

**An Introduction  
To  
Islamic Banking**

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## INTRODUCTION

In the last 20 years, commercial banks share of US financial assets has declined to 24.5% from nearly 40%. New technologies of communication and computerized financial transaction made it possible for many savers to by-pass commercial banks and directly reach out to users of funds. This diminishing role of banking is, effectively compensated for by growth of financial markets (money and capital markets). As their ability to make their own credit judgment improves, more and more savers prefer to eliminate the “middle men” , by directly taking the risk of borrowers, than the risk of banks. This is exactly the idea of Islamic banking. An Islamic bank is a financial intermediary. However, its operation is not based on a “borrower-lender” relationship with savers. Alternatively, it functions as an agent procuring investment opportunities to its depositors, where they directly take the investment risk. To prevent *adverse selection* and generate incentive compatibility, this agent does not get fixed fees for its fund-management. rather it is compensated on the basis of actual profits of these investments.

The model of Islamic banking is built on what is called in Islamic jurisprudence “Mudarabah”. Mudarabah is a principal-agent contract. It is based on trust, where assets remain the ownership of the principal (the saver in this case) managed by the agent (the Islamic bank).

Islamic banking *raison d'être* is prohibition of usurious transactions. Because usury arise in loans, a financial intermediary established on the idea of borrower-lender relationship is not compatible with the Islamic system.

Both being essentially financial intermediaries, the differences between an Islamic bank and a conventional bank are basically that of operation. These differences can be summarized in two main points:

- that an Islamic bank advances are, effectively, off-balance sheet assets, and
- that value can pass from the bank to its clients either in the form of goods and services sold on differed payments or in the form of money. In the latter case risks and returns are shared between the bank and the users of funds.

It is not too difficult to see, therefore, that there is “common ground” between the two models of banking. Many conventional banks are discovering that Islamic banking is not as *intricate* as the name may sound. Responding to increasing demand from its clients, numerous conventional banks started offering interest-free banking products in the last 5 years. Most popular of these products is the Murabahah, where the bank takes constructive possession of assets and then re-sell on differed payment with a mark-up. Murabaha, which is in vogue now-a-days in automobile and housing finance, is not very dissimilar to bank lending, and actually creates comparable bank assets. The mark-up, however, is not compounded and if penalties are charged in the case of delayed payments, they should be deposited off to

charity and not constitute on income to the bank.

Murabaha is the *main-stay* mode of finance in Islamic banking. Because the prohibition of interest is very serious in Islam, pressure to innovate new banking products is very strong. This is one area where Islamic banks are quite distinguished.

This is a *birds-eye* view of the subject matter of this book. In the next few chapters we will examine the model of Islamic banking and aspects of Islamic equity-investment.

# CHAPTER 1

## ISLAMIC ECONOMIC SYSTEM

The economic system of Islam is the collection of rules, values and standards of conduct that organize economic life and establish relations of production in an Islamic society. These rules and standards are based on the Islamic order as recognized in the Koran and Sunna and the corpus of jurisprudence opus which was developed over the last 1400 years by thousands of jurist, responding to the changing circumstances and evolving life of Muslims all over the globe.

Three aspects of the economic system are usually referred to as the major distinguishing elements of any economic system.

### 1.1 Property

In the Islamic system, property is a trust. The real owner is Allah (Subhanahu Wa Ta'ala). Man's disposal of worldly goods is in the capacity of a viceroy and a trustee. His rights are, therefore, circumscribed by the limits Allah has prescribed, and should be exercised toward the ends Allah has defined. Unlike the capitalist system, the right to property is not absolute but has limitations and qualifications enforced not by the power of the government but by the power of one's faith and desire to be a pious Muslim. Hence, the common-good and the welfare of follow

Muslims are internalized in the decision making process of every Muslim. It is Socialism with at the state.

In view of the purposive nature of man's life in the Islamic *world view*, even these limited rights of ownership are not devoid of purpose. Wealth is an instrument in the effective discharge of man responsibilities as the viceroy of Allah, and the achievement of well-being in the life for himself, his fellow Muslims and fellow human beings. No where this *viceroysip* is displayed like in the *Shari'ah* laws of inheritance. These laws clearly assume that once the individual is dead, his wealth goes back to the original owner, who specifies to whom the wealth should go. The laws of inheritance specify where exactly this wealth should go, regardless of the approve or the consent of the deceased owner. He is permitted to endow only 1/3 of his legacy. Even then, such endowment should not go to a beneficiary (one also is included in the inheritors) not to uses that are not considered is *Shari'ah* a charity.

## 1.2 Distribution

Because *al-adl* (justice and fairness) is a basic value of the Islamic economic order, distributive justice is a major concern of the system. Equitable distribution of income and wealth is therefore an objective by itself. Operationally, this is accomplished through certain institutions which form the back-bone of the social security in Islam. Examples are a bound:

### 1.2.1 Zakah

Zakah is the third pillar of the Islamic faith. It is a unique system of social security. Zakah is not a hand-out from the rich to the poor. It is a right of the have-nots in the wealth of the haves. It is a measure designed to directly transfer part of the wealth from the well-to-do to the poor and not to the government. Because the purpose is redistribution of income and wealth, without creating a class society zakah is levied on almost every one. Even the not very well to do, pay zakah. He may then receive the zakah of others at the same time. Zakah is levied annually on the wealth itself and not on the individual or income, at a general rate of 2½ % per annum. This is not all. Zakah is a requirement. However, a Muslim is always engaged not to confine his charity to that requirement by giving alms (*sadaqat*).

### 1.2.2 Laws of Inheritance

It would not be possible to guarantee the functioning of the system free from injustices without a built-in-mechanism to prevent injustice reproducing it self generation after generation. Studies show that one of the major causes of inequality in income distribution, is the distribution of wealth. One major outcome of the Islamic laws of inheritance, is to prevent concentration of wealth. This is because legacy is distributed in a pre-set ratios which take into consideration need and closeness to the deceased. Yet giving the deceased the right to assign part of his wealth (not exceeding 1/3) to charitable uses.

### **1.3 Economic Freedom**

Freedom is a cornerstone in the Islamic economic system. In fact, it is so basic that the whole message of Islam came to free man from all kind of slavery. Freewill is a necessary condition for the validity of all contracts. The basic human rights which are now included in the laws of civilized countries has been a part of legal system of Islam since the Prophet (P.B.U.H) . In fact, all the so called Magna-Charta has been enjoyed as the basic individual rights in Islam for centuries. Furthermore, to guarantee competition in the market place and freedom of transaction, many measures were adopted by the Prophet (P.B.U.H). Prohibition of monopoly, manipulation of prices and restricting entry to the market are but a few of these measures.

### **1.4 The Islamic Economy is Interest-Free**

Today's trade and commerce in the whole world is run on the basis of interest based debt. If we look at the money and capital markets in any country we find that they are basically markets for exchanging financial obligations and receivables. It is no wonder that just the mere thought that interest rate may go up (or down) will bring havoc to all sectors of the economy. Standard economic analysis tells that interest rates play important roles in the economy. Firstly, that it provides incentives for savings, and secondly that it performs an allocative function with regard to capital. The argument goes as follows:



1. Saving is essential to any economy because on which depends the rate of investment, and hence the rate of growth of the economy and the property of its citizens. Since economic development is the objective of every society, improving the nascent rate of saving becomes a basic requirement for the achievement of a viable and sustainable economic growth.

Because too much saving may be just as unproductive as too little, interest rates, furthermore, provide a tool for policy as regards savings where this rate is controlled in such a way as to attain the right magnitude of savings as required by the going economic circumstances.

2. As regards the distributive function of interest, it is believed that interest rate plays a yardstick (benchmark) for evaluating the feasibility of investment projects and other uses of scarce resources. Since capital is scarce, the economy needs a tool through which this resource is directed to the best use, i.e. the one that produces the highest returns. Without such a tool, it is quite possible to see capital going to relatively poor projects, while the sound ones are left out of investment capital. With the tool of interest rate, expected profits are always compared to the rate of interest. Since the latter measures the cost of capital, only those projects which make more returns than “cost” will be financed. Even self-financing will be subject to such a benchmark since interest plays an “alternative” to any investment opportunity (i.e. an opportunity cost).

Efficiency is an objective of every modern economy. To attain “more” efficiency, resources have to be allocated in the economy in such a way as to attain the maximum overall return (rate of growth for the economy).

It appeared to many economists that no modern economy can function without "interest" for then saving will be very low, and utilization of scarce resources will not be efficient.

An Islamic economy is free of usurious transaction, hence interest based finances are not allowed. This may appear unattainable in this modern age. Islamic Economists claim that this is not only possible but it is superior to the interest based system. Firstly, we need to qualify some of the statements we just mentioned. Even in a capitalist economy, the rate of interest is not the “raison d’être” of saving. Savings does not hinge on interest. J.M. Keyens, in his famous General Theory, had shown how the volume of savings basically depended on income. If income rises, savings will rise regardless of the level of interest. Empirical studies, furthermore, have shown in all major industrial countries, the validity of this conclusion. The motives for saving are, in the most part, unrelated to the rate of interest.<sup>1</sup>

Hence, in a society where interest is not used, one cannot say that saving will not exist, nor that it will be lower than otherwise.

However, interest rate does play an effective means of attracting savings to the banking system.

This is because is considered interest a “reward” given to the saver.

In an interest-free Islamic economy, savers will still be rewarded. Any banking system, Islamic or otherwise, will fail to attract savings without such rewards. However, the reward will be contingent on the performance of the fund-users, i.e. a share in the profits generated through the use of savings and not a predetermined fixed return. It , therefore, cannot be assumed that saving will have to decrease in a system where interest is not used.

It might be claimed that deposits in a profit/loss sharing (PLS) banking system will bear a higher degree of risk compared to a conventional banking system. Hence, savers in an interest free system are at a disadvantage. However, this is true only of rates of return in an interest-free banking system are equal to interest rates in conventional banking system while risk in the former increases. Since returns will significantly increase in a PLS system, more risk will be tolerated by depositors, because it is then compensated for by higher rate of return. More importantly, however, differed-payments sales which constitute the back bone of Islamic banking are similar in their risk profile to interest based lending. It can't be claimed, therefore, that they will have a different effect on saving.

As regards the allocative function, interest will play the role of an efficient allocator only in a market that is perfectly competitive, and where marginal productivity of every project is perfectly known and comparable to the going interest rate. In reality, no such markets exists. Even in the advanced industrial economies, money markets and capital markets suffer from “great” imperfections. One aspect of such imperfections is the fact that credit-worthiness of the borrower is far more important to the lender than the feasibility of the project. There are many good projects whose rate of return exceeds interest rate, and which meet the efficiency rate criteria described above, will go unfinanced. The reason is that they are *too risky* from banking point of view which only looks at credit-risk not profitably. Furthermore, governments almost everywhere, rarely rely fully on market forces in the allocation of scarce resources. They do influence the market mechanism, directing resources in accordance to “social” considerations and political priorities, away from marginal productivity.

Interest rate is a financial bench mark. Investments in the real sector which produce real goods and service will not produce “interest”, but profit. Hence for purpose of efficiency and optimal allocation of resources, profit rate is a more relevant an indicator than interest. Not only that rate of profit is a “real” (not monetary) index, its use for the purpose of resource allocation will reduce to dominable of the financial sector over the real sector in the economy. This will

introduce a higher degree of stability in the system. After all, people who invest in the production of real goods and services receive profit not interest.

### 1.5 Usury in Islamic Jurisprudence

Usury is as old as money. Almost all human societies since time immemorial practiced usury, and almost always struggled with reformers and learned men who felt, even before the advent of religions, that usury is unjust. There is little or no difference between usury which was practiced in antiquity and that of a modern money center bank<sup>2</sup>.

At the advent of Islam, the Makkans were principally merchants. The economy of Makkah, a city in the heart of the desert, depended on the annual trade journey done by these merchants. In financing their caravan consisting of no less than 2000 camels, carrying goods from southern Arabia to the borders of the Roman empire, the Makkans depended heavily on usury. It is that type of usury (called riba in Arabic) which was addressed in the Koranic prohibition. Riba is basically two types: One doing with debt the other takes place in certain types of sales. The riba of debt is itself two kinds: a stipulated<sup>3</sup> increase in loans, and a compensating increase in the nominal value of debt when payment of such is postponed. These are not dissimilar to contemporary banking practices. The other type of riba, which is not mentioned in the Kuran but narrated through authentic Hadiths from prophet Muhammad (P.B.U.H) is called riba of sales. This riba, is prohibited to

edge against from principal mode of usury, which is riba of debt. The prophet (P.B.U.H) specified six items (commodities) and set special rules for their exchange. The common denominator of these six items is their capability of being a medium of exchange. On top of the list is gold and silver both as coins or bullion. The rules go as follows: When the exchange contract involves gold for gold, then it is not permissible to conclude a sale except if the quantities exchanged are exactly the same and transaction is done with no delay in delivery of either. In transactions involving gold and silver (or dirham and dinar) equality of quantity is not a requirement. However, the contract is void if delay in delivery of either is part of the agreement. Contemporary scholars agree, unanimously, on applying the rules of exchange of gold and silver on modern paper money transaction. An exchange involving dollar (\$) and pound (£) must have spot delivery. No delay is allowed. It is not hard to see that if such delay is allowed then it would be easy to circumvent the prohibition of interest.

## **1.6 Is Interest Riba?**

It is not difficult to see that interest in conventional banking is riba. It does fit the definition: an increase stipulated in a loan contract. Credit provided by the bank to its clients which is based on interest is clearly so. But even time deposits and current accounts are nothing but loan contracts (The lender here is the depositor and the borrower is the bank) with stipulated increase. (current accounts are loans with no stipulated increase). Furthermore, revolving credit is a type of loan where

interest calculation is based on outstanding debt which is payment postponed. Claiming that interest is not riba is therefore unattainable.

### 1.7 Time Value of Money

Does the fact that Islam prohibits interest mean that there is no time value of money in the Islamic economic system? The answer is negative. *Shari'ah* does recognize the time value of money. There is ample evidence to show that monetary value in many *Shari'ah* prescribed transactions is attached to time.

For example, it is permitted in *Shari'ah* to increase the price in differed payment sales in accordance to the length of the term of debt arising from such sale. *Shari'ah* scholars, do recognize this, and many of them allow seller to reduce the price of differed payment sale in cases of pre-payment. Their argument is that part of the price was related to time. Now that "time" is shorter, price should be reduced. There are similar direction in the rules of other exchange contracts. In particular the Salam contract shows very clearly that *Shari'ah* does recognize the time value of money. This Forward sale of goods where goods that are already available in the market are sold for a lower price but future delivery, shows that time is basically what is paid. It is only in loans and debt obligations that are outstanding that time related increase is not allowed.

However, even the prohibition of increase in these two transactions shows *Shari'ah* recognition of the time value of money. For instance in loan, *Shari'ah* clearly states that the *here-after* reward for loan is even bigger than that of giving alms to compensate for the loss of the utility of one's money loaned at no interest. It has been narrated from the prophet (P.B.U.H), that loan recipient is more likely to be in need than one who receives Alms. It is important to remember here that the purpose of loan in *Shari'ah* is benevolence and philanthropy not profit. Profit generating uses of funds must always be financed through profit and loss sharing arrangements. Giving more time to debtors who genuinely are not capable of making their timely payments<sup>4</sup>, is by itself considered a sort of donation, and generously rewarded in the hereafter.

But why does *Shari'ah*, while recognizing the time value of money allows it to have a monetary consideration only in certain transactions. More interestingly why is it prohibited to attach monetary value to time in sale but not in loans?

It is only now that we can understand the wisdom of such prohibition. Allowing lenders to generate income from pure monetary transactions (i.e. not involving goods or services) will create a financial sector in the economy which generates its income just from the passage of time independently of the real sector where goods and services are produced. A dichotomy will then take place in the economy, creating instability (boom and bust) and redistributing income and wealth



in, towards one sector or the other depending on the state of the economy. Injustice is then created.

## **1.8 Islamic Model of Financial Intermediation**

The function of banks is financial intermediation. While experts may differ on the history of banking, there is no question that the importance of financial intermediation had been recognized even by ancient societies. It is because of this, we find that people in antiquity had always had arrangements to carry out such function. Temples and chapels at the time of the Pharaohs and the time of Hamorabi carried out the function of by arranges the transfer of funds between lenders and borrowers financial intermediation. The Greeks did have an even more advanced arrangements for financial intermediation.

What gave rise to such financial intermediation is the fact that human societies, since time immemorial had been divided to two groups. One with more resources that it needs now and the other needs more resources now that it owns today. People discovered very early that the welfare of both groups will be significantly improved if a process of transferring resources from the first to the second group was initiated. Because every individual in society is prone to be m the first or the second, it is quite advantages to everyone to participate in this process.<sup>1</sup>

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1. Clearly this is not a line dividing society to rich and poor as all the members of both groups are well-off. In fact, members of the shortage group are mostly the rich who want to invest.

At the dawn of the middle ages, a social movement towards division of labor and specialization took place. It included the institutionalization of many activities which used be rendered as part of the religious or social relationships.

The ‘bank’ as an institution for financial intermediation was born.

It was quite natural that such institution is built on the same arrangement which was the basis of financial intermediation in almost all historical stages, that is the *Loan contract*.

The bank is, therefore, based on a borrower-lender relationship. The bank borrows (and depositors lend) and then lends (and users of tends borrow)

In both asset and liability sides of the bank’s balance sheet, this borrower-lender relationship is easily recognizable. The term "loan" is never used in the realign of banks relations with its sources of funds (depositors). This, however, doesn't hide the legal and actual fact that all bank deposits are loans; the borrower is the bank and the lender is the bank client.

But why didn't savers go directly to borrowers and cut the cost of the middle man? In other words: why did bank came to existance? The answer relates to the cost of information. An institution that specializes in credit analysis is more

efficient in minimizing the risk involved in lending because of its ability to gather and analysis information. It is because of this the role of banks is decreasing as the cost of information is reduced, giving more space to finance market where savers select their choice of visits.

## CHAPTER 2

### SOME *SHARI'AH* ASPECTS OF ISLAMIC BANKING

#### 2.1 Introduction to *Shari'ah*

##### 2.1.1 Meaning of *Shari'ah*

*Shari'ah* is the body of Laws which *Allah* prescribed for His servants through Prophet Muhammad (PBUH). *Fiqh* is the knowledge of the rules of *Shari'ah*. A “*Fiqh*” is the one who is knowledgeable to these rules and their relevance to changing circumstances.

*Shari'ah* is a much wider concept than the term “Law” in English or “Droit” in French. This is because *Shari'ah* is actually the worldly side of the religion Islam.

Rules of *Shari'ah* relate to beliefs and to acts.

A Muslim is required to obey and adhere to the rules of *Shari'ah*, as part of the faith.

This body of laws contain rules about actions (conduct and behavior) of the believers. These rules are in the form of:

- 1- obligation
- 2- recommendation
- 3- prohibition
- 4- disapproval
- 5- permission.

### **2.1.2 Rules of *Shari'ah* and Rules of Law**

Positive law is a body of rules and precedents which lay to the people a specific conduct, and prescribes punishment to those who violate, awarded by the authorities responsible for the protection of law.

#### **Rules of *Shari'ah* differ significantly from rules of law:**

- a) The source of the rules of *Shari'ah* is divine. It is the judgment of Allah conveyed by the Messenger (PBUH) and expounded by the great learned jurists who derived (and do derive) from the texts of *Shari'ah* and its sources. These sources are the *Kuran*, *Sunnah*, Consensus and Analogy.

Rules of *Shari'ah* are settled, can't be changed. Their application to contemporary incidents and events may change. The *Fatwa* (legal opinion)

may change and vary from time to time and from place to place and from jurist to jurist, yet *Shari'ah* remains the same. Human effort doesn't create new law but only reveal from the texts and sources the rules of *Shari'ah*.

- b) The subject matter of the rules of *Shari'ah* is not confined to rules regulating the relations between human beings such as sale and partnership, but also includes acts and deeds required from the believers as symbols of devotion and submission to *Allah* such as prayer and fasting. These two branches of *Shari'ah* are not necessary separate.

Man made law doesn't concern itself with the relationship between people and their lord.

- c) Punishment for disobeying the rules of *Shari'ah* will be inflicted in times only in the hereafter, in others in both now and the hereafter.

Punishment for violating man made laws are in this world only. Obedience to *Shari'ah* is a devotion to *Allah*, a firm belief in the just rules of *Shari'ah* and a hope for great rewards in the hereafter.

### **2.1.3 Divisions of *Shari'ah***

The rules of *Shari'ah* are divided into two major divisions, religious observance and transactions.

The division of transaction bears great similarity to positive law. These rules of transaction fall into three types: regulating relations between individuals, rules relating to relations between individuals and governors and rules relating to relationship between Muslim society and other states and communities.

It is clear that these divisions resemble those of positive law. The first, is similar to private law which includes civil, commercial, family and private international law. Except that *Shari'ah* doesn't make special laws for merchants (commercial law). The second have the same subject matter of constitutional law.

### **2.1.4 Major Schools**

There are five major schools of *Fiqh* (jurisprudence), which constitute two “sect-like” (not sect) divisions of Islam: *Sunni* and *Shia*. The *Sunni* branch of Islam consists of four major school, Hanafi, Maliki, Shafie and Hanbali. The *Shia* branch consists of one major school (the *Ithna-ashariah*) and several other smaller ones. These divisions have their roots in history and methodology.

## **Sunni-Shia**

The origins of the division between Shia and Sunni go back to the early part of the 7th century.

The Sunni maintain that the first four Caliphs, which are called the rightly guided (Abybaker, Omer, Othman and Ali) are the rightful successors of the Prophet (PBUH) as they were chosen by the leaders of community then.

Shia believe that only Ali (who is the cousin and son in law of the Prophet) is the legitimate heir (Ali himself was agreeable to the governance of the three), and his siblings. (The Sunnis have more egalitarian methodology for selecting the leaders). In methodology, Shia only recognize narrations by source of *Shar'ah*.

### **The four major Sunni schools:**

It is the firm belief of the Sunni Muslims that all four schools are and the difference between them is methodological. Yet, the basic approach of these schools can be identified to have two main patterns vis sources of law those who are more inclined toward the “Haddih” (Traditions of the Prophet (PBHU)), and those who have a more “rationalist” inclinations.

The four schools formed in less than two centuries. Abu Hanifa died in 767, Ahmed bin Hanbal died in 855.

### 2.1.5 Primary source of Islamic *Shar'ah*

The primary sources of *Shar'ah* are:

#### 1- The Qur'an

The Qur'an is Allah word revealed to Prophet Mohammad (PBHU). It has been recorded and transmitted through the centuries word by word and letter by letter. Believing in every word in Qur'an is a basic requirement for being a believer in Islam. Reciting is itself a prayer. The Qur'an is in Arabic, but it is beyond any Arab to do like source from which rules are deducted it. Qur'an is the primary as the supremacy of the Qur'an are laid down in the Qur'an. While the words and letters of the Qur'an is certain and definitive, the meaning of these words is sometimes definite and sometimes presumptive. When the meaning is definitive, there is no room for Ijtihad. When the words signify several meaning, then other sources may reveal the correct ones.

#### 2- The Sunnah

Sunnah means the words, deeds and tacit concurrence to the words and deeds of others of the Prophet (PBHU). The Sunnah is transmitted through narration. The authority of each narration is the subject matter of the science of *Hadith*. Hence, Sunnah varies in respect of its establishment and transmission, and have authority. The Sunnah is the second source of *Shari'ah*. It is the expounder of the Qur'an, where specific meaning are given to general statements of the Qur'an. Not only this, but Sunnah lays down rules for



matters not attended to in the Qur'an, or extension of rules laid down in the Qur'an.

### **3- Ijma**

Ijma in Arabic is consensus. Ijma refers to the unanimous convergence of the views of reputable jurists at one time on certain issue. Ijma takes place when there is no specific authority on a given point from the first two sources. Clearly Ijma doesn't mean the consensus of all and every scholar at the time, but only the major ones.

#### **2.1.6 Secondary Sources**

##### **Al-Qiyas, or Analogy**

This is where a rule is applied to a particular situation because of its analogy to one with a preset rule from Qur'an and Sunnah. The analogy is based on what is called "illah", i.e. the logic or the effective cause of the rule. This effective cause of the rule. This effective cause is sometimes mentioned explicitly in the first two primary sources, or arrived to at by consensus of jurists.

## **2.2 Principles of the Islamic Law of Contract**

*Shari'ah* restrictions on certain financial and trade transactions is the *raison d'être* for the emergence of Islamic banking. It is, therefore, important for any

student of Islamic banking to grasp the basic elements of the *Shari'ah* law of contract.

### **2.2.1 Meaning of contract**

Contract in *Shari'ah*, *Aqd*, means a tie or a knot binding two parties together. The contract is a declaration of offer and acceptance. Unlike English law which developed through the work of judges, Islamic law of contract developed through the work of *Fugaha* (jurists), based on the principle laid down by the Kuran and the narrations from the Prophet (P.B.U.H).

The Qur'an contains a large number of specific contracts, and axioms of wide application in the area of contractual relationships. These include various commercial contracts such as sale, hire, guarantee, security and deposits. In some of the verses of the Qur'an where such contracts are stated, foundation for rules of new contracts were initiated, in others recognition and legitimization of already existing practice at the advent of Islam are confirmed.

The Islamic contract law is wider in scope than the English or French because it embraces some dispositions which are not considered "contract" in either English or French legal systems. Endowment is an example of such dispositions.

Contrary to some western writings, *Shari'ah* does have a general theory of contract<sup>6</sup>. Therefore, *Shari'ah* has facilities to accommodate uncatalogued agreements. Contracting an arrangement that is not falling in the categories of recognized nominate contracts is not forbidden in *Shari'ah*. Furthermore, conditions attached to an irrevocable contract have been used by Muslims to extend the applications of such contracts.

Moreover, declaration of intention and consenting is central to the law of contract in *Shari'ah*. Though contracts in *Shari'ah* are not as consensualistic as ones in English law, consenting is central to the law of contract in Islam, for without consent a contract will not have a binding force. Further more, the intention to create a contract is actually more important in *Shari'ah* than the formalities of a contract. This shows that *Shari'ah*'s capability to respond to peoples needs is limited by peoples ability to understand its rules.

### **2.1.2 Classification of contracts in *Shari'ah***

There are several classification for contracts in *Shari'ah*. What we are concerned with, however, are those doing with Islamic banking.

#### **a) Definitive and suspensive contracts**

A contract is definitive when the offer and acceptance are both categorical and the contract is validly concluded. A contract is suspensive when the offer and acceptance are kept in suspense i.e. for future effect. The latter is not permitted in

*Shari'ah*, particularly in sale contracts. Hire contracts, to majority of scholars, may be suspensive.

**b) Binding (or obligatory) and facultative (or permissible)**

Some contracts are binding, *Lazim*, once concluded they cannot be revoked except by mutual consent of the two parties. Some are facultative, *Jaiez*, which can be revoked by either party, and in some cases by a given party.

An example of the binding contracts are the contracts of sale, hire and lease... etc. An example of the permissible contracts are agency, deposit, and *Mudarabah*. These can be revoked by either party any time. While the contract of security (*rahn*) can be revoked any time, this can only be done by the beneficiary, i.e. the creditor.

Some contracts start as facultative and then turn to be binding such as donation. Donation becomes binding only after delivery. Distinguishing obligatory from facultative is important. However, such classification is itself subject to *Ijtihad*. For example, the *Mudarabah* contract in Islamic banking is no longer facultative but binding for the duration of the contract. Contemporary jurists think that it was quite logical for *Mudarabah* to be facultative in the old days since it had no time limit. Once a maturity has been agreed on by the two parties, it makes no sense to give either one the right, still, to revoke any time without the consent of the

other. Furthermore, most investment opportunities require time, which means that, unlike the old days, investment assets cannot be liquidated before maturity.

**c) Correct and corrupt contracts**

A contract is correct (sahih) when it is valid, effective and enforceable. A contract is considered corrupt (fased) when it is non of the above and referred to as a void one. Some contracts are salvageable when they become corrupt. For example if the reason for corruption is a non- permissible condition in the contract, then removal of such condition will correct it. For example a Mudarabah contract with a condition that the agent guarantees capital for rub-ul-mal is corrupt. It can be valid again by just removing this condition. If the reason for corruption is the object of the contract, like purchase of non-permissible goods such as wine then it can't be salvaged.

**d) Contracts of Exchange and Contracts of Gratuities**

Contracts of exchange are those where the two parties interchange price on the one hand and a good or a service sold on the other. Sale, hire...etc. are all examples of exchange contracts. Contracts of gratuities are those which are done for benevolence purposes such as donation which is considered in *Shari'ah* a contract. Distinction between the two is important particularly when Gharar is present.

#### e) **Specific or nominate contracts**

*Shari'ah* includes certain pre-designed contracts derived from the Kuran, Sunnah and Ijma. These are, basically, sale hire, agency, guarantee, donation, partnership and Mudarabah.

Islamic *Shari'ah*, nevertheless does have its own theory of contract and hence, allows contracting arrangement not falling in the categories of recognized nominate contracts, given that they are within the parameters of *Shari'ah*. A new contract may not be completely new, but an amalgamation of a number of nominate contracts. The modern Murabaha contract may be considered an example.

### **2.3 *Shari'ah* Maxims Relevant to Islamic Banking**

A *Shari'ah* maxim is a set of principles determined with precision, derived by jurists from the known rules of *Shari'ah*. They present an exposition of the spirit of a legal text. It is intended to facilitate the application of *Shari'ah* rules in diverse situations in human society.

#### **2.3.1 In contracts, what counts is objective and meaning not words and form**

This is a very important maxim, because the meaning is more revealing to the intention of the parties to a contract. It is because of this contracts in *Shari'ah* may, shift to be something different from what they are called just because of inclusion of one condition. A condition that makes the agent pledge the Mudarabah capital to the

financier, alters the Mudarabah contract from a profit/loss sharing contract to a loan contract.

Another example is that of Kafala: A guarantee (Kafala) implies coexistence of liability between guarantor and guaranteed, while a transfer (hawalah) implies in *Shari'ah* the discharge of principal debtor. Therefore, if a contract of hawalah is made with the condition to hold the principle debtor liable in case the transferee fails to pay, contract will be treated in *Shari'ah* as Kafalah (guarantee) not transfer. This shows that, though such contract is called hawalah, name was not important, what is important is the meaning.

One has to be very careful when designing a contract, about the conditions and stipulations in that agreement.

### **2.3.2 The benefit of a thing is a return for the liability for loss from that thing**

This is very Important maxim which has wide application in Islamic banking, where liability means risk, a bank transaction that transfers such liabilities to the other party while the bank remain at the receiving end of profit is a violation of this rule. For example, a Mudarabah contract where the agent is asked to guarantee either capital or return is not permissible. This is because in such an arrangement the benefit which is the probable return on investment, is not going hand m hand with risk taking. Rather, risk is borne by one party.

A well known application of this rule is current accounts in Islamic banks. Because they are guaranteed by the bank, account holders are not entitled to get any return, though these funds are invested and they generate profits. This is because the bank is carrying all the liability of loss, hence the bank is entitled to all the returns.

A classical application of this rule in *Shari'ah* is the requirement of possession before resale. Ownership is established in the sale contract by the mere offer and acceptance. However, this ownership does not entitle the owner to resell unless he also establishes possession. The reason is that without actual receipt and acquirement of the sold goods it is possible that the liability for loss is still borne by the original owner, as the goods remain in his hands or warehouse. If the buyer makes profits, then such benefit is accruing free of liability, which is not permitted.

It is because of this a standard Murabaha contract starts with just a promise, while sale is postponed until actual possession is established by the bank.

### **2.3.3 Contracts in suspense are not permitted**

All exchange contracts must be definitive, categoric and validly concluded at the time of contracting. When the offer and acceptance are kept in suspense, then the contract is void from *Shari'ah* point of view. Mutual obligations (or binding promises) to contract in the future are also not permitted. One example of such



contract in modern finance is found in the leasing contracts, where lesser offer that at the end of the contract (5 years for example) he will sell the equipment to the lessee for, say, \$ 1000/- and the lessee accepting such offer. This means that a sale contract, though has been concluded, is kept in suspense for 5 years. This is not permitted. To avoid such *Shari'ah* complications, Islamic banks usually make transfer of ownership just an option to sell.

#### **2.3.4 A contract that contain gharar is non permissible**

Gharar is contractual uncertainty. An exchange contract that exhibit gharar is void. The meaning of gharar is, nevertheless, very intricate. In *Shari'ah* an exchange contract should spell out clearly the rights and obligations of the parties involved. If part of these rights or obligations is uncertain then gharar is present. For example if one sells, for \$ 5, an item which will be decided by a “draw” of number from the hat of the seller, is purely a gharar contract. Clearly the obligation of the buyer is disposed off fully via the payment of the price. But there is uncertainty about the other parties obligations, is it going to be an automobile or just a pencil. Certainly this example is exotic and can be found only in games of chance. However, the possibilities of gharar in all exchange contracts is very significant. For example if I sell an item to a buyer and tell him the exact price will be revealed to you later, this is also considered a gharar contract, even if the buyer is willing to accept this uncertainty.

## 2.4 The Role of *Shari'ah* Advisors in Islamic Banking

One of the most distinguishing features in Islamic banking is the fact that they are always advised by experts in Islamic *Shari'ah*. Because the *raison d'être* of Islamic banks is the desire to follow the injunctions of *Shari'ah* in finance and investment, it became essential to give assurances to the public, particularly savers, that the bank is getting professional advice in that matter. Furthermore, since it was difficult to find bankers who are also well versed in *Shari'ah*, banks find it pertinent to affiliate to the management a *Shari'ah* board. Not all Islamic banks have a *Shari'ah* board, nevertheless. Some, may have only one advisor. Others may seek the advice of many, but only when the need arises. The majority, however do retain a *Shari'ah* council which meets occasionally and clear model transactions and contracts, and issue an annual statement attesting the adherence of the management to the advice and instructions of the *Shari'ah* board vis the religious aspects of the business.

A typical *Shari'ah* board will have the following functions and duties:

- a) Provide opinion on matters referred to it from the management of the bank, relating to the activities of the bank and their compliance with *Shari'ah* requirements.
  
- b) Endorsing model contracts and standard agreements and assuring their compliance with *Shari'ah*.

- c) Over-looking the activities of the bank in general and management's implementation of *Shari'ah* guidelines issued by the board, in particular.
- d) Issuing an annual declaration which accompanies the bank's financial statement, recording the board's views on the compliance of the bank with the *Shari'ah* requirements, addressed to the equity owners of the bank and its clients.

#### **2.4.1 Limits to *Shari'ah* board participation in the day to day business of an Islamic bank**

A *Shari'ah* board is always a consulting body. However, Islamic banks differ in how much power is bestowed upon such body. Some Islamic banks may grant the *Shari'ah* board an authority to do *Shari'ah* auditing to all branches and offices of the bank, making sure that strict adherence to the set procedures is attained. A direct relationship between the board and the outside auditors of the bank may be established to facilitate *Shari'ah* board investigation.

Other banks, confine their board to strict advisory function, responding to inquiries and questions from the management. Furthermore, some banks find it adequate to seek *Shari'ah* advice when need arises retaining no advisors on permanent basis.

Islamic banks also differ on the position of their *Shari'ah* board in the organizational set-up of the institution. Some *Shari'ah* boards insist on reporting to the general assembly of the equity holders of the bank. It is believed that such board will then have a leverage on management in a way that assures strict adherence to boards directions. In most, however, the *Shari'ah* board reports to the board of director. In all Islamic banks, however, a *Shari'ah* board will never interfere in the day to day business of the bank. No *Shari'ah* board, for example, will get involved in credit analysis, risk assessment or decision to grant finance facilities to a client. *Shari'ah* advisors may have reservation on the structure of finance or the form of contract involved. Even these, however, are rarely handled on a case by case basis for approval. A model is usually cleared by the *Shari'ah* board, and review of application is usually left to end of the year report.

#### **2.4.2 Selection Criterion for *Shari'ah* Advisory**

Because part of the purpose of having a *Shari'ah* board is marketing, banks are keen to recruit reputable *Shari'ah* scholars who, by just associating themselves with the bank will give it legitimacy. These people, however, are hard to come by. It is because of this we see *Shari'ah* boards membership circulates around a limited number of scholars who seem to appear in every *Shari'ah* advisory. While knowledge of *Shari'ah* is essential (and banks usually will entrust such function only to established scholars), knowledge of banking is becoming very desirable. This is because bank clients began to suspect that some *Shari'ah* boards, though

declaring banks adherence to *Shari'ah*, actually don't possess the capability to comprehend all the intricates of modern banking. Hence, they fully depend in their judgment on information provided by the management which creates a situation of conflict of interest. Unless the *Shari'ah* advisor can understand the sophisticated elements of banking, he may not be able to relate transactions to their most appropriate *Shari'ah* axioms and precedents, nor that he will be able to give guidance to the process of product development in the bank.

## **CHAPTER 3**

### **ISLAMIC MODES OF FINANCE**

Conventional banks have only one mode of finance, lending. It may be called commercial loans, mortgage, credit cards, time deposit,...etc. but in the final analysis it is a lender-borrower relationship between the bank and its clients on both sides of the balance sheet. It is completely different in Islamic banking where many modes are employed. Some modes are based on profit and loss sharing arrangements. Others are sale and hire based which create debt obligations. Even the one's that create bank assets in the form of debt obligations involves a procedures that make them very unique and completely dissimilar to bank lending. We will now survey the major modes of finance which are in vogue in Islamic banking.

### 3.1 Murabahah

Murabahah is the most widely used mode of finance in almost all Islamic Banks. In some Islamic Banks, Murabahahs constitutes more than 90% of total assets of the bank. It does have clear advantage which make it very comparable to lending in conventional banking. It is because of this Murabahah is now becoming a mode of finance practiced even by convention banks.

Contrary to what many people think, Murabahah is not new. It is one form of sale contract, which is known in Islamic *Shari'ah* for hundreds of years, albeit, not exactly the same from banks practice now.

Sale Contracts is *Shari'ah* are many forms. They can be auction like where seller and buyer negotiate the price. But they can also be based on mutual trust where parties negotiate the rate of profit, which will be over and above the cost of purchase to the sellor.

Murabahah is the old was a simple sale contract, where a mark-up is negotiated between the parties and calculated on the basis of cost of purchase of the seller. Never the less Murabahah in contemporary Islamic banking present an interesting case of financial engineering where this simple sale contract was developed into a substitute for bank lending. Because banks are not “merchant”, goods are assets that can be subject to murabahah are not owned by the bank when

client desires to buy them. One ~~solution~~ would be for the bank to sell first and then pre-emptively buy goods from the market. This however, is not permissible from *Shari'ah* point of view. Islamic banks opted for obtaining a “*commitment to purchase*” from the client. One may say: if such commitment is binding, then it is akin to contracting for sale, and if it is contract not a valueless promise. The client is not obligated to buy, rather he is obligated to honor his promise. If the bank, relying on such promise, bought these goods and the client decides not to go ahead with the purchase bank will then sell same to a third party. If a loss is made, then the bank will have a recourse to that client since the loss was caused by the promise. Only actual loss is considered and no cost of funds are accounted for. A *murabahah* is a deferred payment sale.

Profits to the bank are basically the difference between the purchase price, which in cash, and the deferred sale price. This difference are very closely- related to the going interest rates which occasionally makes people suspect of Islamic banking. However, they are not the same. The mark-up in *Murabahah* is part of a sale price, it is set only once and then it does not change overtime. The bank can calculate the price (cost-plus), in any way, even basing such calculation on the going LIBOR. Once, it is set, it can't be changed even if the client defaulted on his debt or was delinquent. While principal is easily distinguishable from the mark up, such distinction should remain an accounting exercise. *Murabaha* is a sale contract, the price is just one amount and, contractually, it should be always treated so.

### 3.1.1 Risks

Murabaha mode of finance resembles, in its risk profile, conventional lending. Except for bank's purchase of the goods and resale to the client, Murabaha creates a bank asset similar to that of conventional banks, with much-the same risks, the main difference are basically:

- (a) Risks related to changes in price of the goods when such goods are owned by the bank prior to sale to the client. No specific length of time is required by *Shari'ah* hence such time can be reduced to the minimum to control commercial risks. What is necessary, however, is that ownership as defined by *Shari'ah* is sustained in such time. Hence, these risks can be significantly reduced through efficient procedures. Furthermore, since murabahah is effectively cost-plus, change in the price of goods will not effect the sale price to the client since it is based on cost of purchase.
  
- (b) *Shari'ah* does not permit any financial penalty to be imposed on delinquent debtors for purpose of compensating the creditor. This is clearly a major disadvantage over conventional banking. This makes the risk related to the client default or failure to pay on time is relatively high. Many Islamic banks opt for fining the client and then pay such



fines to charity. This way the impose preserve on the client without falling into the definition of usury in *Shari'ah*.

- (c) Murabaha is a fixed-return type of finance. It is naturally exposed to interest rate risks. Because of this, most Murabahas in Islamic banks are short-term.

### **3.1.2 Hedging the Murabaha risks**

One major drawback of Murabaha mode of finance is the fact that it is fixed-return type of transaction. It is because of this that Murabaha deals are always short term. While a three year Murabaha is not uncommon in Islamic banks, anything beyond that needs hedging of interest rate risks. All conventional hedging mechanisms involve *Shari'ah* non-permissible contracts. Because no hedging method has so far come out of Islamic banking "laboratory", Murabaha remains a commercial short term mode of finance. Securitization of debt is not permissible from *Shari'ah* point of view. This makes such hedging a formidable task.

### **3.1.1. Constructing a Murabaha deal**

In the majority of cases, a bank client applies for a loan because he wants to buy something. This could be a new car, a house, an office building, a yacht or a new machinery for his factory. These needs and many more, can be accommodated through Murabaha contracts. Such Murabaha can be constructed as follows:

- (1) Client approaches the bank showing his interest in the purchase of say, an airplane. He will present full description and detailed specification including the source of supply.
- (2) The bank will run a credit evaluation, the same way this is done in conventional banking.
- (3) If he is a good risk, then the Murabaha margin (i.e. bank's profit or mark-up) for him will have to be decided. This margin will be quoted, most probably as a per annum flat rate based on the total cost of acquiring the airplane by the bank which includes price paid and all related expenses.
- (4) If he is agreeable, he will be asked to sign a *pledge agreement*, committing to buy such airplane, once it is the ownership under the possession of the bank. If the bank owns it within the agreed-upon time with the exact required specification, then honoring this pledge by the obligatory. However, this obligation does not mean he is going to be forced to buy because this clearly makes the pledge nothing but a defacto sale contract. Rather, it means that, if the client fails to honor his commitment he will be liable for any loss that may accrue to the bank due to such failure. In such cases the bank will sell this airplane to another client. If losses are sustained, bank will have a recourse on that client. If profit were made, it is the right of the bank.

- (5) As part of the Murabaha transaction, the client will be asked to present some securities to the bank at the time of signing the pledge. These securities can be in the form of cash or in any other liquid asset, equivalent to about 5% to 10% of the value of the deal. This is called, in Islamic banking Jargon, **seriousness Margin** i.e. evidencing that the client is serious. This will be used to compensate the bank in case the latter fails to honor his commitment to purchase and loss was sustained by the bank on the goods are sold to third parties. It is to be noted that this is not a down-payment, because the sale contract is yet to be concluded. In *Shari'ah* no sale is to be made unless the seller actually have the goods to be sold in his ownership.
- (6) Once goods are ready, the client will be asked to sign the sale contract and receive them. There is no need for the bank to actually have these goods in his own ware-house to satisfy *Shari'ah* requirements. Rather, if they are clearly identifiable and risk of damage is borne by the bank, then this considered satisfactory.

#### 3.1.4 L/C Murabaha:

One of the major applications of the Murabaha contract in Islamic banking is “documentary credit”. Murabaha is used as part of an L/C opening. Whenever a merchant wants to finance the importation of good, he can approach an Islamic

bank to open a murabah L/C. The bank, applying Murabaha, will (after doing credit evaluation etc.) will ask him to sign on a written promise that he will buy these goods on differed payment once the because the ownership of the bank and that he is willing to pay an agreed upon mark-up to the bank. The bank will then open the L/C for its own benefit. The Uniform Customs (UCC) indicates that the owner of the goods in transit are the one to his order the goods are sent and whose name is mentioned in the shipping document. The bank will inform the exporter once a L/C is opened for the account of the bank that it is the bank that is buying the goods. This do it violate established rules of the UCC. Once goods are received at the harbor (or airport etc.) they will then be sold, by the bank to its client, who will be given an authorization to clear them through customs. Cost of L/C opening as well as all other incidental expenses including any foreign exchange transaction cost will be added to the purchase price of the goods for purpose of calculating the mark-up and the total cost.

Clearly Murabaha L/C is useful when the client needs finance, i.e. don't have liquidity to settle the L/C value at the time of receipt of documents. Otherwise, a standard sight L/C will suffice. However, many Islamic banks opt for opening all their L/C's on Murabaha basis. This is because experience show that, while bank client is sure at the time of opening the L/C that he will be able to pay his dues once documents were received, sometimes he goes for an overdraft to do that. An Islamic bank will not be able to avail an overdraft facility for him. Then the bank will find it

self in a difficult position. This because an Islamic bank is not allowed to lend money on interest, nor to provide an overdraft to a client. To avoid such eventuality, bank will open all its L/C's on Murabaha basis. Goods will be the ownership of the bank. If the client is capable of making the payment, the good will be sold to him on cash with minimal profit (not exceeding L/C opening fees). If he is not, then they will be sold on differed payment basis at a mark-up. In the first instance (i.e., if a sight L/C is opened), goods can't be sold by the bank to the client for they are already his ownership.

### **3.1.5 Murabaha in pre-arranged deals**

Islamic banks which are active in international markets, finance many pre-arranged deals using the Murabaha. This is especially done in commodity markets. This arrangement can be as follows:

Company A, is an industrial firm buying on regular basis Zinc from Company B which is either an actual producer or a trading house. A company usually borrows from the bank to buy from B alternatively, an Islamic bank can extend credit through Murabaha, buying from B on cash basis and selling to A on deferred payment. Usually such deals are concluded as part of a Murabaha agreement. For each transaction, company A will inform the bank, via telex, of its desire to buy from B, giving details of quantities, qualities, price and date of delivery. Bank will then appoint A as Agent, to buy on behalf of the bank and to sell to its own self.

Payment will be transferred by the bank to company B, the seller, once sale is concluded. Company A will defer the payment and pay a profit to the bank (which is the seller here). Ware-house warrants have to be provided to show the actual existence of the commodities sold at the time of sale, and transfer of title. Being part of a pre-arranged agreement, this transaction is usually concluded in a “few hours” . Usually an L/C or similar type of guarantee is provided by the buyer (company A), which makes this a low-risk type of finance for Islamic banks. It is also a technique used by Islamic bank to invest their short term excess liquidity.

### **3.2 Salam**

Salam is a sale forward contract intended from the very beginning to be a mode of finance. It was known before the time of prophet Muhammad (PBUH), so *Shari'ah* came with rules governing this kind of arrangement. In a ordinary sale contracts, price and object of contract may be exchanged simultaneously which makes a spot sale. If goods sold are delivered while price is deferred, it will then be an installment sale contract. Salam however, is a sale contract where price is advanced while delivery of goods is deferred, in a fashion similar to “Futures” in modern commodity market. Salam used to be the mainstay in agriculture finance. Where farmers sell their crop at the time of planting. Nevertheless, its use is not restricted to agriculture, rather it can be used for any formgible non- manufactured goods. The advantage of the salam contract, compared to murabaha in that the bank

can advance money to its client which can be used to satisfy clients needs of liquidity.

### 3.2.1 The *Shari'ah* Aspects of Salam Contract

The two parties in Salam are the seller who is not necessarily a farmer and the buyer, who is mostly a merchant. The subject of the contract can be any fungible, other than money, silver or gold. If the good (or goods) can be pinpointed at the time of contracting, then Salam is not applicable, subject should be something that is going to be produced or purchased at time of delivery by seller from the open market. Therefore, a given automobile or a known building cannot be the subject matter of Salam. The subject matter of the contract must be described precisely enough to dismiss and restrict any future conflict, yet it is a sale of goods that are not in the hands of the seller, but known to be available in the market at the time of delivery. Even if the seller owns such goods at the time of concluding salam contract, the subject of the salam is the denoted goods not the own in existence then. Clearly he can deliver the ~~sa... at maturity~~. But only then they become the salam goods.

Sale price has to be determined at the time of contracting and must be paid in full to the seller. Some *Shari'ah* scholars permitted a delay of no more than 3 days, but majority insist are of simultaneously. This is one of the most important conditions in Salam, which ~~gisting~~ distinguishes it from ordinary forward contract.

The term, i.e. the period of the duration of the contract must also be specified, either as a date in the future or a number of days, weeks or months. Buyer is not allowed to sell the goods brought before actual delivery, i.e. possession. Constructive possession is not permitted. Failure to follow these conditions will make the Salam contract void.

### **3.2.2 Salam as mode of Finance**

Unlike other sale contracts in *Shari'ah*, Salam is basically a mode of finance. By advancing the price and deferring the goods a farmer(or merchant) is actually financed by that buyer. An Islamic bank can be the buyer in a Salam contract, providing funds as a consideration to acquire the goods for delivery in 90 days for example. The time value of money will then be the difference between the price in the Salam contract of the underlying commodity and the one that is going to prevail at the time of delivery at which the goods will be sold.

### **3.2.3 Risks**

In addition to the credit risk (seller default) which is normal for any type of finance, the bank will be facing a high degree market risk. While prices at the time of delivery will most probably be higher than that of the Salam price, market may fluctuate in any direction. Unfortunately not many measures can be taken to mitigate this. Goods bought under a Salam contract can't be sold before actual



delivery and possession by the bank. Hence, bank will not be able to “unload” the contract if forecast of future prices changes before delivery. One possibility of hedging may be adopted through what is called “parallel Salam”. In this case the bank will enter the market as a seller of goods of similar specification. Once Salam contract is concluded, the term of the new salam can be designed to fall on same date of delivery of the first one. It is important to note here that bank is not actually selling those same goods which were the subject of the first Salam, she is only selling similar description goods. Hence there are two separate contracts, in the first the bank is the buyer in the other a seller.

#### **3.2.4 Guarantees and Securities in a Salam Contract**

Salam Contract creates a debt obligation, albeit in goods not money. It is natural, therefore, to support this obligation by guarantees and securities equal or more than the value of these goods.

#### **3.2.5 Constructing a Salam Deal**

Salam contracts offered Islamic banking with attractive investment opportunities. This is because many manufactured goods satisfy the “fungibility” requirement of the salam contract. By introducing an agency agreement, Salam contract can work very efficiently as working capital mode of finance.

For example, the bank can sign a contract with the local soft drink bottling company to buy 50,000 cans of soft drinks to be delivered after 3 months at \$ 0.25 each. Total price is paid upfront or this is a requirement by salam. The bank can appoint the company as an agent to market the quantity at the time of delivery through its channels of distribution. It will be sold at the going market price of say \$ 0.30 each. The difference is the profit to the bank. The company may charge an agency fee, but it is not allowed to repurchase these goods. Shipment sold the bank must be adequately identified so that bank will bear the risk of price fluctuation if any, as well as loss or damage.

### 3.3 Istisna

We mentioned earlier that Salam can be used for fungibles only. No custom manufactured goods can be the subject of a Salam contract. Istisna is a forward contract specifically designed for these kind of goods. It is sometimes called Salam in manufacturing because of the similarity between these two contracts. However, Istisna is more flexible making it suitable for many banking purposes. Unlike Salam, consideration can either be advanced, paid at the time of delivery or even deferred to be paid on installment basis. Istisna is, therefore, a pre-manufacture sale contract.

Istisna is a contract on which *Shari'ah* scholars significant *Ijtihad* over the centuries and particularly during the Ottoman rule. Al-Majallah, which was the

Ottaman's code based on the Hanafi school included a reformed form of Istisna. Hanafi Scholars made an important departure from the original Istisna form by permitting price to be paid not up-front, as in Salam but to be deferred. Some scholars even permitted seller to buy from the open market and need not himself be a manufacturer. It is because of these two points, Istisna is, now, attracting the attention of Islamic bankers.

### **3.3.1 Istisna as a mode of finance**

Banks are no manufacturing agents. They are financial intermediaries. Istisna can be made a financial mode, where banks play the role of credit providers. Thrg... Istisna and parallel Istisna, banks can sell, on deferred payment, manufactured goods, machinery, real estate, bridges...etc., and buy or contract to construct on cash basis. The difference between these two prices is what the bank will make as return on investment for the bank. The contract between the bank and the client will include technical specification of the manufactured good or the building to be constructed. These same specifications can be in the contract between the bank and the manufacturer or the contractor. The role of the bank, is therefore, financial intermediation, albeit on the basis of sale and not lending.

### **3.2.2 Risks**

Apart from the credit risk of the client of, the bank, in Istisna, will be carrying a performance risk. Since bank client has no recourse on nor any contractual

relationship with the actual manufacturer or contractor, the bank will always be liable for any failure. This risk, however, can be reduced by taking performance bond from the manufacturer or contractor. Furthermore, the contract to manufacture or construct will be based on the same blue prints and specifications provided by the client. The latter can also provide information concerning the best source of supply or the reliable contractors. The bank will have no incentive to select a contractor or a manufacturer other than the one recommended by the client. Client can even participate in negotiation, without involvement in decision making in the contract between the bank and the manufacturer or contractor. Furthermore, many scholars permitted the bank, once the goods are delivered, to be only a guarantor of the manufacturer or contractor. Hence, client can have a direct contract to them while bank bears the risks only if they fail to honor their commitment Viz. the client.

### **3.3.3 Guarantees**

The price of the goods or the assets to be constructed will become a debt obligations on the client. Bank can therefore, request any guarantees equal or in excess of this amount in a fashion similar to conventional banking. Further, the bank can request performance bonds or L/G from contractors, and warranties after delivery. In all cases the two contracts (bank / client, and bank / contractor or manufacturer) should always be separate.

### 3.3.4 Constructing of an Istisna transaction

The deal usually starts with the client approaching the bank to finance, say, a new building. Rather than extending a loan, the bank may use Istisna to put together an interest-free transaction. The client will be asked to present the bank his ready made blue prints and plans and government required permits. He will also advice on contractor of his preference for possible consideration by the bank. After concluding a credit evaluation of the client, the bank will then get an offer from contractor (preferably the one recommended by the client) which is usually valid for one or two months. During this time the bank will sign a contract with the client, where the latter is actually buying, on deferred payment, the building which is to be constructed by the bank. The bank will then sign a contract with the contractor to construct that building using the exact the same specifications and contract conditions agreed upon with the client. Payment by the bank to the contractor will be in cash, while bank receives the sale price from the client with a mark-up through installments. This is clearly, a financial intermediation which exactly what bank should be engaged in. Bank profits are actually the difference between the cash payments made to the contractor and the deferred payment made by the client, profit can be calculated in any way, as long as it is known as an amount to the client at the time of contracting, it is not variable, and will not increase if installments are not paid in time.

### 3.4 Mudarabah

Mudarabah is a participatory mode of finance. It consists of two parties, one providing the finance, called “Rub-ul-mal” and other providing labor or management called “Mudareb”. They join together in a project to generate profit which will be shared by them. Mudarabah is a principal-agent type of arrangement. The early writers in Islamic banking thought Mudarabah should be the predominant mode of finance in Islamic banking. This is because they thought a banking system based on Mudarabah will produce a more equitable distribution of income and wealth in the society. Since it provides opportunities for entrepreneurs who, while they have innovative ability and managerial skills to create wealth. They can't prec... finance from banks because bank lending requires collateral which they lack. Clearly, this is a major advantage over conventional banking.

It is not difficult, however, to see that Islamic banking developed a way from Mudarabah. Mudaraba, as a principal-agent type of arrangement suffers from a high degree of moral hazard and adverse selection. Early attempts by Islamic banks to apply mudarabah is creating banks assets failed, because of the lack of good conduct on the part of the bank client. While the original model of Islamic banking is based on two-tier Mudarabah, the bank receives deposits in its investment accounts on the basis of that contract and finance on the same basis. In the first, bank is a Mudareb (agent) and in the second it is a Rub-ul-mal (primary of capital). Mudarah required the basis of the liability-side of all Islamic banks. It is obvious

that the degree of moral hazard and adverse selection in the mudarabah contract is much less than the assets side. The reason being that banks will pay a high price if they believe in less than the highest level integrity, notwithstanding the supervision of the regulatory agencies and central bank.

### **3.4.1 *Shari'ah* aspects of Mudarabah**

Mudarabah is a sort of partnership. Both parties participate in the profit that is going to be generated by the financed activity. The parties are free to agree on the ratio of profit distribution (70% - 30% or 50% - 50% or any other). However, unless they agree at the initiation of the contract, the latter is, from *Shari'ah* point of view void. Furthermore, it is a *Shari'ah* requirement in mudarabah that all of the capital has to be paid at the signing of the contract. It is not allowed to pay it later or on installments basis. Rub-ul-mal can impose any (reasonable) instructions and conditions on the agent, if they are acceptable to the latter they become part of that contract. Once operation starts, the financier has no right to interfere in the day to day business. If agent fails to follow the instructions and satisfy the conditions, then he is liable for loss of capital. The mudarib don't guarantee capital nor profit to the financier. Rather he or promises good conducted nonosty. This is the source of moral hazard and adverse selection in mudarabah.

Profits are any amount in excess of capital. It is therefore, imperative to liquidate the Mudarabah before declaring any profit. In recent years, many *Shari'ah*

scholars have accepted what is called constructive liquidation constructive liquidation. Simply means that accounting procedures are applied to decide the profit and loss status of the operation. This liquidation process can be done periodically using accounting procedures and based on the outcome profit (loss) can be declared every quarter or year.

The agent in Mudarabah is entitled to nothing but his share of profits. If he (or the financier) receives any income before liquidation, it is always subject to adjustment when financial results are declared. Both parties are required to avoid any conditions in the contract that can fade away the particular nature of the mudarabah being a “company in profit”. For example, if one requested that he gets the first \$ 500.00 of profits and the rest is for his partner then the contract is void. This is because it is quite possible that the whole profit will only be \$ 500.00.

### **3.4.2 Mudarabah as a Mode of Finance**

Before the advent of Islam, Mudarabah was the most common mode of finance in Makkah. The Makkan were the foremost traders in their area of the world in the 7th century, bringing goods from India and Yemen and selling to the Roman Empire. To finance this international commercial project, the majority of the merchants of Makkah presented themselves to the rest of the community as Mudaribs (agents), collecting Monies from men, women...etc. who become financiers.



Contemporary scholars were able to develop the Mudarabah contract to suite modern needs. In Pakistan, for example, a special Mudarabah law has been introduced which allows the floating of negotiable Mudarabah Certificates. An attempt to introduce a similar scheme was tried in Jordan, and many Islamic banks are trying to go into special Mudarabah finance with major clients, where the problem of moral hazards is less severe.

### 3.4.3 Risks

Mudarabah is a high-risk mode of finance. It is so risky that it is almost “Unthinkable” to any banker. This is because the bank advances capital to client relying completely on his integrity, ability and good management. The bank is not only risking the expected return but also capital itself. This high degree of moral hazard and adverse selection is present in the classical form of Mudarabah. Recently, however, many Islamic banks were able to develop a new, albeit *Shari’ah* based, forms of Mudarabah with significantly reduced degree of risks. For example:

- (a) Mudarabah is used only with public limited Companies, where a reasonable degree of transparency is possible i.e. audited accounts, and quarterly reported performance...etc.

- (b) Securities and guarantees are introduced in the contract, but not against profit or payment of capital. Rather, only against loss due to negligence or mismanagement and delayed repayment of capital and profit after end of mudarabah.
  
- (c) Only those economic activities where the bank can easily see what the money is being used for can be financed on Mudarabah basis. For example, a car dealer who buys autos from manufacturer and then sells on installments will be suitable for such mode of finance.

### **3.5 Ijarah (Leasine)**

Leasing is well known in the west as a mode of finance. There are many reasons why an agent will opt for leasing rather than borrowing from the bank to purchase the needed asset. For example:

- (a) It is easier to lease than borrow for short term needs since it mostly do not require credit evaluation.
  
- (b) Gives more freedom of changing equipment as technology advances.
  
- (c) Easier to get finance through leasing for companies with lower credit standing. These kind of companies may not be able to borrow from banks or the public and if they do, have to pay high of interest.

(d) In many cases leasing can be advantageous from taxing point of view. These advantages may accrue to lessee and sometimes to the lessor since equipment leased remains the ownership of the lessor and hence can be counted, from tax point of view, an investment.

(e) In many countries leasing is an off balance sheet finance. As we are well aware, there are many types of leasing arrangements. These are but few:

1. Operating leases:

Short term and cancelable during the contract period at the option of lessee.

2. Capital, financial or full-payment lease:

Extend over most of the estimated economic life of the asset and cannot be canceled, or can be canceled only if the lessor is reimbursed for any losses. Financial leases are a source of financing and it is borrowing money. The lessee assumes a binding obligation to make the payment specified in the lease contract. He could have borrowed the full purchase price of the asset by accepting a binding obligation to make interest payment to the lender.

Cash flow consequences of leasing and borrowing are similar.

3. Full-service or rental lease:

The lessor promises to maintain and insure the equipment and to pay any property taxes due on it. In a **net** lease, the lessee agrees to maintain the asset, insure it and pay property tax. Most financial leases are net leases.

4. Direct lease:

Where user identifies the asset arranges with leasing company to buy it from manufacturer and lease it.

5. Sale & lease back arrangement:

Firm sells an asset it already owns, leases it back from the buyer. Common in real estate.

6. Leveraged leases:

There are financial leases in which the lessor borrows part of the purchase price of the leased asset using the Lease Contract as security for the loan.

### **3.5.1 *Shari'ah* Aspects of Leasing**

Operation lease are known in *Shari'ah*. What Islamic banks did was to develop such leases so as to provide a mode of finance, without violation of basic *Shari'ah* requirements in such contracts. The most important aspects of *Shari'ah* in leasing contract are:

I. It is not permitted to enter into a retail and a sale agreement in one leasing contract. Further, it is not permissible in *Shari'ah* to forward a sale contract with no payment mode. To avoid this, therefore:

(a) Sale should only be an “option” provided to lessee (while lessor is obliged to sell if lessee exercise such option).

(b) They both commit their sales to sale but at the (then) prevailing market price.

II. In every contract, price must be fixed and known at time of concluding the contract. This creates a problem in long term contracts because interest rate may change. Conventionally, financial leases tie installments to LIBOR or any other index. This is not permitted in *Shari'ah*. This resulted into a general tendency in Islamic banking towards a relatively shorter term leases. Some banks, however, assume that contract is renewable every six months so as to charge the rates. Unless each party has the full freedom to walk out at that time, this is not permitted in *Shari'ah*.

### **3.6 Musharakah**

In the early writings on Islamic banking, Musharakah was supposed to be the basic mode of finance in the model of interest free banking. However, in contemporary Islamic banking, Musharakah is almost not existent. The reason for

this is obvious, complexity and a relatively higher degree of moral hazards. In *Shari'ah*, the Musharakah is the simple partnership, where two parties participate in a venture providing capital. Developing "partnership" into a banking mode of finance is not easy. Firstly, it has to be temporary, as bank can not engage in ownership and operation of joint stock companies. Secondly, because Musharakah is the "mixing" of two capitals, whenever the Islamic bank gets into Musharakah by providing capital, it has to engage into an evaluation of the "worth" of the other party. This is because profit at the end of Musharakah are the difference in the value of the Musharakah between the two points. This is extremely complex.

### **3.6.1 Some *Shari'ah* aspects of Musharakah**

In two parties may provide shares of any size into the partnership. In case of loss, share of each party is based on its share of capital. The case of profit is different. They can be shared differently. This is very suitable to Islamic banks, because they can take a share of profit lower than their share in capital, and hence compete with conventional banks. In Musharakah the two partners may or may not participate in management. However, it is allowed for the one who manages, if he happened to be the partner to charge salary or a higher share of profit.

### **3.6.2 Musharakah as substitute for regular overdraft**

Some Islamic banks succeeded in developing musharakah to be a substitute for regular overdraft. In this case the bank opens an account for the client from which overdraft can be drawn. A musharakah agreement is signed with the client, in which the bank become live partner with the client in the overall operation of his business. Whenever the client has excess cash he can deposit in the account thus reducing the obligation. At the end of the period, which is usually one financial year, the bank will have a share of profit proportion to the banks equity share and the number of the days in which the account in overdrafted. The agreement for such transaction is quite capliceted as it includes many measure to guard against changing the nature, procedures and management of the clients business is adverse way.

### **3.7 Parameters for Islamic modes of finance**

#### **3.7.1 Shari'ah parameters for Murabaha.**

1. The seller(S) in this contract is the bank, and the buyer (B) is called al-Amer bil *Shira*.
2. Pre-sale Order: The pre-sale agreement (the order) is not binding on B, but if he fails to fulfill his promise, S Is entitled to compensation for actual damages incurred. These may NOT include foregone profit opportunities.
3. The agreement must specify the quantity, quality and place of delivery of goods, the mark-up, terms of payment of sale-price, items that will be included in the cost, etc.

4. Before consummating the sale contract, S must have owned and possessed the goods in question.
5. Mark-up must be known at least at the time of concluding the sale contract or even before. It may be fixed percentage of the cost, or a fixed absolute amount. While it is permissible to use a bench mark like LIBOR, the price must be known as a fixed amount.
6. To satisfy the requirement of the seller's *possession* of goods before reselling them, a seller must bear the cost of loss, damage and storage before delivery to B.
7. S can ask B for any guarantees and collateral's against the debt outstanding and against possible debtor's delinquency.
8. The seller may not increase the outstanding debt in case of delinquency. In such case S can foreclose on the collateral's or go to court.
9. The bills of trade arising out of the above transaction cannot be sold, but must be kept until maturity. However, such bills can be transferred at face value.

### **3.7.2 Shari'ah parameters for Istisna**

1. Istisna is a sale contract. It is a pre-production sale.
2. The subject of the contract can be any manufactured good.
3. It is acceptable for the price to be paid at the time of contract, at the time of delivery or at any time afterwards, in lump sum or on installment basis.



4. The seller can manufacture the goods himself, and he is also allowed to subcontract.
5. Price has to be known as a fixed amount, goods sold must also be described fully at the time of contracting.
6. Seller is fully liable *vis a vis* buyer for quantity, quality and potential hidden defects of goods sold. If seller has subcontracted the works to a 3rd party, he may specify that any claims must be made against such party. But seller must remain a guarantor of last resort.

### **3.7.3 Shari'ah parameters for Mudarabah**

1. The financier can claim neither fixed amount of money as profit nor a fixed percentage of the capital. Nor can be ask for a guarantee of the principal.
2. The contract must spell out the ratio of division of profit between the two parties. They can agree on any ratio but it has to be known at the time of contracting.
3. Only accounting loss is recognized by *Shari'ah*. It has to be born by the participants according to their capital contributions.
4. The mudarib (manager) may have an escalating share of profit in accordance with the level of profit achieved.
5. Profit (or loss) can be recognized only after liquidating of the assets of the Mudarabah. Such liquidation need not be actual sale, but can be an accounting procedure (Constructive Liquidation).

6. Mudarabah contract can be for any term, at the end of which the contract is liquidated.
7. While it is not permissible to take guarantees for achieving a certain level of profit or against loss, it is allowed to take such guarantees against negligence, mismanagement and for prompt repayment of capital and profit (if any) at the end of contract.
8. The Mudarabah can be a vehicle to finance any legitimate profit-making activity. Such activity can be specified in the contract or left to the discretion of the Mudarib (manager).

#### **3.7.4 *Shari'ah* parameters for Musharakah**

1. The basic difference from Mudarabah is that in Musharakah both parties are entitled to participate in management.
2. It is permissible to have an escalating (or variable) profit-sharing ratios depending on the level of profits achieved.

#### **3.7.5 *Shari'ah* parameters for leasing**

##### **3.7.5.1 *Shari'ah* parameters for operating lease**

1. Only durable goods can be the subject of a leasing contract.
2. Owner of the asset is entitled to lease payments (rentals) as long as the usufruct of the asset is available to the lessee.

3. The lease contract must spell very clearly who bears the maintenance costs. As a general rule responsibility against total loss and accidental damage must be at cost of the owner.
4. Owner of the leased asset may sell it to a third party, or to the lessee himself. In either case, the sale may include or exclude the prospective (uncollected) future rentals.
5. The lessee may sub-lease at more or less rental rate to a third party, unless expressly prohibited from doing so by the terms of the lease contract.
6. The owner of the asset can sell the leased asset and hence transfer the lease contract to the new owner. It is possible to sell asset to third party conditional on his retaining all the benefits of the old lease.

#### **3.7.5.2 Shari'ah parameters for financial lease**

A financial lease should be considered a sale contract for a deferred price. Hence, the I.O.U's of future "rental" payments represent money debt that cannot be sold but had to be kept by the creditor till maturity. The I.O.U's may be transferred (for their face value and stated terms).

### **3.8 Handling Delinquency and Default in Islamic Banking**

Failure to pay finance obligations when due is not uncommon even in Islamic banking. The fact that mudarabah and musharakah, which are not debt based modes of finance, are used doesn't guard an Islamic bank against this possibility. The problem is that charging a penalty (late charges) is not permitted in Islamic

*Shari'ah*. Only actual cost of debt collection may be imposed. The reason is that such penalties fall under the definition of usury in Islamic jurisprudence. This is quite problematic in Islamic banking because it makes delinquency “costless” to bank clients. The problem is many fold: firstly it prevents the Islamic bank from being compensated for lost time and opportunities of profit. More importantly, however, it creates an incentive for the clients not to pay on time. Furthermore, it increases the cost of finance in an Islamic bank compared to conventional banking. This is because the effective cost of delinquency would have to be borne by those who pay their obligation with delay. Such people will refuse to pay the higher cost, which means that the Islamic bank will end up with the “bad risks” clients.

Islamic banks differ in handling delinquency cases. The most common form is changing penalties on those who fail to pay on time. Rather than taking this as an income to the bank, it is donated to charity. This way the effect and pressure of late charges is orientated towards falling into a usurious transaction. This is because such a penalty will be considered “riba” if it has become an income to the creditor, which is not so here. The basis of such a penalty is the consent of the debtor in the contract that originates the cost.

## CHAPTER 4

### ISLAMIC EQUIDTY FUNDS

#### 4.1 Islamic Equity Funds are Basically “Ethical Investing”

Ethical Investing is not new. It goes back to the 1920's. They became popular, however, in the 1970's and thereafter. In 1971 a group of Methodist clergy in the USA discovered that their church regularly received letters from individuals asking how to invest in companies not manufacturing weaponry. After finding that no organization specializes in this kind of investment, the ministers went to Wall Street firms asking for assistance in setting up a fund for this purpose. Pax World Fund may be the first equity fund to adopt a full set of ethical issues in its screens. The pioneer fund which excluded companies producing alcohol & tobacco from its portfolio holding was available to investors in 1928. Then the environmental movement and the equal employment opportunities programs in the 1970's produced a number of equity funds tailored to the preferences of investors who are concerned about these issues, and want their money to help influence the business sector into more compliance. Dreyfus third century fund was pioneering in this regard. Such funds do exist now in USA & Europe.

Islamic Equity Funds are, therefore, part of a larger group of ethical investment programs. They address the needs of a class of investors, who are

concerned about public issues and social justice. However, the main concern of Islamic “ethical” investor is the sources of his income. He is obliged religiously to make sure his earnings always come from “clean” sources.

## 4.2 Three Shifts in Islamic Banking

Islamic equity funds came amid fundamental shifts that were taking place in the development of Islamic banking in the 1990’s. These changes gave rise to these Islamic equity funds and other investment and financial innovations, and will sustain a phenomenal rate of growth for them in the near future. They are:

### a. From defensive to positive Islamic banking:

In the 1970’s & 1980’s the major concern of the clients of Islamic banking is just the avoidance of interest. Islamic banks, at that time, were “brimming” with free-money in current account deposits. The major worry of these deposit holders was to make sure that their funds are distend from usurious transactions. The 1990’s witnessed an important shift. More and more Muslims who want to stay away from interest, also want their money to earn a return. This created opportunities for innovations to bring to the market investment programs that, while abiding by the *Shari’ah* prohibition of interest they are capable of providing reasonable return on investment.

**b. From Non-Islamic to Islamic:**

Islamic religious revivalism is now disseminated into segments of the Muslim societies which are wealthy, more influential and educated. These groups of people are not new to business and investment but their religious solace included a movement from conventional to interest-free banking. It is because of this private banking departments catering primarily to HNW individuals are the most active in the provision of Islamic banking service in many conventional banks. Islamic equity funds are responding to the needs of this group of investors.

**c. From local to international:**

Banking and financial services are being globalized. Islamic banking and investment are no exception. More and more Muslims now are looking outward, searching for investment opportunities beyond the boundaries of their home countries. They no longer identify Islamic banking with Muslims or Muslim countries. An increasing-number of investors are adopting selection criteria based on examination of the transactions and investment offers to ascertain *Shari'ah* compatibility, rather than relying on the vender name. This created opportunities for major financial institutions in the west to cater to the needs of these investors. Equity funds play a major role in this regard.

### 4.3 Islamic Equity Funds are Recent Phenomenon

The oldest Islamic Equity Fund offered the public goes back to only 2 years ago when the National Commercial Bank in Saudi Arabia decided, with the help of the Wellington Management Company of Boston, Massachusetts, to launch a global equity fund that follows the *Shari'ah* restrictions on investing in shares. NMCC, a consultant of NCB, worked very hard to articulate the relevant *Shari'ah* principles into workable screens that can be used by the manager in the selection of the portfolio holdings, and the daily operation of the fund. Through the joint effort of the three institution, the first ever Islamic equity fund was launched in January 1995. It was not too long when other funds were to follow. In less than 2 years, already five equity funds are in the market, based on the same basic model.

### 4.4 The Religious Foundation of the Islamic Equity Fund Design

Like any legal system, *Shari'ah* is a set of do's and don'ts. The difference, however, is that *Shari'ah* is not just worldly, but a part of a system of beliefs that relates life to the hereafter. Therefore, a believer is supposed to internalize in his method of judgment and "cost-benefit" analysis this aspect of heaven & hell. This means that, through *Shari'ah*, the now and the hereafter are united into one spectrum. Because of this, believers are keen to make sure that their investment decisions are in tune with religious requirements by abiding by *Shari'ah* rules. As a result *Shari'ah* approval of structure & operation is the most important element of the working of equity funds.



## 4.5 *Shari'ah* Aspects of Islamic Equity Funds

Investment funds are created when investors pool their money for a shared investment goal. Collective power affords an opportunity to participate in a well diversified, professionally managed investment portfolio. To be acceptable from *Shari'ah* point of view, it is essential to examine certain aspects of investment funds. In particular we will evaluate the contractual relationships between the parties involved in the working of a fund, choice of portfolio holdings as well as some operational elements of such funds .

### A. Contractual Relationships

The most visible is the relationship between investors and the manager of the fund. Fund management may be based on Mudarabah, where the manager, either individual or institution, the Mudarib and the investors are rab-ul-mall (providers of funds). In such a case, manager will only share in the profits generated. Sharing of profit must be in accordance with the ratio spelled-out in the prospectus which constitutes, from *Shari'ah* point of view, a contractual relationship. His income will be based on the difference between the initial NAV and the NAV at the pricing date which represent profit in such arrangement. Pricing date represents the accounting liquidation of the Mudarabah.

Many managers would not like their compensation to be tied to profit, but rather prefer to get a fixed remuneration. In such case, the relationship can be based

on the Ijarah contract. The manager is, then entitled to an income linked to his managerial effort. Most investment funds management is based on such arrangement. In this case, the manager charges a percentage of the NAV at the pricing date. Ijarah is a permissible contract. However, compensation in the Ijarah contract, like any exchange contract in *Shari'ah*, must be known at the beginning of the period (time of contracting) not the end (time of liquidation), otherwise gharar will be present which may void the contract. Such compensation will not be known exactly at the time of contracting (since it is based on end-of-the-term NAV), but only known in approximate amount, which reduces such gharar, though by no means eliminate it. Although the writer is of the view that such Ijarah is permissible, there are some contemporary scholars who think otherwise. Making compensation for the next period depend on last period's NAV is a straight forward solution.

## **B. Restrictions on the types of equities in the fund**

This could be the most Important aspect of Islamic Equity Funds. We can classify the *Shari'ah* restrictions on the types of equities in the fund in two categories:

- (a) Restrictions related to the area or the core business of the company whose equities are to be held by the fund: Any company whose business activities are basically in the non-permissibles is not suitable for an

Islamic equity fund. The list is not very long and it includes financial services banking, insurance companies, gambling, liquor, port, pornography ... etc. Notice here that we are talking about the “core” of the business activities of the company. A big company whose cafeteria in the headquarters building sell beer don't present a violation of this restriction. Border-line cases, however, can only be resolved by a *Shari'ah* board on a case by case basis.

- (b) Restriction related to the finances of the company. This is an operational restriction. A company that is already short-listed through our first screen may still be unsuitable for an Islamic equity fund. It is important that such companies are not engaged in non-permissible financial transactions. Certainly it would be preferable if one can find companies so pure that they depend completely on their own income, and always rely on self financing. But this is hardly possible. The question becomes, then, how to set parameters that guarantee selection of companies with minimal involvement in such non-permissible financial transactions. These parameters are:

**1- Debt to equity ratio:** The problem with debt in the capital structure of a company, from an Islamic point of view is that it is interest based. A company indebted through Murabaha, for instance, need not have any

such restriction. Borrowing on interest is not permitted, therefore it is necessary that such borrowing is limited to a tolerable level. In certain situations *Shari'ah* treats minute and insignificant amount of non-permissibles as negligible having no effect on the permissibility. But what is the cut off-point? There are many indications in *Shari'ah* which points out to the "one third" as "plenty", and that anything less than one third is "trifle". Though such distinction came in a different context, many contemporary *Shari'ah* scholars thought it relevant and assumed that a debt to equity ratio of less than 1/3 is tolerable. It is extremely important to note that such criteria will never be suitable for wine production for example. This because, as we mentioned above, hardly any company can do without some debt. Our objective here is, therefore, to measure the extent of the firms financing with debt. Debt to equity ratio represent the relationship between funds supplied by creditors (debt) and investors (equity).

**2- Interest earning:** Companies whose core business is production of goods and services draw their income from profits generated from sale of such goods or services. It is not likely for any such company to earn any significant percentage of income from interest. It does happen, however, that excess cash is deposited in interest-bearing account or invested in money market instruments. This amount must be identified and investors

should be advised to set aside what ever such percentage constitute out of the portfolio returns on investment. The investor may then donate the same to his favorite charity. Such amounts are usually very limited.

**3- Cash and Receivables:** *Shari'ah* distinguishes between sale of real good and that of money and debt. In the latter such sale can only be done at par value. The share of any company don't actually have an existence of its own but its value comes from the undivided portion of the assets of the company it represent. Therefore, when one buys a share he is actually buying these assets. If the latter are primarily cash and receivables then the market value of the share must be equal to the face value of these assets. Any thing more (or less) may be considered usurious from *Shari'ah* point of view. Because such pricing is not possible in practice, a restriction is imposed to eliminate the likelihood of such thing. This could be done by, again, putting a cap on the size of such class of assets.

### **C. Reserves**

Reserves are important to the proper management of the fund and the smoothing of redemption payments to the investors. If distribution of profit and redemption of units is done on accrual basis, then reserves are a must for the operation of the fund. Reserves are deducted from the profit generated through the

invested funds. This raises two *Shari'ah* questions. Firstly, whether investors are aware of such deduction and they are consenting to their amount. This problem can be solved through clear mention in the prospectus and signed on the agreement with each investor. Secondly, who own such reserves at the winding down of the investment fund? Many investment funds that are managed by Islamic banks opt for donating such amount at the closing of the fund to charity. One should remember, however, that most of these open-end funds have no specific date nor any future plan for ending the operation of the fund.

#### **D. Guarantee of capital of the fund by the manager**

To attract investors, many conventional fund managers guarantee to the investors the nominal value of their investment. This is not acceptable from *Shari'ah* point of view. Many advanced to a manager that guarantees it return at the end of the period (or at any time in the future) makes it, from contractual point of view, a lender-borrower relationship. Profit on such money will then be a form of usury (*riba*), even if such profit is variable. In an Islamically managed fund no such guarantee should be made.

#### **E. Gearing:**

One of the most important advantages of investment funds in conventional setting is gearing, i.e., the possibility of pledging the assets in the fund for

borrowing and re-investing to enhance the earning in the fund. This is clearly not acceptable from *Shari'ah* point of view since these borrowings are interest based.

The rationale behind this approach, is to have some resources in the fund that receive fixed return. Because the fund can generate higher earnings than that fixed return, then participants will have their return on investment improved. It is not wholly unlikely that an Islamically acceptable design to the same effect. For example, the fund can purchase some assets on Murabahah basis using the rest of assets in the fund as collateral.

#### **F. Source of information:**

The main source of information from which data that can help make the right selection for all Islamic equity fund is the balance sheet of the company and its income statement (profit & loss account). These are the usual services of financial information about any company. It may be agreed that both reflect the state of a company's finances only one day in the year. While this is true, there is unfortunately no alternative.

#### **4.6 The Surprising Performance of the Islamic Equity Funds:**

Whenever one mentions religious preference or social responsibility in investment being part of investment parameters, the question in mind then becomes whether this means less income. Surprisingly enough all the equity funds (5 now)

whose portfolios are constructed alongside the *Shari'ah* restrictions, out performed the benchmark Morgan Stanley Capital International (MSCI). One may say that equities in general did very well in the last few years. While this is correct, we still think that Islamic funds have an added advantage. The selection criteria actually pick-up superior quality companies.

#### **4.7 Investment Guidelines for Private Equity**

##### **1. Company Selections: No Investment may be made in:**

- a. Companies whose interest-bearing debt to equity ratio is more than 30%.  
Equity is the company's enterprise value. This applies when investing in existing businesses. For companies yet to formed, the debt to equity ratio is zero.
- b. The portfolio must not be invested in companies:
  - (a) Involved in the following businesses:
    - i. Manufacture and/or sale/distribution of alcohol, tobacco, pork, gold, silver, music and pornographic productions.
    - ii. Restaurant and hotels/motels except those not selling alcohol
    - iii. Operators of gambling casinos and manufacturers of gambling machines Paraphemalia.
    - iv. Operators of movie theaters.



- v. Financial services (for example: bank, brokerage firms, investment funds that invest in companies that engage in the restricted activities, insurance companies).
- (b) Whose total assets are made up solely of cash, including balances with banks, non-tangible assets and/or accounts receivable.

## **2. Financial Instruments:**

The following instruments or any derivatives therefrom must not be used in the portfolio:

- a. Futures contracts of all kinds
- b. Options contracts of all kinds
- c. Swaps
- d. Preferred shares
- e. Short sales
- f. Other instruments where any of its components involve the payment or receipt of interest.

## **3. Handling Excess Cash**

Funds must be fully invested at all time. Uninvested cash or short-term liquidity must be invested in Murabaha transactions.

## 4.8 Purification in Islamic Equity Fund

### 4.8.1 Introduction

*Shari'ah* scholars succeeded in the last few years in developing an equity investment program that lends itself to implementation by professional investment managers. Doubtlessly the basic concept of modern corporation has never been rejected by Contemporary *Shari'ah* scholars who saw in it a contemporary form of the Anan company, well known in Islamic jurisprudence.

Except for a minor dissent, majority of contemporary scholars accept the basic transaction of purchase and sale of shares. It remained, however, that the model of public company on which all the jurisprudential effort was based, is one that is free of every prohibited activity, including borrowing and lending on the basis of interest. Such company, it turned out, does not exist even in Muslim countries. Even if the company refrain from prohibited activities, it is hardly possible for a modern corporation to survive without having a regular overdraft account from a bank. Such account is based on interest and purports to borrowing on *riba* basis. Many Muslims started shunning equities all together as it appeared to them the best thing to do from religion point of view. It was only after the *fiqh* academy took a clear and decisive ruling about “what is a company share” and what exactly is the object of the sale contract when such share is sold. Only then that these scholars were able to revisit the relevant *Shari'ah* principles to deal with companies that are not so pure. Islamic equity funds were then born. Today the market for such funds is quite

sizable. In the authors estimate, it may have already passed the \$ 10 billion mark worldwide. While the study of the *Shari'ah* basis of Islamic equity funds is important it is the subject of a different paper. The present paper doesn't attempt to cover this part. Rather, it takes such aspects as given and concentrate on the issue of purification.

#### **4.8.2 Meaning of purification**

Purification simply means: deducting from one's investment those earning the source of which is not acceptable from *Shari'ah* point of view. In the case of equity investment, this refers primarily to interest earning and incidental income from other non-permissible sources such as sale of liquors or pork. While the idea looks simple, infact it is not. A company is a going concern. It is a living entity with far-reaching activities and a widely stretched concerns. It is also very complex from accounting and financial point of view. Things are not as simple as they may look. Therefore, estimating such income is a formidable task. One that require an excellent knowledge of accounting and corporate finance and exceptional ability to handle *Shari'ah* issues, a combination that is not always within reach.

#### **4.8.3 *Shari'ah* basis for purification**

Although the Islamic equity investment program gains more and more acceptance everyday from an increasing number of *Shari'ah* scholars and the public at large, it remains that some still believe that its *Shari'ah* basis are doubtful. It is

not the same for the concept of purification. Purification finds clear *Shari'ah* basis exemplified in the classical annals of *fiqh* and statements of major learned scholars of the early centuries based on their understanding of the texts (Quran and Sunnah).

However, articulating those *Shari'ah* principles into a formal procedure for purification is quite a heroic task and one with a number of unsettled issue. For example: what is exactly to be purified? Is it dividend and therefore if the company doesn't distribute dividend no purification is required, or capital gain, although capital gain is a market earning that derives no direct income from the company, or both. Do we treat interest earning as net or gross variable. For the first, we will then assign no expenses on such earnings for the second, interest earned will be netted by deducting operating expenses.

#### **4.8.4 Methods of purification**

We have deducted several methods of purification which will be present below. Each method is based on assumptions the purpose of which is to embody *Shari'ah* requirements in a formula that lends itself easily to implementation by fund managers. All the methods presented here are already in practice, and are used by fund managers. However, these; I am sure, are not the only methods. Nevertheless, I am quite confident they are the most common. In each methodology we are trying to find factor P, by which we can estimate interest income.

**First method:**

Let us assume that we have a portfolio of company shares. On January 1 ( $t_1$ ) we have an investee companies (c) each earning interest equal to  $I'$  hence we have interest income equal

$$I'_{c1} + \dots + I'_{cn} = a$$

let us assume that the net operating income for any company is  $y$  hence the total net operating income for the portfolio is =

$$y_{c1} + \dots + y_{cn} = b$$

$$\text{then } H = \frac{a}{b}$$

let us assume that the net asset value of the fund on Jan 1 equal  $NAV_{t1}$ .

Then calculate  $Z$  which equals  $NAV_{t2} - NAV_{t1}$

purification factor  $P$  will then equal  $ZH = P$  Hence for every dollar invested, the investor must multiply by  $P$  and donate this amount to charity. If  $P = .007$  and the investors  $Z = \$ 2000$  then he must dispose of \$ 14.00

**Second method:**

Assume we have  $n$  companies in the portfolio:  $C_1, C_2, \dots, C_n$

$$\text{Dividend yield} = \frac{\text{dividend}}{\text{market value}} = d$$

then annual portfolio dividend yield =  $d_{c1} + d_{c2} + \dots + d_{cn}$

$$\text{calculate interest income ratio} = \frac{\text{interest income}}{\text{net operating income}} = \mathbf{I}'$$

$$\text{for the portfolio} = \mathbf{I}'_{c1} + \mathbf{I}'_{c2} + \dots + = \mathbf{I}'_{cn}$$

$$\text{purification} = (d) (\mathbf{I}') = P$$

Hence for every dollar invested the amount of \$ P must be donated annually to charity.