involved**

Only qualified people can enter into a valid sale contract.

Mutual consent between the seller and the purchaser is mandatory for a sale contract.

The seller should be the owner of the object of sale (Mabi’) or an agent of the owner. Hence, one cannot sell an object if he does not own it. For example, A cannot sell a car to B, which he intends to first purchase from C. Since A does not own the car at the time of sale, the sale is void.

**Terms**

The sale must explicitly define:
- Price
- Date and place of delivery
- Time of payment of the price

The price determined cannot be changed. For example, seller A may offer two options to buyer B for an object: $ 75 if paid after 1 month or $ 200 if paid after two months. Once B decides, A cannot change the price.

The sale must be instant and absolute. A sale promised at a future date, or a sale depending on a future event is invalid. For example, if A tells B on the first of October that he would sell his car on the first of November, the sale cannot be dated first of October. This kind of sale is invalid because it depends on a future event. It is valid only if A sells on the first of November.
The delivery should be assured, not dependent on a future event. For example, A cannot sell an object he has lost in the hope that he will be able to locate it before the delivery.

A sale cannot be conditional unless the condition is a normal trade practice and is not prohibited by the *Sharī'ah*.

**Asset Title**
The *Mabi'* should be transferable. Transfer of title requires acquisition of title by the purchaser and assuming the risks related to ownership, such as the risk of damage, destruction, pilferage or theft, the risk of obsolescence and the price or market risk.

**Subject**
The subject of sale must exist at the time of sale. For example, The seller cannot sell the unborn calf of cow or a bank cannot execute *Murabaha* on goods that have already been consumed or used.

The subject must exist at the time of sale. For example, a seller cannot sell an unborn young of an animal, or a bank cannot execute a *Murabaha* contract on goods that have already been used.

The subject must be specifically identified to the buyer to ensure it can be distinguished from others of the same kind. For example, the seller cannot say, “I sell you 100 heads of corn lying in that barn” unless those 100 heads are identified specifically and the buyer can distinguish between those and others.

The seller must physically or constructively possess the subject of sale at the time of sale. For example, A has purchased an appliance from B. B has placed the appliance in a warehouse to which A has access. The risk of owning the appliance has practically passed to A. Therefore, A has “constructive possession” of the appliance and can sell it to a third party.

**A Murabaha Sale**
*Murabaha* means gain, profit or addition. Islamic scholars like Imam Malik, Hanafi jurist Al-Marghinani and Hanbali jurist Ibn Qudama essentially agree on the definition of *Murabaha*, as a sale that involves a certain cost to the seller and his profit margin. The original cost
and profit should be known to the seller and buyer. Murabaha is considered as a contract of trustworthiness. Murabaha protects innocent customers who lack skill in making purchases in the market on the basis of Musawamah. Such persons can deal with a Murabaha dealer and purchase goods by paying an agreed additional cost over the original price.

Islamic banks conduct Murabaha in a deferred payment basis. Upon execution of Murabaha, the bank creates a receivable and that becomes the liability of the customer. The aspect of disclosing the banks’ cost price details does not remain a serious issue between the bank and customer because the customer is involved in locating and purchasing the goods.

**Conditions for a Murabaha Sale**

Since Shari’ah permits Murabaha, all transactions under this type of sale should meet the general conditions that are applicable for ordinary sale. The specific conditions regarding lawful transactions of Murabaha are related to:

- The goods that are the subject matter of the Murabaha
- The original price paid by the seller
- Any additional cost that serves as the basis of Murabaha and
- The margin of profit charged on the cost

Let us discuss some basic conditions for a Murabaha sale.

**Condition 1**
Goods to be traded should be real, but not necessarily tangible. It can be non-tangible.

**Condition 2**
Any currency and monetary units that are subject to the rules of Bai’ al-Sarf cannot be sold through Murabaha as it requires simultaneous exchange of currencies.

**Condition 3**
Credit documents that represent the debt owed by someone cannot be the subject of Murabaha. Debt cannot be sold except when it is subject to the rules of Hawala, and any profit taken on the debt would be Ribâ.

**Condition 4**
The seller must reveal the original price and the additional expenses to the buyer. Additional expenses, such as transport, processing and custom charges can be added into the purchase price on the basis of Murabaha.
Condition 5
The seller must disclose all aspects related to the commodity, any defects or additional benefits and the mode of payment to the original seller or supplier. If an Islamic bank receives a discount for goods purchased even after the Murabaha sale, the buyer is eligible to benefit from the same discount.

Condition 6
A mutual agreement between the buyer and seller on the margin of price is mandatory. As the fixed price cannot be increased further, it can be decreased when the seller gets a discount from the original seller or supplier.

Condition 7
Any Majhul or unspecified price should not be involved in Murabaha. To avoid uncertainty due to unspecified price, the seller must express the cost in identical unit, such as Dirhams and Dinars.

Condition 8
If the seller provides incorrect information about the original price of goods, the buyer can annul the sale.

Condition 9
The buyer in Murabaha has the right to opt out of a contract if he detects that the seller has indulged in fraud, provided false statements, or is involved in an illegal sale of goods. However, if the buyer detects cheating after he has used the goods or it has been destroyed while in use, he is not entitled to reject the contract or deduct any amount from payment to the seller.

Murabaha Structures
Trading, marketing, and other real sector business activities require special expertise. As it is impossible for banks to train all staffs for this expertise, banks allow specific purpose companies or third party agency to undertake trading and leasing activities. With relevant specialised expertise, the staff may be entrusted the job of trading in goods to fulfill the Sharī‘ah essentials of Murabaha-Mu‘ajjal. Let us discuss about the options for conducting Murabaha.
**Direct Trading by Bank Management**

Direct trading by bank officials can be used only in cases of selected specific assets. In such cases, banks make bulk purchases of high value asset or specific goods with trademarks to build their inventory and sell them to clients on a cost-plus basis.

However, involving bankers in retail trade can lead to a lot of managerial problems and corruption. This issue can be resolved through effective internal controls.

**Bank Purchases Through a Third Party/Agent**

After purchase from the supplier, the bank is liable if anything goes wrong before handing the asset over to the *Murabaha* clients. Therefore, banks appoint qualified suppliers as agents to purchase according to their inventory plans or as and when required by clients. The inventory creating plans agreement includes a memorandum of understanding or MoU, sale deed executed at the time when the commodity is in the ownership of the bank, and ‘promissory note’ signed by the client.

**Murabaha Through the Client as Agent**

This structure of *Murabaha* normally used by Islamic banks is the safest way for banks to avoid commodity-based risks and related problems. The foremost requirement of this structure is that goods come under the ownership and risk of the bank and customer should explain to the supplier about his agency status.

If the bank makes direct payment for the goods purchased and received by the client from the supplier/vendor, it will be a remittance of the amount of money on behalf of the client, which will be a loan to him and any profit on this amount will be the interest.
Murabaha to Purchase Orderer

Modern Murabaha transactions normally take the form of Murabaha to Purchase Orderer, or MPO, or Murabaha li 'amri bil Shira, or Murabaha li Wa’da bil Shira. In this arrangement, the bank purchases an asset, from a third party upon request by the customer, and sells the asset to the customer on a deferred payment basis.

The MPO comprises a master contract, which defines the overall facility to be availed, an agency contract, whereby an agent should purchase an item and possess it on behalf of the bank, and an actual Murabaha contract, which should be concluded when the bank owns the concerned commodity.

Murabaha transactions also involve other contracts such as a promise to purchase. According to the promise to purchase contract, if the promisor has caused the promisee to incur expenses or undertake labour or liability based on a promise, then the promisor should fulfill his promise for which he may be compelled by the courts.

Another variant of the MPO is ‘Customer as the Bank’s Agent to Buy’. The general structure of this variant involves six major stages, such as pre-promise understanding, promise stage, agency stage, acquiring possession, execution of Murabaha and post-execution.

It is important to note that neglect of even one of these stages will render the whole agreement unacceptable according to the Shari’ah.

Across these stages the relationship between the bank and client is that of:
- Principal and agent
- Promisor and promisee
- Buyer and seller
- Seller and buyer and
- Creditor and debtor.

Pre-Promise

In this stage, the bank and the client sign a MoU or what is known as ‘agreement to sell’. According to this agreement, states that the client agrees to buy the commodity and the bank agrees to sell it with an agreed percentage of profit margin.

Pre-requisites for the pre-promise stage are:
• The contract between the bank and the client must be authentic.
• *Murabaha* cannot be used for providing liquidity or for business involving ready cash.
• Past contracts between the client and the supplier are excluded.
• The supplier has to be a third party. The customer, his agent, or an entity that has more than 50% ownership by the customer, is not eligible to be the supplier.
• The commodity should conform to *Murabaha* standards.

The bank should check the credibility of the commodity from the point of view of risk, marketing value, uniqueness, and profitability. The client should be tested for cash flow and risk profile.

**Promise**
The bank assigns the client as its agent, who will purchase the commodity on their behalf. Both the parties sign a general purpose agreement of agency.

Pre-requisites for the promise stage are:
• The Bank signs a master *Murabaha* facility agreement, or MoU that provides facility, commodity, payment, and security details.
• This MoU may support sub-*Murabahas* for future consignments of assets.
• With the consent of both the parties, the agency agreement may also be signed at this stage.

**Purchase Requisition**
• The purchase requisition contains details of goods to be purchased, name of the supplier, cost price and the expected date of delivery.
• The requisition also contains a promise from the client that he will buy the goods acquired by the bank.
• If the client already possesses the requested goods, the *Sharī'ah* advisor will instruct the bank to credit the transaction income to the Charity Account.

**Agency**
It is mandatory according to the AAOIFI Standard that the client purchases the goods on behalf of the bank and the bank in turn pays the supplier. Some Islamic banks may not follow this procedure. The purchase order, delivery report, and delivery *challan*, should be in the name of the bank.
Pre-requisites for the agency stage are:

- An agency agreement can be signed along with the MoU, but before the purchase of goods by the client.
- An agency agreement should be “specific agency”, when the purchase of the commodity is not of a consistent nature, and “general”, when the purchase of the commodity is of a consistent nature.

**Purchasing**

In this stage, the client informs the bank about the purchase, the possession of the asset, and offers to purchase it from the bank at a profit margin. This is in accordance with the “agreement to sell”. The *Murabaha* will stand invalid if this is done after the consumption of the commodity.

Pre-requisites for the purchasing stage are:

- Any discount offered by the supplier should be passed on to the client, while executing the *Murabaha* sale, by reducing the cost of sale.
- The bank or the principal must be informed about a price rise. The bank has the right to reject a purchase that does not tally with the agreed price.
- If the goods to be purchased differ from those in the agency agreement, the change of commodity can be made with mutual consent.
- A delay in the purchase of goods allows the bank to ask the client to refund the cost of goods without any opportunity cost.

**Acquisition of Title and Possession of the Asset**

- In compliance with the *Shari'ah*, the bank takes ownership and possession of the goods before executing the *Murabaha*.
- The forms of taking possession of goods are bound by their nature and customs.
- Goods must exist at the time of execution of *Murabaha*. A client may not take delivery of goods; use them before informing the bank and “offer and acceptance”. This creates a *Shari'ah* objection.
- The bank appoints a person for physical inspection to ensure that the commodity exists in its original form.
All ownership-related expenses like *Takaful*, until the transaction, need to be paid by the bank. Any loss before the date of transaction also belongs to the bank.

**Execution of *Murabaha***

The bank accepts the offer and concludes the sale. This transfers the ownership and the risk of the commodity to the client.

Pre-requisites for the execution stage are:

- The customer takes possession of the goods, gives a possession report, and offers to purchase the goods acquired by him on behalf of the bank. The bank accepts the offer and completes the transaction.
- All the terms of the *Murabaha*, such as contract price (cost plus profit), due date, schedule of payments, etc. should be part of the bank’s letter of acceptance.
- The relationship of buyer and seller between the client and the bank transforms into a relationship of debtor and creditor.
- The customer should confirm about his satisfaction regarding the goods received.
- He should relieve the bank from any loss or third party liability.
- The AAOIFI Standard recommends that the bank should assign to the customer the right to obtain compensation in case of any defects in the goods received.

**Post-execution**

In this stage, the customer will furnish security to the bank regarding timely payment of the deferred price. The commodity itself can be given as security. The customer owns the risk and reward of the goods.

The bank can acquire any type of security, based on the amount of facility, type of business and reliability of the customer.

Some *Shari‘ah* boards even allow interest-bearing securities as collateral (*Murabaha* facility against TDRs and FDRs). It is preferable to ask the customer to offer *Shari‘ah*-compliant securities.
Issues in Murabaha Contracts

The Shari'ah prescribes certain norms to free Murabaha from Ribâ and other abuses to the system. Let’s now look at some of the issues that need to be managed in Murabaha contracts.

Risk and Rights
Murabaha is an equity-based product that involves sharing of returns and risks. Possession under Murabaha may be physical or constructive, where the bank may not have taken the physical delivery of the commodity, but is in control of it with all the rights that include even the risk of destruction and legal responsibilities.

Legality of Promise
In Murabaha, when a promise is made by a bank and its client, it is in the nature of a moral obligation. But there is much debate among scholars on whether it is also a legal obligation.

A promise that is not enforceable by law may result in a difficult situation. If the price of a commodity varies between the first contract, which is between the bank and the vendor, and the second contract, which is between the bank and the client, either party will have an incentive to default.

For example, an independent promise of a gift cannot be enforced by law. It is just a moral obligation. But in commerce, as in the case with Murabaha, it should be legally enforceable by law when a party incurs a liability based on a promise by another party.

Subject of Murabaha
A Murabaha must not involve sale of forbidden commodities, such as liquor, pork and the like.

The subject of sale should be classified as property in Fiqh. In Murabaha financing of education, the bank buys the "right to enroll in the university" and then resells it to the student at a marked-up price.

Price and Payment
A valid sale requires knowledge and specification of price and payment conditions. Both the price and the mode of payment are fixed at the time of contracting. This helps to avoid a source of conflict in the form of Gharar or uncertainty.

A BBA-Murabaha contract allows both cash, or spot, payment and deferred payment.

The deferred price may exceed the cash price, but it has to be fixed at the time of sale.

The terms of deferred payment must be clearly specified and once the price is fixed, it cannot be subject to modification.

**Profit Benchmarks**

In a Murabaha, price includes potential profit. Profit rate is often decided in relation to the market interest rate, such as London Inter Bank Offer Rate or LIBOR.

This method of pricing in a Murabaha is legally permitted by the Shari’ah, even though the outcome is not as desirable. But the alignment of rates, on both Islamic and conventional products, is understandable in an integrated market where both products exist. It is also natural for a client of Islamic bank to use conventional banks as a benchmark to compare products. As a result, it is also natural and legal for an Islamic bank to standardize its Murabaha rates on par with the lending rates of conventional banks.

**Profit Rates**

Interest rates are extremely unstable and many conventional banking products have floating-rates. The rates on such loans are automatically adjusted with changes in interest rates.

BBA-Murabaha financing products have fixed rates. The rate is not allowed to swing according to the changes occurring in interest or any other rate.

The conversion of a fixed rate facility into a floating rate facility, by opting for a debt rollover at periodic intervals, is possible with a conventional bank but is not allowed by Murabaha.
A rollover in Murabaha means that another Murabaha is booked on the same commodity and this practice is prohibited by the Shari’ah.

Risk Mitigation
A major problem related to the BBA-Murabaha financing is the possibility of willful non-payment by clients. In conventional system of borrowing, a defaulter is penalised with additional interest.

Since this practice is entirely due to time value of money, it is considered to be a case of prohibited Ribâ and hence not allowed.

In dealing with the problem of delays, various alternatives are suggested:
- The defaulting client shall donate a specified amount for a charitable purpose.
- Deliberate defaults, if established, may be penalised.
- The bank may lay down a condition in the contract that a default of a single payment will render the remaining installments due immediately.
- The bank may seek security in the form of a mortgage, a lien, a charge on any of the client’s assets, a guarantee from a third party, a promissory note or a bill of exchange.
- The bank may reschedule installments but this is not allowed in BBA-Murabaha as no additional amount can be charged, as done by conventional banks.

The Murabaha contract, apart from battling issues like sale contract, credit price and the legal inferences of combining promise and agency with the actual Murabaha contract, also faces allegations that it constitutes two sales in one - the contract of promise and the sale deed. The objection is to the binding promise that takes on the nature of a sale.

But it must be noted that it does not violate any major Shari’ah principles, and the promise does not take the form of a formal contract. The implication of a sale contract differs from a promise to purchase. It is a unilateral promise that remains a promise and does not take the form of a contract.

Avoiding Buy-back
Bai’ al-Inah, generally known as “buy-back”, is a double sale by which the borrower and the lender sell and resell an item among them, once for cash and then for a higher price on
credit. The net result of this is a loan with interest. It is a legal trick to get around the ban on Ribâ and is thus prohibited.

Islamic banks need to ensure that the goods ordered by clients are not already owned by them. The AAOIFI agrees with this view.

*Khiyar in Murabaha*

*Khiyar* is not considered to be necessary in modern *Murabaha* by most scholars. Some banks specify in the contract that a defect is the responsibility of the buyer and any discrepancy in the quantity or specification of the goods is considered to be the liability of the seller. This discrepancy is taken care of by reducing the sale price by an amount proportional to the missing goods, along with the buyer having the right to withdraw or cancel the contract.

Hence, from a legal point of view, a buyer:
- Can avail *Khiyar al-'Aib* and *Khiyar al-Wasf* if the goods are defective or are not according to the stipulated specifications and
- Shall be compensated by good quality goods through the same or a new *Murabaha*.

The bank can also specify that it shall not be responsible for any discrepancies once the goods have been inspected by the buyer and the *Murabaha* has been executed. Banks can also assign cases with warranties, to the client.
**Time of Executing Murabaha**

A *Murabaha* contract should be conducted only after the bank gets ownership and possession and is responsible for loss or defects. This is even recommended by the *Shari'ah* scholars.

Agency contracts, where a client buys the goods on behalf of the bank and immediately sells it to the client, are part of *Murabaha* contracts. Islamic banks should avoid this practice and treat agency contracts as being independent of *Murabaha* contracts. After the client takes possession of the goods, there should be a separate offer and receipt between the client and the bank.

**Defaults by Clients**

Some of the options to deal with delayed payments are:

- The client should pay to charity in case of default.
- *Shari'ah* scholars have authorised banks to impose late fees on delinquent clients. But the proceeds of such penalties can be used only for charitable purposes. Only a court or any independent body can allocate any part of the penalty to banks, and
- Courts or any resolution committees appointed by the State can determine the compensation for the actual damage but not for the loss of income calculated on the basis of the conventional idea of opportunity cost.

Following the path of *Ijtihad*, a *Fatwah* of the *Shari'ah* board of *Al Barakah*, Sudan, authorized Islamic banks to impose late fees taken as the bank’s income based on a profit rate gained by it during the period of default, as if the delayed payment had also earned that profit. But it is very important, for the credibility of the Islamic financial system, to differentiate *Murabaha* contracts from the conventional concept of opportunity cost.

**Rebates on Early Payment**

A majority of contemporary *Shari'ah* scholars do not allow remission for earlier payment in *Murabaha* operations. The OIC *Fiqh* Academy, the *Shari'at* Appellate Bench of the Supreme Court of Pakistan, *Shari'ah* committees of Islamic banks in the Middle East, and *Shari'ah* scholars consider it to be similar to interest-based installment sales techniques.

However, the AAOIFI’s *Shari'ah* Standard on *Murabaha* allows a rebate if it is not already predetermined in the *Murabaha* contract. Therefore, the bank has discretion in allowing the
rebate or not. But, this is not to be made a practice and such cases should be decided on merit, in consultation with the Shari‘ah advisor.

**Rollover in Murabaha**

A “rollover” in Murabaha means booking one more Murabaha against receivable on a previous Murabaha, and the payment for which has not been made by the client. Further mark-up is added to the receivable in default by a client. This is explicit Ribâ, as the bank is not entitled to any amount above the debt created in a Murabaha transaction. Rescheduling is allowed, but re-pricing and rollover is not allowed. The bank can reschedule the payment without an increase in the original receivable.

Banks can justify the mark-up they charge with Murabaha contracts on account of the risks they share. If all risks are mitigated or transferred to the client, there can be no mark-up.

**Murabaha Through Shares**

There have been instances of Islamic banks conducting shares Murabaha, where they buy shares through a client as agent and sell them on a Murabaha basis to the clients. Shares represent tangible assets of joint stock companies. So their trading is allowed if the screening criteria based on the Shari‘ah are taken into consideration. Their sale through Murabaha is permitted too, but Islamic banks need to consider the following to be Shari‘ah compliant:

- Banks should make payment directly to the brokers.
- The client should not be appointed as an agent for purchasing shares.
- Banks can sell shares on a Murabaha basis once payment is made by the bank and the shares are transferred to it.
- In case settlement takes time, banks should wait for actual transfer. The risk of price fluctuation for three days has to be borne by the bank, and
- The shares should not be of any associate firm of the client as this will imply any purchase as “buy-back”, which is prohibited.

**Commodity Murabaha**

Commodity Murabaha is a short-term placement mechanism that involves purchase and sale of commodities in the international markets like the London Metal Exchange or LME.
Internationally, Islamic banks have used this to manage their cash flow. The banks use *Tawarruq* and appoint a commodity broker to purchase metal and subsequently sell it to a third broker on a deferred payment basis on the same day.

Generally, Islamic banks ask the agent of a conventional bank to buy any metal from broker A on cash basis on their behalf. The Islamic bank then sells that metal to broker B on deferred payment basis.

It doesn’t matter if any actual transaction takes place, and when risk is transferred to the bank. It's not known if the amount of metal available is sufficient to cover the transaction volumes.

**Risks and Mitigation Measures**

In *Murabaha*, Islamic banks face additional risks like the asset risk, fiduciary risk, legal risk and the *Sharī'ah* compliance risk.

One way to mitigate the risk is by paying special attention to completing documentation for various contracts under the guidance of the bank’s legal department. Any slip in documentation may lead to loss of income.

The role of *Sharī'ah* supervisory boards or advisors is vital in the application of proper internal controls for *Sharī'ah* compliance.

Let’s now see some risks and mitigation measure for them.

**Risk 1**

Suppose the bank’s customer is acting as its agent to procure goods that the bank will sell back to customer. After taking possession as the agent, the customer refuses to actually buy the goods for some reason.

To protect against such a risk, at the time of appointing them as agents, banks can obtain a promise from the customers that they will buy the goods from the bank.

Alternatively, the bank can use *Hamish Jiddiyah* and recover any loss from that.
**Risk 2**
Suppose the customer does not purchase new assets. They have already purchased the goods and now want finance to pay the supplier. The transaction involves Bai’ al-‘Inah and therefore, not compliant with the Sharī‘ah.

To protect its interests, the bank should:
- Make direct payment to supplier through a demand draft or pay order.
- Obtain invoice for the goods purchased and any other evidence. For example, gate pass, inward register, entry in stock register or truck receipt.
- Inspect goods physically.

**Risk 3**
Suppose goods have been used by customer prior to offer and acceptance. Alternatively, goods were non-existent when the Murabahah was executed.

In such cases, to protect its interests, the bank should:
- Make only periodic offers.
- Inspect the goods randomly.

**Risk 4**
There is often a risk that goods owned by the bank will be destroyed in transit, prior to offer and acceptance, without agent’s negligence.

To mitigate such risks of ownership, the bank can buy Takaful insurance to offset the loss.

**Risk 5**
Some customers may delay payments frequently, knowing that the bank cannot earn income through penalties on late payment.

To discourage such behaviour, banks can obtain a promise from the customer to donate a certain amount to a charity supported by the bank every time payment is delayed.

**Risk 6**
With some customers, there may be high risk of default on payments. In such cases, the bank can recover the loss by selling securities or collateral.
Risk 7
Sometimes, suppliers may not deliver goods as promised. To protect against such non-performance, banks can ask for guarantees from the agent.

Risk 8
Some customers may fraudulently purchase from or resell goods to their associates/subsidiaries. This can make the transaction invalid according to the Sharī‘ah.

To prevent such fraud, banks must obtain and examine balance sheets, account statements, and other documents related to the company and its associates or subsidiaries before entering into any agreement.
Bibliography


